

CABINET ECONOMIC DEVELOPMENT COMMITTEE

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS: REGULATION OF NON-BANK DEPOSIT-TAKERS

PROPOSAL

1. In June this year, the Committee agreed to proposals for changes to the regulation of Non-Bank Deposit-Takers, such as finance companies, building societies and credit unions. Cabinet confirmed this decision on 18 June (CAB Min (07) 21/10). I was asked to report back to Cabinet on remaining details for the regulation of Non-Bank Deposit-Takers. This paper sets out proposals for final decisions on these matters and seeks approval for the submission of drafting instructions to Parliamentary Counsel Office.

EXECUTIVE SUMMARY

2. In June this year, the Committee agreed to a new framework for the regulation of Non-Bank Deposit-Takers (referred to in this paper as Registered Deposit Takers – RDTs). The main elements of the framework are summarised later in this paper.
3. The Committee’s agreement to the RDT proposals was on the basis that I would report back to the Committee with further details on the proposed regulation of RDTs, including in respect of:
 - a. the proposed definition of deposit-taker;
 - b. the requirements for minimum capital, capital adequacy and restrictions on lending to an RDT’s related parties;
 - c. the credit rating requirements, including options for minimising compliance costs, especially for small RDTs; and
 - d. the powers required to enable the Reserve Bank to respond to RDT financial distress where the soundness of the financial system is affected.
4. I am now recommending that the Committee agree to the details of the RDT regulatory framework, as set out in the recommendations section of this paper, with the following main features:
 - a. Deposit-takers would be defined in accordance with the principle that they are entities that offer debt securities to the public and are directly or indirectly in the business of lending money or providing other financial services. Some fine-tuning of this definition will be required in the legislative drafting process.

- b. The legislation would empower the designation of entities as deposit-takers by regulation to cover situations where some entities which are deposit-takers in substance are technically not caught by the definition.
 - c. The legislation would empower the Reserve Bank to exempt entities or classes of entity from the RDT requirements in situations where it makes no sense to capture them in the RDT regime.
 - d. The legislation will make it unlawful to be a deposit-taker without being licensed by the Reserve Bank as a Registered Deposit Taker (RDT).
 - e. RDTs will continue to be subject to Securities Act requirements, as enhanced by the RFPP reforms, including the need to have a trust deed and a prospectus and investment statement.
 - f. Trustees will continue to be the supervisors of RDTs, and will have responsibility for enforcing most of the requirements imposed on RDTs by the RDT framework.
 - g. Unless exempted, all RDTs must comply with requirements prescribed by regulation under the RDT legislation, including minimum capital of \$2 million, a capital ratio set by trustees measured by a standardised capital adequacy framework, a limit on exposures to parties related to RDTs, possibly liquidity requirements, and a credit rating. I am proposing that RDTs with total assets of under \$10 million will be exempted from the rating requirement.
 - h. RDTs will be required to maintain policies and procedures to ensure that they check the suitability and integrity of prospective directors and senior managers. The Reserve Bank will have the power to dis-approve proposed appointees as directors or senior managers, and to remove them from office if already appointed, where the Bank is satisfied that they do not meet the suitability and integrity criteria. Legislation will set out suitability and integrity criteria, with scope for this to be amended or added to by regulation.
 - i. Trustees will continue to have primary responsibility for dealing with RDT financial distress and failure. However, in circumstances where an RDT's distress poses a threat to the soundness of the financial system, I am recommending that the legislation empower the Reserve Bank to be able to take crisis response actions, with the agreement of the Minister of Finance.
 - j. In accordance with Cabinet decisions in June, I am proposing that credit unions should be brought into the RDT framework on much the same basis as other RDTs, and that existing prudential constraints in the Friendly Societies and Credit Unions Act (FSCU Act) be removed. It is proposed that credit unions will be exempted from some RDT requirements – particularly in the case of small credit unions – on the basis that they will be subject to some additional prudential restrictions.
5. The proposed regulatory framework for RDTs will require legislation. I wish to have as much of this legislation as possible introduced into Parliament this year, with a view to enactment in 2008. However, given the linkages between the licensing requirements for RDTs and some other aspects of the non-bank financial sector reforms within the Review of Financial Products and Providers, the legislation will need to be progressed in two stages, with one bill being introduced before Christmas and a second bill being introduced by

March/April 2008. In both cases, the bills are likely to take the form of amendments to the Reserve Bank of New Zealand Act.

6. I am proposing that the first bill will implement the credit rating and prudential requirements, including those relating to minimum capital, capital adequacy, related party lending and liquidity, and associated offences, penalties and enforcement powers for the Reserve Bank. Once enacted, that legislation would facilitate the promulgation of regulations in these areas, and for these to become binding on RDTs after a transition period. The second bill will implement remaining elements in the RDT framework, including the requirement for RDTs to be licensed by the Reserve Bank and the associated suitability and integrity requirements for directors and senior managers of RDTs.

BACKGROUND AND OVERVIEW

7. In June this year, the Committee agreed to a number of proposed reforms to financial sector regulation as part of the Review of Financial Products and Providers (RFPP). These reforms included a new framework requiring all providers of financial services to be registered with the Companies Office, a strengthening of Securities Act requirements for disclosure by issuers, a new requirement for all trustee corporations to be authorised and supervised by the Securities Commission, and enhancements to the trustee-based supervision arrangements for issuers, including deposit-takers.
8. One of the RFPP proposals related to the regulation of deposit-takers – referred to in this paper as Registered Deposit Takers (RDTs). The Committee agreed to a new regulatory framework for RDTs.
9. The main features of the proposed regulatory framework are summarised below.
 - a. **Regulatory objectives.** The objectives for the regulation of RDTs are to promote a sound and efficient financial system by:
 - encouraging sound governance and risk management in RDTs and promoting depositor confidence;
 - providing depositors with a clearer basis for distinguishing between lower-risk and high-risk RDTs; and
 - resolving RDT distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.

However, for the purposes of the proposed RDT legislation dealt with in this paper (relating to the licensing of RDTs and minimum prudential and other requirements for RDTs), it is proposed that a subset of the above objectives will be incorporated into legislation – only those that are relevant to the matters dealt with in the legislation. On that basis, it is proposed that the purposes for which powers may be exercised under the RDT legislation will be to:

- promote the maintenance of a sound and efficient financial system; and
- avoid significant damage to the financial system resulting from the failure of an RDT.

These purposes encapsulate the concept of promoting depositor confidence. The other objectives, such as providing depositors with a clearer basis for distinguishing between

lower-risk and higher-risk RDTs, and the minimising of disruption to depositors, can be appropriately incorporated into legislation dealing with the enhanced trustee and offer document disclosure requirements, being implemented in other parts of the RFPP process.

- b. **Securities Act regulation.** RDTs will continue to be subject to Securities Act regulation as issuers of securities to the public. As such, they will continue to be required to have a trust deed with an independent trustee and an offer document.
- c. **Trust deeds.** The trust deed will continue to set out the financial and reporting obligations of RDTs. Most of the content of the trust deed will be determined between by the trustee and the RDT and will continue to vary across the RDT sector. However, all trust deeds will have to comply with new minimum standards applicable to RDTs, as set out in the RDT legislation and in regulation made under that legislation.
- d. **Licensing by Reserve Bank.** All RDTs will be required to be licensed by the Reserve Bank, in its capacity as the prudential regulator of RDTs. At the time of licensing and thereafter, RDTs will be required to meet prudential requirements set in regulation. It is proposed that these requirements will include:
 - A minimum amount of capital (ie owners' equity).
 - A minimum capital ratio, agreed between the RDT and its trustee, measured in accordance with a capital adequacy framework specified in regulation.
 - Restrictions on lending to parties closely related to an RDT.
 - An RDT's directors and senior management meeting suitability and integrity criteria set out in the RDT legislation.
 - A requirement to obtain and disclose a credit rating from an approved rating agency – subject to Cabinet being satisfied on measures to avoid excessive compliance costs for small RDTs.
- e. **Role of trustees.** Trustees will be responsible for ensuring that RDT trust deeds comply with the minimum standards set out in regulation, evaluating their financial condition, enforcing compliance with trust deeds and taking remedial action in situations of non-compliance or distress.
- f. **Responding to RDT distress.** In most cases, trustees will have responsibility for responding to an RDT's distress, including by appointing a receiver. Some strengthening of the powers to deal with RDT distress and failure may be necessary; these will be incorporated, as appropriate, into the enhancements to the trustee regime. These are being advanced in a separate work stream in the RFPP process. The Companies Office will also continue to have the capacity to intervene in distress or fraud situations under the Corporations (Investigation and Management) Act. In situations where an RDT poses a risk to the soundness of the financial system, I am proposing that the Reserve Bank will be empowered to give directions (with the consent of the Minister of Finance) to an RDT or to recommend to the Minister of Finance that the RDT be placed into statutory management under the Reserve Bank of New Zealand Act.

10. As the minister now responsible for RDT regulation, I was invited by the Committee to report back with detailed proposals, including:
 - a. the proposed definition of deposit-taker and whether the Securities Commission or the Reserve Bank should administer this definition;
 - b. the power to exempt an entity from being brought into the RDT regime and whether the Securities Commission or the Reserve Bank should have that power;
 - c. the requirement for minimum capital;
 - d. the requirements in respect of related party exposures;
 - e. credit rating requirements – including the options for minimising the compliance costs of a rating regime, particularly for small RDTs;
 - f. powers to deal with RDT distress and failure; and
 - g. the appropriate legislative vehicle for the proposed arrangements.
11. In June, the Committee also agreed that the supervisory framework for the regulation of RDTs should be applied in full to credit unions, subject to further advice on satisfactory options for minimising the compliance costs of a ratings regime for RDTs.
12. The Committee agreed, subject to the RDT regulatory framework applying to credit unions, that the following changes to credit union regulation be adopted:
 - a. Credit unions be given the equivalent flexibility to borrow and invest surplus funds and to hold land as any other RDT if credit union rules allow and if trust deeds are amended accordingly.
 - b. Credit unions be allowed to raise capital by issuing securities to their members if their rules and trust deeds allow it.
 - c. Credit unions have legal status so that they can have limited liability, own property, have perpetual succession, and sue and be sued.
 - d. A mechanism be created to enable credit unions to convert to a limited liability company, provided that credit union reserves are locked up for a minimum of five years or are applied for charitable purposes, with restriction on the use of the moniker “credit union”.
 - e. Require the members of a credit union’s management committee to have the duties of directors.

FINAL PROPOSALS FOR CHANGES TO RDT REGULATION

Definition of Deposit-Taker

13. In the June paper to the Committee, the definition of deposit-taker was based on the concept of entities that offer deposits (mainly in the form of debt securities, as defined in the Securities Act) to the public and that lend money or provide other financial services.

14. This concept is broadly consistent with the definition of deposit-taker in many OECD countries and reflects the objective of targeting the regulatory requirements to entities that fund from ordinary, non-expert depositors. It would have the effect of including finance companies that fund from the public, building societies, credit unions, the PSIS and other such entities. The proposed concept has the intended effect of excluding finance companies and other entities that fund solely through non-public sources – eg those raising funds solely from related parties or from corporate or wholesale sources.
15. I am proposing that “deposit-taker” be defined in legislation as a person, other than a registered bank, which offers debt securities to the public, within the meaning of the Securities Act, and is in the business, directly or indirectly, of lending money or providing other financial services. The definition would explicitly include building societies and credit unions. The definition will need to be fine-tuned in the legislation drafting process, including possibly needing to distinguish between those entities that only issue discrete issues of debt securities (such as bonds) and those that are continuous issuers. It is the latter that are intended to be encapsulated in the definition of deposit-taker.
16. A Registered Deposit Taker would be defined as a person that is licensed by the Reserve Bank.

Power to designate entities as deposit-takers

17. Although the proposed definition of deposit-taker is broad, there is always a possibility that some entities may structure their business in ways that avoid their inclusion in the RDT regime or that financial market developments result in deposit-taking being in forms that are not caught by the proposed definition (eg where deposits may not necessarily always be in the form of debt securities). In order to ensure that entities which are, in substance, retail deposit-takers, but which avoid capture because of technicalities, are brought within the deposit taker regime, I am proposing that the legislation will empower the designation of an entity or a class of entities as deposit-takers by regulation made in Executive Council on the advice of the Minister of Finance in accordance with a recommendation from the Reserve Bank.
18. I propose that the legislation would specify the criteria on which such a regulation may be promulgated, where the criteria anchor to the concept that the entity meets an in-substance test for being a deposit-taker. I also propose that the legislation would require the Reserve Bank to consult interested parties and have regard to their views before making a recommendation for the promulgation of a regulation.

Power to exempt entities from the RDT regime

19. The proposed definition of deposit-taker is intended to apply to a wide range of retail deposit-taking entities. It is likely that the definition of deposit-taker may capture some entities that should not be brought within the deposit-taker regime – eg some charitable or religious organisations which have a small amount of deposit-taking business. In order to avoid the RDT requirements applying more widely than intended, there will need to be a power to exempt entities or classes of entity from the RDT arrangements.
20. I am therefore proposing that the legislation would empower the exemption of individual deposit-takers or classes or deposit-taker from the RDT regulatory regime, and that this be

done by notice issued by the Reserve Bank, where the Bank would be empowered to issue a notice on conditions, and to amend or revoke a notice. The Bank would be required to consult interested parties, including the Securities Commission, before issuing, amending or revoking a notice of exemption.

21. I propose that the legislation would set out the criteria on which an exemption notice may be given, including where an entity's deposit-taking business is immaterial or is ancillary to its core business, and where it is not substantially in the business of lending or providing financial services.

Prohibition of deposit-taking by entities that are not RDTs

22. Under the proposed arrangements, it is intended that it would be an offence for an entity to be a deposit-taker, as defined, unless it is either an RDT or a registered bank, or has been exempted from the RDT regime. It would also be unlawful for an entity to hold itself out as an RDT unless licensed as an RDT.

Licensing of RDTs

23. As previously agreed by the Committee, it is intended that all deposit-takers, as defined, must be licensed by the Reserve Bank as RDTs unless exempted. I am proposing that the legislation would set out the criteria which the Reserve Bank must apply when determining an application to be licensed as an RDT, including the following:
 - a. The applicant must be able to comply from the time of licensing with the requirements prescribed in or pursuant to the RDT legislation.
 - b. The applicant must have a trust deed registered, or eligible to be registered, by the Companies Office that complies with the minimum prudential requirements of the RDT legislation.
 - c. The applicant must have a prospectus and investment statement registered, or eligible to be registered, by the Companies Office that comply with the requirements of the Securities Regulations as they relate to RDTs.
 - d. The applicant must have either been registered, or be eligible to be registered, by the Registrar of Financial Service Providers as a financial service provider.
 - e. The applicant's directors and senior management must meet suitability and integrity criteria prescribed in legislation.
 - f. The trustee of the applicant must have attested to the Reserve Bank that the trustee is satisfied that the applicant has sufficient capital relative to the size and nature of the applicant's business, governance, and risk management systems and internal controls to manage its proposed business, consistent with the level of risk represented to depositors in the prospectus and investment statement.
 - g. Unless exempted, the applicant must have obtained a credit rating from an approved rating agency, in accordance with requirements specified in regulation under the RDT legislation.

- h. Such other matters as specified by regulation made under the RDT legislation.
24. The legislation would require the Reserve Bank to consult the Companies Office and Securities Commission before licensing or deciding not to license an RDT.

Transition period for existing RDTs

25. It is proposed that the legislation (either in whole or in parts) will be brought into force on a date or dates appointed by Order in Council or in regulation. I am proposing that all deposit-takers, including those in existence at the time the legislation comes into force, will be required to apply to the Reserve Bank to be licensed as an RDT, unless exempted. In order to allow time for this to occur, it is intended that a transition period will apply, such that deposit-takers in existence at the time the legislation comes into force will be given a specified period of time – possibly 12 to 24 months – to become licensed and to meet the RDT requirements. Exemptions issued by the Reserve Bank, to individual RDTs or classes of RDT, will also provide time for RDTs to come into compliance with the requirements.

De-licensing of RDTs

26. The legislation will need to make provision for the de-licensing of RDTs. De-licensing could either be voluntary – at the initiative of the RDT – or mandatory.
27. In the case of a voluntary de-licensing, I am proposing that the legislation would empower the Reserve Bank to de-license an RDT on its request, where this may only occur once all of the RDT's deposits have been repaid or transferred to a registered bank, another RDT, or to a non-RDT entity with the consent of depositors.
28. In the case of an RDT that wishes to cease taking new deposits, but needs to retain existing deposits on its books pending the repayment or transfer of the deposits to another entity, I am proposing that the legislation would empower the Reserve Bank, at the request of the RDT, to impose a condition on the RDT's license to prohibit it from taking new deposits, but to continue to have the ability to service existing deposits for a period agreed between the Bank and the RDT.
29. It will be necessary for the legislation to make provision for the suspension of a license, and for the de-licensing, of an RDT in circumstances where an RDT fails to comply with RDT requirements. These grounds would include:
- a. serious or persistent failure to comply with the licensing requirements and obligations of an RDT, as set out in the Act;
 - b. failure to comply with conditions of a license;
 - c. failure to provide the Reserve Bank with information or providing false or misleading information to the Bank, when requested by the Bank pursuant to the powers in the legislation;
 - d. insolvency, receivership, liquidation, voluntary administration or statutory management under the Corporations (Investigation and Management) Act.

30. I am proposing that the legislation will require the Reserve Bank to issue a written notice to the RDT in question, stating the intention to suspend the license of an RDT, or de-license the RDT, the grounds on which this is being given, and advising the RDT that it has a minimum period within which to rectify the situation in order to avoid de-licensing.
31. The legislation would also require the Bank to consult and have regard to the views of the Securities Commission, Companies Office and trustee of the RDT in question before de-licensing or suspending the license of an RDT.

Mechanism for imposing prudential requirements for RDTs

32. It has been agreed that RDTs will be required to comply with prudential and other requirements. The details of these requirements will need to be amended from time to time to take into account changes in the financial sector and developments in prudential standards. I am therefore persuaded that it would not be desirable to set the details of prudential or other requirements in legislation. Rather, I am proposing that the legislation would provide for RDT requirements to be specified in regulation, made in Executive Council on the advice of the Minister of Finance in accordance with a recommendation from the Reserve Bank. I note that this approach is consistent with international supervisory principles and practice.
33. In order to provide some certainty on the matters for which regulations may be made to apply to all RDTs or classes of RDT, I am proposing that the legislation will specify that regulations may be made in relation to the following matters in respect of the RDT and/or its borrowing group:
 - a. minimum amount and form of capital;
 - b. level and form of capital in relation to the size and nature of business of an RDT;
 - c. restrictions on exposures to parties related to an RDT;
 - d. liquidity requirements;
 - e. credit rating requirements, including requirements applying to RDTs exempted from a credit rating obligation (such as a requirement for the prominent disclosure that an RDT does not have an approved rating, prohibitions or restrictions on the disclosure of alternative ratings, and minimum prudential requirements);
 - f. size and composition of the board of directors (or equivalent); and
 - g. the management of financial risks, including interest rate risk, exchange rate risk and other market price risks.
34. In some cases, it is intended that the regulations will specify matters that must be included in, or implied into, trust deeds, such as minimum capital, capital adequacy and related party exposure requirements. I am therefore proposing that the legislation would empower the making of regulations to specify such matters. The legislation will also need to make provision for situations where trust deeds do not authorise amendments to be made, to ensure that matters prescribed in regulation can be incorporated into trust deeds.

35. In order to ensure that there is an appropriate level of transparency and accountability in the regulation-making process, I am proposing that the legislation will require the Reserve Bank to:
- consult interested persons, including the Securities Commission and trustees of RDTs, before making a recommendation to the Minister of Finance on regulations; and
 - publish a Statement of Principles that explains the regulatory requirements for RDTs.

Power to exempt from regulations

36. There will be situations where particular RDTs or classes of RDT are, for varying reasons, unable to comply with regulatory requirements or where it would be inappropriate to require them to comply. I am therefore proposing that the legislation will empower the Reserve Bank to issue notices to exempt particular RDTs or classes of RDT from regulatory requirements, where such exemption notices may be issued with conditions, and may be amended or revoked by the Bank from time to time.
37. I propose that the legislation will set out some broad criteria for the making of exemptions and the types of matters which may be included as conditions to exemptions.
38. I propose that the legislation will require the Bank, before issuing, amending or revoking exemption notices, to:
- consult interested parties, including the Securities Commission and the trustee of the RDT in question; and
 - publish in a Statement of Principles the general principles the Bank applies to the making, amending and revoking of exemption notices.

Minimum amount and form of capital

39. In June, the Committee agreed that RDTs should be required to have a minimum amount of capital (ie funding provided by the RDT's owners, such as shareholder equity). The purpose of a minimum capital level is to ensure that RDTs have sufficient capital to demonstrate serious shareholder commitment and to provide a minimum level of substance to the RDT.
40. The Discussion Document issued in 2006 proposed a minimum capital level in the range of \$500,000 to \$2 million. I am advised that most submissions favoured a minimum of at least \$2 million and some argued for more.
41. I am proposing that the minimum amount of capital be prescribed in regulations made pursuant to the legislation, and that, subject to consultation with stakeholders at the time regulations are prepared, the minimum amount be set at \$2 million, with a view to reviewing this level from time to time. It is proposed that the regulations would specify the form that the capital may take.

42. I am satisfied that \$2 million is sufficient to require a reasonable level of shareholder commitment and to prevent insubstantial operators from entering the sector, while still keeping it sufficiently low to facilitate contestability and allow small niche operators.
43. As noted later in this paper, I am proposing that credit unions be exempted from the \$2 million minimum as part of a special set of arrangements for credit unions.

Capital adequacy requirements

44. It is intended that all trust deeds for RDTs will be required to contain a minimum capital ratio relative to the size and nature of an RDT's business, set by the trustee, and measured on a framework set out in regulation. The purpose of the capital ratio is to ensure that all RDTs have a capital ratio measured on a standardised basis, where capital must meet defined standards and must be calculated in relation to risk-weighted on and off-balance sheet credit exposures, market risks and other risks.
45. The capital measurement framework will need to be developed in consultation with stakeholders at the time regulations are drafted. However, subject to the views of stakeholders, the intention is to apply a simplified form of Basel 2 – the international standard for measuring capital adequacy for banks and deposit-takers. This would have the advantage of measuring capital adequacy in a relatively comprehensive way, taking into account on and off-balance sheet risks, and other risks, and would facilitate comparisons of RDTs' capital ratios with those of banks.
46. At this stage, it is not intended that the Reserve Bank would specify a standard minimum capital ratio. Setting a minimum capital ratio for RDTs creates a risk that the minimum would be seen as adequate for all RDTs even though it is likely to be insufficient for many of them. Specifying a standard minimum ratio also has the potential to dilute the responsibility of trustees to form their own view on what an appropriate capital ratio is for RDTs. However, in recognition that it may one day prove necessary to specify a minimum capital ratio for RDTs, I am proposing that the legislation would include provision for the making of regulations to specify a minimum capital ratio for all RDTs or classes of RDT.
47. The Bank would have the ability to issue guidelines to trustees and RDTs to assist them in determining an appropriate capital ratio.

Restriction on credit exposures to related parties

48. In June, the Committee agreed that there should be some form of restriction of lending or other business dealings with related parties (such as an RDT's subsidiaries and affiliates, major shareholders and directors). This was an issue on which I was asked to report back to the Committee.
49. Lending by RDTs to related parties is a major source of risk in any financial institution. It carries the risk that loans or other business dealings with related parties may be on non-commercial terms, to the possible detriment of the soundness of a financial institution. This risk is particularly significant in the RDT sector, given that RDTs are often part of a wider group of companies and that lending to related parties can involve very complex arrangements. The risks are compounded in situations where the boards of RDTs include directors or management of other group companies and where conflicts of interest are not

always well identified or managed. A number of finance company failures, including in recent years, have involved related party lending that was detrimental to the interests of depositors.

50. Some form of restriction of related party lending is therefore important. I am proposing that the legislation would empower the making of regulations relating to the restriction of lending and other credit exposures to related parties. The details of the restriction will need to be developed at the time regulations are prepared, in consultation with stakeholders. At this stage, however, it is proposed that the regulations would require RDTs to include in their trust deeds a limit, set in relation to an RDT's capital, on exposures to related parties, where the limit is agreed by the trustee and RDT, and measured on the basis of a framework set out in the regulations. If it proves necessary, the regulations would enable a standard maximum limit to be imposed on all RDTs or classes of RDT. The Bank may also issue guidelines to assist trustees and RDTs in this area.
51. I am proposing that the definition of "related party" would be set out in legislation, with the scope for the definition to be amended by regulation.

Liquidity requirements

52. Liquidity is a major risk for RDTs. Financial distress or failure can be triggered or exacerbated by an RDT having too little liquidity to enable it to meet its obligations as they fall due. In recognition of this, and the need for a more standardised approach to liquidity risk management across the RDT sector, it is proposed that the legislation will empower the making of regulations to prescribe liquidity requirements for inclusion in RDTs' trust deeds. The nature of the liquidity requirements will need to be discussed with stakeholders at the time regulations are prepared, but may include minimum liquid assets relative to short-term liabilities, maturity matching between assets and liabilities or other measures to ensure that RDTs maintain a liquidity buffer sufficient to enable them to withstand a plausible range of liquidity shocks.

Credit rating requirement

53. In June, the Committee agreed that RDTs should be required to obtain and publicly disclose a credit rating from a rating agency approved by the Reserve Bank, subject to further advice on options to minimise compliance costs, especially for small RDTs. It was agreed that a credit rating is the most effective way to inform depositors and financial advisers of an RDT's risk and to facilitate comparison of risks across RDTs. It was also recognised that credit ratings would strengthen the incentives for RDTs to develop and maintain sound governance and risk management practices and reduce the need for more comprehensive and expensive prudential regulation and supervision.
54. Officials have conducted further analysis on the ratings proposal and I am now in a position to propose details for the rating requirement.

Ratings requirement

55. I am proposing that the legislation will require RDTs to comply with requirements in relation to credit ratings prescribed in regulations. The details of the ratings requirements will need to be the subject of consultation with stakeholders at the time the regulations are

prepared. However, subject to that consultation process, I am proposing that the regulations would have the following features:

- a. **Issuer rating.** The credit rating would be a long-term “issuer rating” applicable to the RDT and would therefore measure the strength of the RDT’s ability to meet its financial obligations.
- b. **Approved rating agency.** The rating will need to be obtained from a rating agency approved by the Reserve Bank in order to ensure that ratings are of acceptable quality and that meaningful comparisons can be made between the ratings of different rating agencies. The legislation will empower the Bank to approve rating agencies for this purpose, and to withdraw such approvals. It will require the Bank to disclose in its Statement of Principles the criteria it applies in making rating agency approval decisions.
- c. **Disclosure of ratings.** I am proposing that RDTs will be required to disclose their rating, and qualifications to the rating, in a manner prescribed in regulation made under the Securities Act. The details of disclosure requirements will need to be consulted on at the time regulations are prepared. However, the current intention is that the disclosure of ratings will:
 - be made in an RDT’s offer documents and in all advertisements for its deposits or investments where these are offered to the public; and
 - require the disclosure of the current rating, the name of the rating agency, a description of the rating (based on the descriptors made available by the rating agency), the rating relative to the rating agency’s rating scale, any qualifications to the rating, and any changes to the rating made in the preceding two years.
- d. **Prohibition or restriction on the use of alternative ratings.** In order to reduce public confusion over ratings and the risk of misleading ratings information being disclosed, I am proposing that the regulations would prohibit or restrict an RDT from disclosing in advertisements or offer documents a rating, ranking or scoring from an entity not approved by the Reserve Bank.

Improving public understanding of ratings

56. In order to lift public understanding of credit ratings, and to encourage their use, there will be a need for various education and disclosure initiatives, from both the public and private sectors. The Reserve Bank, in conjunction with other government agencies and the private sector, will develop proposals for disclosure and public education to assist in this area and these will be reported to Cabinet in the course of implementing the RDT arrangements. This will be done in the wider context of developing a strategy to strengthen financial literacy and capacity in the public.
57. The options to be considered will include:
 - a. joint initiatives between the rating agencies and the Bank (among others) to promote explanatory material on ratings aimed at the non-expert depositor;

- b. working with financial advisers, planners and brokers to make greater use of approved ratings when advising clients on their investment options;
- c. briefings and explanatory material for the business news media to promote informed comment on financial institution risks and the role played by credit ratings in measuring risk;
- d. educational initiatives in schools and universities to promote greater understanding of financial and investment issues, including financial risks and the role of credit ratings; and
- e. disclosure of comparative information on ratings agencies' rating scales and guidance on how to interpret particular rating grades.

Cost of ratings – proposed exemption for small RDTs

58. Cabinet requested that I report back on options for the reduction of compliance costs associated with credit ratings. There are three main options available for reducing costs for small RDTs:
 - Exempt small RDTs (with conditions).
 - Provide a subsidy for small RDTs.
 - Negotiate a standard base fee for small RDTs.
59. I am advised that the annual direct cost of a rating (ignoring management time and costs of providing information or changing systems) is an average of around \$30,000 for a typical RDT. The rating fee will vary depending on the rating agency and the size and nature of the RDT. This cost is minor for most RDTs, relative to the size of their balance sheets and profits. However, the cost is higher for very small RDTs, including the costs of management time and information system changes.
60. Officials have assessed different options for reducing the cost of ratings, especially for small RDTs. The main option, and the one I am recommending, is that RDTs below a defined size be exempted from the rating requirement. This would avoid the direct and indirect cost of ratings for small RDTs, including credit unions, and would enable small niche players to continue to operate in the market. I note, however, that an exemption would also reduce the ability of depositors in small RDTs to understand the risks of the RDT and would reduce the incentives that ratings can create for sound governance and risk management.
61. Subject to the need to consult stakeholders at the time regulations are prepared, I am proposing that the regulations specifying ratings requirements would apply only to RDTs with total assets in an RDT's borrowing group of \$10 million or above. I am advised that this will result in all of the small credit unions and a small number of other RDTs being exempted, representing around 1 per cent of total RDT deposits.
62. Under this proposal, an RDT would be exempted from the need to have a credit rating until its total assets (including those in its borrowing group) reach \$10 million, at which point a rating will be required. Allowance would be made for an RDT to retain a temporary exemption (issued by the Bank by notice) where necessary to enable an RDT time to obtain the rating.

63. I propose that the exemption be reviewed after a period of three years, and if an exemption is retained, that the total asset level be reviewed from time to time, with a view to the threshold increasing in line with growth in RDT balance sheets.
64. In the case of exempted RDTs, I am proposing that the legislation would empower the making of regulations to:
 - a. require exempted RDTs to prominently disclose, in offer documents and advertisements, that the RDT is unrated;
 - b. prohibit or restrict the RDT's disclosure of ratings, gradings, scorings or rankings issued by non-approved agencies. A prohibition would avoid the risk of public confusion over the disclosure of alternative (non-approved) ratings, and reduce the risk of people being misled by ratings that can sometimes be of questionable accuracy. However, prohibition would also seriously impede the business of the New Zealand-based entities that provide such ratings and may discourage the emergence of an effective domestic rating agency. Equally, however, allowing the disclosure of non-approved ratings may give rise to confusion by depositors and result in misleading portrayals of RDT risk;
 - c. require the RDT to comply with additional prudential requirements prescribed in regulation, potentially including in relation to a minimum capital ratio, a maximum limit on exposures to related parties, liquidity requirements and restrictions on the nature of the RDT's operations.

Governance requirements

65. The Cabinet paper in June recommended that RDTs be subject to minimum governance requirements, mainly relating to the size and composition of the board of directors. These recommendations were made in recognition of the importance of sound governance and the risks for depositors and others when RDTs have inadequate governance arrangements.
66. Officials have further assessed the efficacy of prescribing minimum governance requirements for RDTs. They have noted that minimum requirements along the lines set out above might help to strengthen the corporate governance of RDTs, and thereby help to strengthen risk management and reduce reliance on prudential regulation. Minimum governance requirements can also assist to underpin or complement good disclosure practices by RDTs.
67. However, there are also arguments to suggest that it may not be necessary to impose minimum governance requirements on RDTs in order to achieve sound governance outcomes. The credit rating requirement could be expected to strengthen the incentives for most RDTs to maintain good standards of governance. Fit and proper checks on directors and senior managers might also assist in strengthening governance, as might the proposal for RDT directors and CEOs to sign regular attestations in RDT offer documents affirming the adequacy of their governance and risk management systems. Moreover, governance requirements (eg director duties and matters relating to director conflicts of interest) in company law, and the proposed strengthening of mutuals governance, also help to underpin sound governance practices.
68. I am proposing that, for the time being at least, there be no minimum corporate governance requirements for RDTs as part of the RDT regulatory framework. However, I think it is

important that there be scope to prescribe governance requirements in the future if the need arises, given that governance can have a major effect on the soundness and risk management of RDTs. Hence, I am proposing that the legislation empower the making of regulations in this area, relating to board size and composition.

69. In order to prevent a situation where an RDT's constitution permits its directors to act in the interests of a holding company (even if this conflicts with the interests of the RDT), I propose that the legislation will allow regulations to be made to prescribe matters in relation to the constitution of an RDT.

Fit and proper requirements

70. Cabinet has agreed, as part of the proposed financial service provider registration framework that RDTs will be subject to criminal and bankruptcy checks in respect of shareholders with control, directors, and senior managers. These will be part of the financial service registration framework administered by the Registrar of Financial Service Providers in the Companies Office.
71. In addition to the criminal and bankruptcy checks, the Committee agreed in June that fit and proper checks (relating to suitability and integrity) should be applied to an RDT's directors and senior managers to ensure an acceptable level of suitability and integrity for their role. Applying fit and proper checks to directors and senior management is consistent with international standards for the supervision of banks and deposit-takers, and with international practice, and was proposed in the Discussion Document issued in 2006. The application of such checks to directors and senior managers would also be consistent with FATF requirements for anti-money laundering supervision.
72. The objective is to ensure that primary responsibility rests with the RDT's owners and board for ensuring that directors and senior management have suitable skills and experience, and the integrity, to do their jobs effectively. The Reserve Bank's role should be limited to a "backstop" function to ensure that persons who do not meet the prescribed suitability criteria are not appointed or can be removed.
73. I am proposing a combination of policies that will achieve these objectives:
- a. I propose that the legislation will require RDTs to maintain fit and proper policies and procedures for directors and senior management in accordance with regulations. Indicatively, the regulations would be likely to specify:
 - o The broad nature of the policies and procedures that RDTs should adopt in order to ensure that prospective directors and senior managers are subject to scrutiny prior to appointment, and are subject to periodic review thereafter, including as to their experience, qualifications and skills relevant to being a director or senior manager of an RDT, and their involvement in previous business operations.
 - o An obligation for the board of an RDT to attest to the Reserve Bank, at the time of referring to the Bank a prospective appointee, that the policies and procedures have been applied and that the board is satisfied that the appointee has the required level of suitability and integrity for the position in question.

- b. I propose that the legislation will empower the Reserve Bank to dis-approve the appointment of directors and senior managers if the Bank is satisfied that the person does not meet the fit and proper requirements. I am also proposing that the legislation will empower the Bank to require the removal of a director or senior manager if the Bank is satisfied that the person no longer meets the fit and proper requirements. The Bank may set a term and other conditions on the period of disqualification. Legislation will include appropriate natural justice requirements including appeal rights.
 - c. I propose that the fit and proper criteria will be prescribed in legislation or regulation.
74. There will need to be appropriate coordination between the application of fit and proper requirements under the RDT legislation and the criminal vetting functions to be performed by the Registrar of Financial Service Providers.

Disclosure and director/CEO attestation requirements

75. RDTs will continue to be covered by the disclosure and advertising requirements of the Securities Act as debt issuers. It is proposed that amendments to the Securities Act will be made in the second phase of the RFPP reform legislation to strengthen and simplify disclosure requirements for issuers, including RDTs. Proposals on these matters are expected to be brought to the Committee in November this year.
76. In addition to the proposed changes to disclosure requirements for debt issuers, I am proposing that the disclosure requirements for application to RDTs, contained in the relevant Securities Regulations, will require the following:
- a. Disclosure at six monthly intervals of a brief Key Information Summary, either as part of or a supplement to, an RDT's offer document, which must contain information prescribed in regulation, including in relation to:
 - an RDT's credit rating, the name of the rating agency, a description of the rating (as used by the rating agency), where the rating sits on the agency's rating scale, qualifications to the rating, and changes to the rating in the preceding two years;
 - the capital ratio of the RDT;
 - the level of related party exposures relative to capital and relative to the limit in the trust deed.
 - b. Attestations signed by the directors and CEO of the RDT in offer documents, including in relation to:
 - whether the RDT is complying with its trust deed and regulatory requirements;
 - whether they are satisfied that the RDT has sufficient capital and adequate governance and risk management systems for the nature of the RDT's business;
 - whether credit exposures and other business dealings with related parties have been entered into and conducted on commercial terms and are not contrary to the interests of the RDT's depositors.

- c. Disclosure in the RDT's offer document of a summary of the terms and conditions of its trust deed.
77. It is proposed that the Securities Commission will be required by that Act to consult with the Reserve Bank in preparing disclosure regulations. It is also proposed that the Securities Act will require the Securities Commission to consult and have regards to the views of the Reserve Bank in the preparation of any exemption notices in respect of RDTs and on any enforcement actions taken in relation to disclosure or advertising matters.

Guidelines issued by the Reserve Bank

78. It is intended that the Reserve Bank will be able to issue guidelines, of a non-binding nature, to RDTs and trustees to assist them to interpret prudential or other requirements promulgated under the RDT legislation. Guidelines could be issued in relation to a number of matters, including the capital adequacy framework, which is technical in nature and where explanatory guidance may be useful to stakeholders. Guidelines in other areas may also be helpful, potentially including corporate governance, liquidity, related party dealings, fit and proper requirements and other matters.

RDT distress and failure

79. In June, the Committee agreed to a proposal that the Reserve Bank should have the statutory powers to respond to RDT financial distress and failure in situations where the Bank is satisfied that its intervention is required in order to maintain the soundness and efficiency of the financial system or to avoid significant damage to the financial system resulting the distress or failure of the RDT.
80. I am proposing that the RDT legislation will include powers for the Reserve Bank to intervene in an RDT distress or failure situation where the Bank considers this necessary for maintaining the soundness and efficiency of the financial system or for avoiding significant damage to the financial system resulting from the failure of an RDT by extending the application of crisis management powers under the Reserve Bank of New Zealand Act to RDTs. In these circumstances, it is proposed that:
- a. The Bank would be empowered to recommend to the Minister of Finance that, by notice issued by the Minister, an RDT (and any of its subsidiaries or associated persons) be made subject to the Reserve Bank of New Zealand Act for the purposes of exercising powers under that Act to give directions to the RDT (under section 113 of that Act) or to recommend that the RDT be placed into statutory management (under section 117 of that Act), on the basis that the Act would apply to the RDT as if it were a registered bank.
 - b. Once a notice has been issued declaring that the RDT (and any of its subsidiaries or associated persons) is subject to the Reserve Bank of New Zealand Act for crisis management purposes, the Bank would then be able to exercise crisis management powers in that Act as if the RDT were a registered bank. With the consent of the Minister of Finance, the Bank would be empowered to suspend all or some the powers of the trustee of the RDT in question, on the basis that the trustee is exempted from liability as a result of being unable to exercise powers.

- c. The Bank would be required by the RDT legislation to consult with the trustees, Securities Commission and Companies Office before making a recommendation to the Minister of Finance that the RDT be declared by the Minister to be brought under the Reserve Bank of New Zealand, and before exercising any powers under the Reserve Bank of New Zealand Act in relation to the RDT.

Treatment of credit unions

- 81. In June, the Committee agreed that credit unions should be regulated as RDTs and, to the extent that they are subject to the full set of requirements for RDTs, the prudential constraints in the Friendly Societies and Credit Unions Act (FSCU Act) that impede the ability of credit unions to conduct the business of an RDT should be repealed.
- 82. The case for credit unions being regulated as RDTs on much the same terms as other RDTs is strong, given that credit unions perform many of the functions of other RDTs, including deposit-taking, provision of transaction services, lending and other financial services. Although some credit unions are relatively low-risk in nature, they nonetheless expose their members – depositors – to risks that are similar in nature to the kinds of risks that depositors in other RDTs face. Depositors in credit unions are therefore in as much need of the protection measures being proposed in this paper as are depositors of other RDTs. Moreover, in a situation where credit unions are increasingly competing with other RDTs and are wanting greater operational freedom to extend their areas of competition, there is a strong case for a competitively neutral approach to regulation of credit unions.
- 83. I am therefore satisfied that, to the extent practicable, credit unions should be regulated on the same basis as other RDTs, and that further relaxation of operational constraints on credit unions should be contingent on them being brought under the RDT requirements. However, I wish to ensure that the regulatory arrangements for credit unions do not prevent small credit unions from operating effectively or new credit unions being created.
- 84. The FSCU Act will need to be substantially amended to implement proposed liberalisation of credit union regulation, and to give effect to the proposed mutuals governance reforms. It is intended that the Minister of Commerce will report to the Committee at a later date on the scope and nature of the proposed changes to the FSCU Act. This will be progressed separately from the RDT reforms, but it will need to be taken into account when bringing credit unions under the RDT framework.
- 85. I am therefore proposing that the Committee agree to the following proposals in respect of credit unions:
 - a. Credit unions will be subject to the RDT requirements. It may be necessary to exempt credit unions from some of the RDT arrangements until the FSCU Act has been amended. These exemptions can be effected through the proposed general exemption power available to the Reserve Bank.
 - b. Small credit unions – those with total assets under \$10 million – will be exempted from the credit rating requirement, as is proposed for all NBDTs under this size threshold. This will avoid the imposition of compliance costs on these credit unions arising from a credit rating. Exempt credit unions would be subject to conditions, including a requirement to prominently disclose in offer documents and advertisements that they do not have a credit rating, and restrictions on their ability to disclose alternative ratings,

scorings or rankings provided by non-approved agencies. The exemption would also appropriately be conditional on additional prudential requirements imposed by regulation.

The details of these restrictions will be the subject of consultation at the time regulations are drafted, but are likely to include a minimum capital ratio, a limit on related party exposures and potentially restrictions on the nature of business activities that exempt credit unions may undertake.

- c. I am proposing that credit unions be exempted from the minimum capital amount on the basis that they comply with a minimum capital ratio set in regulation, with the level of this ratio being the subject of consultation at the time regulations are prepared.
- d. Some credit unions operate within groups, as opposed to being stand-alone. The main credit union group is that represented by the New Zealand Association of Credit Unions (NZACU). The NZACU has requested that consideration be given to the option of applying regulatory requirements – including the need for a credit rating and possibly trust deed and offer document obligations – to the group, rather than on an individual credit union basis.

I am advised that a group approach to regulation would be appropriate in circumstances where the risks to depositors are spread across the group, such that their deposits can be repaid from the assets of any part of that group. This would require, among other matters, unconditional and irrevocable cross guarantees within the group.

I have asked officials to explore this matter further and revert with their advice. In the meantime, I am persuaded that the legislation should be drafted to enable RDT requirements to be applied on a group, rather than individual entity, basis, where this can be effected by regulation, but only where the Reserve Bank and Minister of Finance are satisfied that a group approach provides the same level of protection to depositors as would be the case for a single entity approach.

Powers of Reserve Bank and trustees to take enforcement actions

Trustee obligations and powers

- 86. In the case of requirements that must be included in trust deeds (such as minimum capital, capital adequacy ratio, a related party exposure limit and liquidity requirements), it is proposed that the trustee would be responsible for enforcing compliance with requirements and will have additional obligations and powers imposed under the RDT legislation for that purpose. I am proposing that:
 - a. The trustees will be required by the legislation to ensure that trust deeds of RDTs comply with the requirements set in regulation under the RDT legislation.
 - b. The legislation will empower the trustees (either directly or by requiring trust deeds to contain the powers) to require RDTs to provide them with information sufficient to enable the trustee to monitor compliance with the regulatory requirements, to appoint a person (at the expense of the RDT) to verify compliance, and to investigate the affairs of the RDT for the purpose of ascertaining compliance.

- c. The trustee of an applicant for licensing as an RDT will be required by the legislation to attest to the Reserve Bank, prior to an RDT being licensed, whether the trustee is satisfied that the applicant has sufficient capital relative to its size and nature, risk management systems and internal controls, and governance to manage its proposed or actual business, consistent with the level of risk represented to depositors in the prospectus and investment statement. The legislation will empower the Reserve Bank to require trustees of RDTs to attest to these matters at intervals specified by the Bank.

I note that the trustees appear to be resistant to this proposal. At this stage, however, I am satisfied that it should be included in the RDT legislation. The RDT regime places a great deal of reliance on the role of trustees. I am therefore keen to ensure that they have strong incentives to reach a view, and convey that view to the Reserve Bank, as to whether they are satisfied that the key financial covenants in the trust deed are consistent with protecting depositors in a manner consistent with the risk profile represented to depositors in the prospectus and investment statement. If trustees remain concerned, their concerns can be discussed at the select committee process.

- d. The legislation will empower the Bank to require the trustees of an RDT to attest to the Bank, at intervals specified by the Bank, whether the trustee is satisfied that the RDT is complying with the requirements specified in the legislation or in regulations. It is also proposed that the trustees will be under a statutory obligation to advise the Bank as soon as practicable if an RDT has failed or is expected to fail to comply with a requirement of the legislation or regulation, or where the trustee has reasonable cause to believe that non-compliance may have occurred.
- e. The legislation will empower the Bank to require the trustees of an RDT to provide the Bank with information to enable the Bank to determine whether an RDT is complying with the requirements of the legislation and regulations.

Reserve Bank

87. The Reserve Bank would directly take enforcement actions in respect of matters that are not included in trust deeds or offer documents and are imposed by regulation – such as breaches of fit and proper requirements. The Bank would also take enforcement actions in the case of criminal sanctions. In addition, it is intended that the Bank would take enforcement action in situations where it is not satisfied with actions taken (or not taken) by a trustee in relation to RDT requirements set out in legislation or regulation.
88. Enforcement powers will include:
- The ability to obtain information from an RDT and its trustee to ascertain whether the RDT is in compliance with regulatory requirements.
 - The ability to appoint a third party (such as an audit firm) to investigate an RDT to ascertain whether it is in compliance with regulatory requirements.
 - The ability to issue a notice to the RDT advising of non-compliance and requiring the RDT to explain how and when it plans to come into compliance.
 - Prosecutions for offences.
 - The ability to suspend the license of or to de-license an RDT.

89. It will be important for the regulatory agencies responsible for the RDT sector to cooperate and coordinate regulatory actions where appropriate. In order to facilitate this, it is intended that the legislation will empower information-sharing between the Reserve Bank, Securities Commission, Companies Office and trustees for the purpose of enabling each regulatory agency to perform its responsibilities effectively. The legislation will also set out confidentiality requirements for information exchange.
90. It is likely that the regulatory agencies will enter into a Memorandum of Understanding (MOU), documenting the respective responsibilities and accountabilities of each agency, and setting out the framework for cooperation and coordination. It is intended that this MOU will be publicly disclosed.

Offences and penalties for non-compliance with RDT requirements; enforcement powers

91. I am proposing that the offences under the RDT legislation will include the following:
- Provision of false or misleading information by an applicant or their agent in respect of an application to be licensed as an RDT.
 - Falsely holding out to be an RDT.
 - Conducting the business of a deposit-taker if not licensed as an RDT (unless a registered bank or an exempt entity).
 - In the case of an RDT or its directors or CEO, failing to comply with regulatory requirements imposed under the Act or with conditions attaching to an exemption notice issued by the Reserve Bank.
 - In the case of an RDT or its directors or CEO, failing to comply with a request from the Bank to provide the Bank with information, or providing false or misleading information.
 - In the case of an RDT, failure to notify to the Reserve Bank a change in director or senior manager.
 - Failure by a trustee to provide the Bank with information as requested, providing false or misleading information to the Bank, failing to notify the Bank of a material breach of regulatory requirements as soon as the trustee becomes aware of the breach, failing to make a required attestation to the Bank or making a false or misleading attestation to the Bank.

Penalties

92. I am proposing that the legislation will set out penalties for offences and that these be modelled on those in the Reserve Bank of New Zealand Act and Securities Act, in terms of fines and imprisonment terms, as the case may be, for RDTs, trustees, RDT directors and CEOs, and other persons committing offences. On this basis, I am proposing that officials work with PCO to draft legislation which incorporates penalties that are appropriately calibrated to the seriousness of offences, and maintain a consistency with Reserve Bank Act and Securities Act equivalents.

93. Indicatively, but subject to officials undertaking more work on this, I am proposing that fines on deposit-takers and RDTs be prescribed in a range between \$500,000 and \$2 million; fines for RDT directors and CEOs ranging between \$50,000 and \$200,000, and imprisonment terms for directors and CEOs ranging between 3 months and 18 months.

LEGISLATIVE IMPLICATIONS

94. Legislation is required to enact the proposals in this paper. The proposals relating to licensing of RDTs will contain cross references to the Financial Providers Bill being drafted by MED, as the licensing and fit and proper regime is interconnected with the registration process to be implemented under that bill. The consequence of this is that proposals relating to licensing will be unable to proceed ahead of the Financial Providers Bill. Officials advise that the consequence of this is that the legislation providing the licensing regime cannot be introduced until next year.
95. However, other proposals are not dependent on the licensing regime and on the Financial Providers Bill. This includes credit rating requirements and the new requirements to be included in trust deeds (such as minimum capital, a capital adequacy ratio, a limit on exposures to related parties and possibly liquidity requirements). I propose that those proposals should be enacted separately from the licensing-related proposals and proceed in advance, with the aim of introduction into the House before the Christmas recess this year, with the aim of passage during 2008. The licensing related proposals should proceed in a separate bill to be introduced by March/April 2008.
96. Each bill would commence on separate dates. This means that the credit rating proposals and trust deed requirements could be introduced ahead of the requirement for deposit-takers to be licensed as RDTs.
97. To enable two bills to be introduced and to proceed through Parliament separately, it is proposed that the bills will amend the Reserve Bank of New Zealand Act 1989, rather than create new RDT-specific statutes. The first bill will also contain the transparency and accountability amendments to the Reserve Bank of New Zealand Act, which were approved by Cabinet in June. This bill holds a category 4 priority on the 2007 Legislation Programme (to proceed to a select committee in 2007). I will seek a priority 5 for the second Bill to acknowledge that drafting instructions are intended for later this year.

REGULATORY IMPACT ANALYSIS

98. The Regulatory Impact Statement is attached. I confirm that the principles of the Code of Good Regulatory Practice and the regulatory impact analysis requirements, including the consultation RIS requirements, have been complied with.

IMPLICATIONS FOR THE TREATY OF WAITANGI

99. There are no implications for the Treaty of Waitangi.

HUMAN RIGHTS

100. There are no implications in relation to the Human Rights Act or the New Zealand Bill of Rights Act.

FISCAL IMPLICATIONS

101. As agreed by Cabinet in June, the Reserve Bank will fund its costs associated with RDT regulation through its Funding Agreement, on the same basis as it is currently funded for its other regulatory activities, rather than through charging fees to RDTs. However, it is proposed that a cost-recovery fee will be charged for licensing an RDT, as is the case with registered banks. I am proposing that the fee would be prescribed by regulation and able to be revoked or amended from time to time.

PUBLICITY

102. It is proposed that this paper will be publicly released if approved by Cabinet.

CONSULTATION

103. The proposals in this paper closely reflect the proposals set out in the RDT Discussion Document released in 2006, in respect of the “Tier 2 RDTs”. They are also substantially consistent with the decisions publicly announced by the government in June this year, following the Cabinet decisions made on 18 June.
104. The following government agencies were consulted in the preparation of this paper: Treasury, Ministry of Economic Development, Securities Commission, Parliamentary Counsel Office, Ministry of Justice and the Department of Prime Minister and Cabinet. In addition, selected stakeholders have been consulted on this paper on a limited basis, including trustee corporations with responsibilities for RDTs, credit unions and two private sector experts on securities law.

RECOMMENDATIONS

Background

- 1 **note** that in June 2007 the Cabinet Economic Development Committee agreed to proposals for governance and accountability arrangements for prudential regulation for the financial sector [EDC Min (07) 11/14];
- 2 **note** that in June 2007 Cabinet agreed to proposals for the regulation of Non-Bank Deposit-Takers, which are referred to in this paper as Registered Deposit Takers (RDTs), and invited the Minister of Finance to report to the Cabinet Economic Development Committee with further detail on the proposals and with any outstanding matters [CAB Min (07) 21/10];

Summary of main features

- 3 **note** that the paper under EDC (07) 160 sets out the details of the proposed regulation of RDTs, which includes the following main features:

- 3.1 RDTs will continue to be subject to regulation under the Securities Act 1978 in their capacity as issuers of securities to the public, and will therefore continue to be required to have offer documents and trust deeds. Trustees will continue to have responsibility for agreeing the terms and conditions of trust deeds with RDTs, and for monitoring and enforcing trust deed requirements;
 - 3.2 RDTs will be subject to the enhanced trustee arrangements previously agreed in CAB Min (07) 21/10, whereby trustees are subject to authorisation and supervision by the Securities Commission;
 - 3.3 All RDTs will be required to be licensed by the Reserve Bank and to comply with minimum prudential and other requirements prescribed in regulation. Some of these requirements will be required to be incorporated into RDT trust deeds and enforced by trustees, and others will be enforced directly by the Reserve Bank;
 - 3.4 All RDTs will be subject to enhanced public disclosure requirements in their offer documents, including in respect of their credit rating, capital position, lending to related parties and key risk information. These requirements will be enforced by the Securities Commission. The disclosure proposals set out below may only be a subset of the disclosure requirements to be prescribed for RDTs;
 - 3.5 trustees will have the principal responsibility for responding to RDT financial distress, however, it is proposed that the Reserve Bank will have powers of intervention, with the agreement of the Minister of Finance, in situations where an RDT poses a threat to the soundness or efficiency of the financial system;
- 4 **note** that in June 2007 Cabinet invited the Minister of Finance to report on details of the proposed RDT regulatory arrangements, including in respect of:
- 4.1 the definition of RDTs;
 - 4.2 ratings requirements for RDTs (and the means of avoiding excessive compliance costs for smaller RDTs);
 - 4.3 prudential requirements;
 - 4.4 the legislative vehicle for the proposed arrangements;

[CAB Min (07) 21/10]

- 5 **note** that in June 2007 Cabinet agreed that the supervisory framework for the regulation of RDTs should be applied in full to credit unions, subject to satisfactory options for minimising the compliance costs for ratings for credit unions [CAB Min (07) 21/10];

Legislative structure

- 6 **note** that the Minister of Finance would like to introduce into the House in 2007 as much as possible of the legislation required to implement decisions on RDTs in order to facilitate enactment in 2008;
- 7 **note** that in order to introduce as much as possible of the legislation it will be necessary to implement the proposals in two phases, in separate bills, given the inability to advance some of the RDT proposals ahead of other financial sector reforms (such as those relating to financial service provider registration);

- 8 **agree** that the decisions below be enacted in two separate bills, each amending the Reserve Bank of New Zealand Act 1989, as follows:
- 8.1 the first bill – Reserve Bank of New Zealand Amendment Bill – will contain required definitions and the provisions permitting regulations to be promulgated to prescribe requirements for credit ratings, minimum capital, capital adequacy, limits on exposures to related parties, board composition and size, liquidity, and associated offences, penalties and enforcement powers, as specified in paragraph 12 below;
- 8.2 the second bill – a Registered Deposit Takers Bill – will contain all remaining amendments to the Reserve Bank of New Zealand Act required to implement the RDT regime, including licensing and fit and proper requirements.;
- 9 **note** that the Reserve Bank of New Zealand Amendment Bill will also include the transparency and accountability amendments to the Reserve Bank of New Zealand Act, as agreed in CAB Min (07) 21/10, and that this Bill holds a category 4 priority on the 2007 Legislation Programme (to be referred to a select committee in 2007);
- 10 **agree** that a Registered Deposit Takers Bill be added to the 2007 Legislation Programme with a category 5 priority (instructions to Parliamentary Counsel to be provided in 2007);
- 11 **note** that that the Minister of Finance intends to introduce the Registered Deposit Takers Bill by March/April 2008;

Reserve Bank of New Zealand Amendment Bill

- 12 **agree** that the following decisions be included in the Reserve Bank of New Zealand Amendment Bill ;

Definition of deposit-taker

- 12.1 “deposit-takers” be defined as entities, other than registered banks and other specified categories, that offer debt securities to the public and that are in the business of lending money or providing other financial services, and include building societies and credit unions;

Power to designate entities as deposit-takers

- 12.2 legislation empower the designation of an entity as a deposit-taker by regulation and set out broad criteria for the making of this regulation;

Power to exempt entities from the RDT regime

- 12.3 the Reserve Bank be empowered to exempt deposit-takers from the requirements applicable to RDTs, with conditions, and to amend or revoke an exemption, where the legislation sets out the broad matters to which conditions may be applied;

Purposes for which powers may be exercised

- 12.4 the purposes for which powers may be exercised under the legislation governing RDTs be:
- 12.4.1 to promote the maintenance of a sound and efficient financial system;

- 12.4.2 to avoid significant damage to the financial system resulting from the failure of an RDT;

Prudential requirements for RDTs

- 12.5 the legislation empower the making of regulations by the Governor General, in accordance with advice from the Minister of Finance on the recommendation of the Reserve Bank, prescribing requirements for all RDTs or classes of RDT, in respect of an RDT and/or its borrowing group, in relation to:
- 12.5.1 minimum amount and form of capital, to be included in trust deeds;
 - 12.5.2 level and form of capital in relation to the size and nature of business of an RDT and its borrowing group, to be included in trust deeds;
 - 12.5.3 liquidity requirements, to be included in trust deeds;
 - 12.5.4 restrictions on exposures to parties related to an RDT and its borrowing group, to be included in trust deeds;
 - 12.5.5 credit ratings and the matters applying to RDTs exempted from a credit rating (including a requirement to disclose that the RDT is unrated, prohibitions or restrictions on the disclosure by an RDT of ratings from non-approved agencies, and minimum prudential requirements);
 - 12.5.6 the size and composition of an RDT's board of directors (or its equivalent governing body), and the constitution of the RDT;
 - 12.5.7 the systems for identifying and managing interest rate risk, exchange rate risk and other market price risks;
- 12.6 the legislation provide that the regulations may specify a minimum capital ratio and a maximum limit of exposures to related parties for RDTs or classes of RDT;
- 12.7 the legislation require the Reserve Bank to consult interested parties, including the Securities Commission and trustees, before making recommendations to the Minister of Finance for the promulgation of regulations;

Power to exempt RDTs from regulatory requirements

- 12.8 the Reserve Bank be empowered to exempt, by notice, an individual RDT, a class of RDT or all RDTs from any or all RDT requirements, to issue exemption notices subject to conditions, and to amend or revoke exemption notices, based on the equivalent power of the Securities Commission provided in section 5(5) of the Securities Act 1978;

Obligations to amend RDT trust deed to incorporate regulatory requirements

- 12.9 RDTs and trustees be required to amend trust deeds to incorporate matters required by regulations;

Minimum amount and form of capital

- 12.10 RDTs be required to include in their trust deed a minimum level of capital, of an amount and in a form prescribed by regulation, with the minimum level of capital being initially set at \$2 million in regulation;

Capital adequacy requirements

- 12.11 RDTs be required to have a trust deed that specifies a minimum ratio of capital relative to the size and nature of an RDT and its borrowing group, in accordance with a capital adequacy framework prescribed by regulation;

Restrictions on credit exposures to related parties

- 12.12 RDTs be required to have a trust deed that specifies a limit on exposures of the RDT and its borrowing group to related parties, in accordance with a framework prescribed by regulation, and on the basis of a definition of related party set in legislation, where the definition may be varied by regulation;

Liquidity requirements

- 12.13 RDTs be required to have a trust deed that specifies minimum liquidity requirements, in accordance with a framework prescribed in regulation;

Credit rating requirement

- 12.14 RDTs be required to have and to disclose a credit rating in accordance with requirements prescribed by regulation, but that RDTs with total assets of less than \$10 million be exempted from the rating requirement;
- 12.15 RDTs exempted from a credit rating requirement be subject to conditions imposed by the Reserve Bank including disclosure requirements and additional prudential requirements relating to minimum capital, capital ratio, liquidity requirements and related party exposures;
- 12.16 the Reserve Bank be empowered to approve rating agencies for the purpose of the RDT rating requirement, and be empowered to revoke an approval or issue an approval with conditions;

Obligations on trustees of RDTs

- 12.17 the legislation place an obligation on trustees:
- 12.17.1 to ensure that trust deeds of RDTs comply with the requirements set in regulation under the RDT legislation;
 - 12.17.2 to provide to the Reserve Bank information in relation to RDT compliance with requirements and financial condition as requested by the Bank;
 - 12.17.3 to disclose as soon as practicable to the Reserve Bank any failure or expected failure by an RDT to comply with requirements imposed under the legislation, any other significant breach of a trust deed and where it has cause to believe that a RDT is insolvent or about to become insolvent;
 - 12.17.4 to make attestations to the Reserve Bank in relation to RDT compliance and financial condition as requested by the Bank from time to time;

Powers of trustees

- 12.18 trustees be given powers to take actions to ensure RDT compliance with requirements prescribed under the legislation, including the powers to:
- 12.18.1 obtain information from RDTs as necessary for the trustee to perform its functions under the regulations and the trust deed;
 - 12.18.2 require amendments to the trust deed to enable trust deeds to comply with regulatory requirements;
 - 12.18.3 require the RDT to come into compliance with trust deed requirements.

Powers of Reserve Bank

- 12.19 the legislation empower the Reserve Bank to:
- 12.19.1 obtain information from an RDT and its trustee to ascertain whether the RDT is in compliance with regulatory requirements;
 - 12.19.2 appoint a third party (such as an audit firm) to investigate an RDT to ascertain whether it is in compliance with regulatory requirements, and oblige the RDT to provide access to relevant records;
 - 12.19.3 issue a notice to the RDT advising of non-compliance with RDT regulatory requirements and requiring the RDT to explain how and when it plans to come into compliance;

Information-sharing powers

- 12.20 the legislation to contain information-sharing powers between the Reserve Bank, Securities Commission, trustees and the Companies Office to enable information gathered by any of these parties to be shared with each other for the purposes of exercising their regulatory responsibilities, subject to maintaining confidentiality of the information;

Reserve Bank statement of principles

- 12.21 the legislation to require the Reserve Bank to publish a Statement of Principles and guidelines setting out the framework for regulating RDTs and explaining the requirements applicable to RDTs and trustees under this framework;

Commencement date for legislation

- 12.22 the legislation commences at a date or dates set by Order in Council providing sufficient time for RDTs to come into compliance with the credit rating and other requirements of this legislation and for the Reserve Bank to prepare regulations that are required;

Registered Deposit-Takers Bill

- 13 agree that the following decisions be included in the Registered Deposit Takers Bill;

Purposes for which powers may be exercised

- 13.1 the purposes for which powers may be exercised under the legislation governing RDTs be:
 - 13.1.1 to promote the maintenance of a sound and efficient financial system;
 - 13.1.2 to avoid significant damage to the financial system resulting from the failure of an RDT;

Definition of registered deposit-taker

- 13.2 “Registered Deposit Taker” be defined as a deposit-taker licensed by the Reserve Bank;

Prohibition on deposit-taking and other restrictions on entities that are not RDTs

- 13.3 it be unlawful for a person to conduct the business of a deposit-taker unless it has been licensed as an RDT, or is a registered bank or has been exempted from the RDT requirements;
- 13.4 it be unlawful for an entity to hold itself out as an RDT unless it has been licensed as an RDT by the Reserve Bank;

Licensing of RDTs

- 13.5 the Reserve Bank be empowered by legislation to license entities as RDTs where:
 - 13.5.1 the applicant is able to comply with the requirements applied to RDTs, including the prudential and other requirements prescribed in regulations under the legislation;
 - 13.5.2 the applicant has a trust deed registered or eligible to be registered by the Companies Office that complies with regulatory requirements for RDTs;
 - 13.5.3 the applicant has a prospectus and investment statement registered or eligible to be registered by the Companies Office that comply with the requirements of the Securities Regulations as they relate to RDTs;
 - 13.5.4 the applicant has either been registered or is eligible for registration by the Registrar of Financial Service Providers under the proposed Financial Services Providers (Registration and Dispute Resolution) Bill as a financial service provider;
 - 13.5.5 the applicant’s directors and senior management meet suitability and integrity criteria prescribed under the legislation or in regulation;
 - 13.5.6 the trustee of the applicant has attested to the Reserve Bank that the applicant has sufficient capital relative to the size and nature of its business, governance, and risk management systems and controls to manage its proposed business, consistent with the level of risk represented to depositors in the prospectus and investment statement;

- 13.5.7 unless exempted, the applicant has a credit rating from a rating agency approved by the Reserve Bank that meets the requirements prescribed in regulations;

Transition period for existing RDTs

- 13.6 the legislation provide a transition period, of a length specified by Order in Council, during which deposit-takers, other than those exempted by the Reserve Bank, must apply to be licensed as RDTs and to enable RDTs to come into compliance with RDT requirements;

De-licensing of RDTs

- 13.7 the Reserve Bank be empowered, after consultation with the Securities Commission and trustee, to de-license an RDT, on the request of the RDT, where the legislation sets out the matters on which the Bank must be satisfied before agreeing to the de-licensing;
- 13.8 the Reserve Bank be empowered, after consultation with the Securities Commission and trustee, and, upon the request of an RDT, to prohibit the RDT from taking new deposits, but to enable the RDT to continue to service existing deposits;
- 13.9 the Reserve Bank be empowered, after consultation with the Securities Commission, Companies Office and trustee, to de-license or suspend the license of an RDT on grounds set out in the RDT legislation, including:
- 13.9.1 serious or persistent failure to comply with the licensing requirements and obligations of an RDT;
- 13.9.2 where an RDT is about to become or is insolvent, or has been placed into receivership, liquidation, voluntary administration or statutory management;

Fit and proper requirements

- 13.10 RDTs be required to have trust deeds that include provisions requiring RDTs to establish and maintain policies and procedures relating to fit and proper assessments of directors and senior managers, in accordance with standards prescribed in legislation or regulations;
- 13.11 the Reserve Bank be empowered to disallow the appointment of a director or senior manager of an RDT, or to require the removal of such a person, where the Bank is satisfied that the person does not meet fit and proper requirements prescribed by legislation or regulation, subject to appropriate natural justice requirements;

RDT distress and failure

- 13.12 the Reserve Bank may recommend to the Minister of Finance that an RDT (including its subsidiaries or associated persons) be given directions (with the consent of the Minister of Finance), under section 113 of the Reserve Bank of New Zealand Act, or to recommend to the Minister of Finance that the RDT be placed into statutory management, under section 117 of that Act, where an RDT:
- 13.12.1 is insolvent or about to become insolvent; or

- 13.12.2 has failed to comply with RDT regulatory requirements; and
- 13.12.3 the failure of the RDT could impede the maintenance of a sound and efficient financial system or cause significant damage to the financial system;
- 13.13 the Reserve Bank be required to consult the Securities Commission, Companies Office and trustee before exercising the powers in paragraph 13.12 above;
- 13.14 the Reserve Bank be empowered to suspend all or some of the powers of a trustee in situations where an RDT has been brought under the Reserve Bank of New Zealand Act;
- 13.15 the legislation make provision for trustees to be relieved of liability resulting from the suspension of their powers or from any actions taken by the Reserve Bank in a situation where an RDT has been given directions or placed into statutory management under the Reserve Bank of New Zealand Act;

Treatment of credit unions

- 14 **agree** that credit unions be subject to the legislation applying to RDTs on the basis that:
 - 14.1 the Friendly Societies and Credit Unions Act 1982 will be amended to remove existing prudential and operational constraints on credit unions as previously agreed;
 - 14.2 credit unions with total assets of less than \$10 million be exempted from the need for a credit rating (where the \$10 million asset threshold be prescribed in regulation), subject to requirements being prescribed by regulation or as a condition to the exemption, including a requirement for:
 - 14.2.1 the credit union to disclose prominently that it is not rated by an approved rating agency;
 - 14.2.2 the credit union to be prohibited or restricted from disclosing ratings or rankings from agencies not approved by the Reserve Bank
 - 14.2.3 the credit union to comply with minimum prudential requirements;
 - 14.3 credit unions be exempted from the need for a minimum amount of capital of \$2 million on the basis that they comply with a minimum capital ratio prescribed in regulation;
 - 14.4 credit unions be exempted by the Reserve Bank from other elements of the RDT requirements where this is required by their mutual form;
 - 14.5 the general power to provide exemptions from requirements under the RDT legislation provides adequate flexibility to deal with the special characteristics of credit unions;
 - 14.6 regulatory requirements, including requirements relating to credit ratings, may be applied to a group of credit unions, rather than to individual credit unions, where the Reserve Bank is satisfied that depositors of a credit union in that group have a claim on the assets of the group as a whole on equal terms to the assets of the credit union,

and that the group has a robust structure to ensure a satisfactory control of each member credit union;

Offences

- 15 **agree** that both the Reserve Bank of New Zealand Amendment Bill and the Registered Deposit Takers Bill set out offences that may be committed by either RDTs or trustees for failure to comply with regulatory requirements to be imposed under the particular Bill, including:
- 15.1 failure by RDTs to comply with the obligations imposed upon RDTs by regulation, such as to have a credit rating and failure to incorporate minimum regulatory requirements into trust deeds;
 - 15.2 failure to comply with fit and proper requirements, such as employing a senior manager who has been disallowed by the Reserve Bank.;
 - 15.3 failure by trustees to meet statutory obligations to the Reserve Bank, such as failure to provide information requested by the Bank;

Penalties

- 16 **agree** that both the Reserve Bank of New Zealand Amendment Bill and the Registered Deposit Takers Bill prescribe penalties for offences, on the basis that:
- 16.1 fines on deposit-takers and RDTs be prescribed in a range of \$500,000 to \$2 million, depending on the severity of the offence;
 - 16.2 fines for directors and the chief executive officer of RDTs, and trustees, be prescribed in the range of \$50,000 to \$200,000, depending on the severity of the offence;
 - 16.3 imprisonment terms for directors and senior managers be prescribed in the range of 3 to 18 months, depending on the severity of the offence;
 - 16.4 fines in the range of \$10,000 to \$50,000 for lower level offences such as failure to provide information requested by the Reserve Bank within required timeframes;

Disclosure and director/CEO attestation requirements

- 17 **agree** that, at the time that new disclosure requirements are introduced for debt issuers under the Securities Act, specific requirements be applied to RDTs by regulation made under that Act, including (but not limited to) the following matters:
- 17.1 disclosure at six monthly intervals of a brief key information summary, either as part of or as a supplement to, an RDT's offer document, containing information on an RDT's credit rating, capital ratio and exposures to related parties;
 - 17.2 a requirement that the directors and chief executive officer of an RDT sign attestations in offer documents in relation to whether:
 - 17.2.1 the RDT and its borrowing group are complying with its trust deed and all RDT requirements;

- 17.2.2 the RDT and its borrowing group have sufficient capital, and adequate governance, risk management systems and internal controls for the nature of the RDT's business;
- 17.2.3 exposures to, and dealings with, related parties have been entered into, and conducted on, commercial terms and are not contrary to the interests of the RDT's depositors;
- 17.3 disclosure of a summary of the RDT's trust deed terms and conditions;
- 17.4 RDTs exempted from a credit rating requirement to disclose prominently that they do not have a rating from an approved rating agency, and prohibitions or restrictions on the disclosure of ratings or rankings from agencies not approved by the Reserve Bank;

Next steps

- 18 **note** that the Minister of Finance intends to release the paper attached to EDC (07) 160;
- 19 **invite** the Minister of Finance to issue drafting instructions to the Parliamentary Counsel Office to give effect to the decisions above.

Hon Michael Cullen
Minister of Finance

Regulatory Impact Statement

Proposal for the regulation of Non-Bank Deposit-Takers

This Regulatory Impact Statement assesses the costs and benefits of the main options considered in finalising proposals for the regulation of Non-Bank Deposit-Takers. It should be read in conjunction with the associated paper to the Cabinet Economic Development Committee.

Executive Summary

In June this year, Cabinet agreed to a new regulatory framework for Non-Bank Deposit-Takers (NBDTs) - referred to in this paper as Registered Deposit Takers (RDTs). These include finance companies, building societies and credit unions. Under the proposed arrangements, all deposit takers will need to be licensed by the Reserve Bank and comply with prudential and other requirements prescribed in regulation. Most of these prudential requirements will be incorporated into trust deeds. Trustees will continue to supervise RDTs under trust deeds, pursuant to the Securities Act. RDTs will continue to be subject to disclosure requirements under the Securities Act, with enhancements. The Minister of Finance was invited to report back to Cabinet on the details of these proposals.

This Regulatory Impact Statement focuses mainly on the areas where options needed to be assessed in finalising proposals for RDT regulation. It does not repeat the cost/benefit assessment undertaken at the time that the RDT proposals were submitted to Cabinet in June this year.

Adequacy Statement

Given that Cabinet has already made decisions on the proposed regulatory framework for RDTs, and that the paper for Cabinet largely sets out details in relation to those decisions, the Regulatory Impact Assessment Unit (RIAU) in MED has advised that this Regulatory Impact Statement is not required to be (and has not been) reviewed by the RIAU. However, as the agency responsible for the preparation of the Regulatory Impact Statement, the Reserve Bank attests to its adequacy.

Status Quo and Problem

There are deficiencies in the existing regulation of RDTs, including the absence of minimum entry requirements for RDTs, inconsistency in governance and prudential requirements across RDTs, inadequate official oversight of trustee supervision, inadequacies in public disclosures, and insufficient means for investors to assess and compare RDT risk profiles. These deficiencies impede the ability to maintain a sound and efficient financial system, undermine competitive neutrality in the sector and have the potential to lead to a misallocation of resources and potential instability in the sector. To some degree, these deficiencies are reflected in the current weakness in the RDT sector.

Objectives

The proposals seek to promote a sound and efficient financial system by:

- ensuring that all RDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in RDTs and to promote depositor confidence;
- providing depositors with a clearer basis for distinguishing between lower-risk and higher-risk RDTs; and
- resolving RDT distress or failure in an orderly and timely manner, with minimum disruption to depositors and the financial system.

Summary of regulatory framework agreed by Cabinet

Cabinet has agreed to a framework in which all deposit-takers, other than registered banks and those exempted by the Reserve Bank, must be licensed (as RDTs) by the Reserve Bank, unless exempted, and which must comply with requirements prescribed in regulation. RDTs will continue to be subject to trust deeds as issuers of securities under the Securities Act, whereby trustees and RDTs determine financial and other covenants relating to issues of debt securities to the public. Trustees will continue to have responsibility for monitoring RDTs and enforcing compliance with trust deed covenants, under the enhanced trust deed arrangements being proposed in the Review of Financial Products and Providers. Under the new arrangements, trust deeds for RDTs will have to comply with regulatory requirements, including a minimum amount of capital specified in regulation, a capital ratio set by the trustee and measured by a standardised framework, a restriction on lending to parties related to an RDT and liquidity requirements. RDTs will also be required to comply with a mandatory credit rating regime, with ratings being obtained from an agency approved by the Reserve Bank.

Cabinet has invited the Minister of Finance to report back on details of these arrangements, including in respect of:

- minimum capital;
- capital adequacy framework;
- restrictions on lending to related parties;
- credit ratings (including options for reducing the compliance costs of ratings); and
- requirements for credit unions.

The alternative and preferred options in each area are summarised below.

Alternative and Preferred Options

The main criteria against which the options have been assessed are:

- Effectiveness in meeting policy objectives
- Compliance costs
- Administration costs and risks to government
- Competitive neutrality and impact on market efficiency

Minimum capital

It has been agreed by Cabinet that RDTs should be required to have a minimum amount of capital (ie shareholders' equity) in order to ensure a reasonable level of RDT shareholder commitment and financial substance.

Alternative options

The main alternatives considered were:

- Minimum capital of \$500,000.
- Minimum capital of \$2 million.
- Minimum capital of \$5 million.

The minimum level of capital needs to be sufficient to ensure a reasonable level of shareholder commitment and financial substance for an RDT, while not so high as to impede contestability and competitiveness in the deposit-taking sector.

A minimum capital level of \$500,000 is considered insufficient for an RDT, given the need for financial substance and serious commitment by shareholders, and the risks to depositors. Most submissions on the Discussion Document issued in 2006 concurred with this view.

A minimum capital level of \$5 million would provide a reasonably strong measure of shareholder commitment and financial substance, but would reduce the contestability and competitiveness of the deposit-taking sector, particularly in niche markets. It would require a significant number of existing RDTs to inject capital and could result in some otherwise financially sound RDTs leaving the market.

Preferred Option

The preferred option is a minimum capital level of \$2 million, in the form of equity (ie share capital) or a similar form of "permanent" funding from owners, with this amount to be reviewed from time to time. This was the upper limit of the range proposed in the Discussion Document for RDTs in 2006. Many submissions on that Discussion Document favoured this figure. This amount of capital would provide some assurance that owners of RDTs are committing a reasonable level of resource to the entity prior to obtaining funds from the public, while not overly constraining the entry of small RDTs. Only a small number of RDTs are likely to have to increase their capital if a \$2 million minimum is specified. A transition period will be adopted to give RDTs time to comply with minimum capital and other prudential requirements.

It is proposed that credit unions be exempted from this requirement on the basis that they be subject to a minimum capital ratio relative to the size and nature of their assets and other exposures, with the level of ratio to be determined by regulation after consultation with the industry.

Capital Measurement Framework

Cabinet has agreed that all RDTs should be required to have a capital ratio in their trust deed, with the level of the ratio determined by agreement between trustees and each RDT, but measured on a framework prescribed in regulation. This will ensure that capital adequacy is measured on a consistent basis across the industry and in a manner that takes into account the nature of exposures and risks of an RDT.

Alternative options

The main alternatives considered were:

- Option 1 - A capital ratio based on the proportion of shareholders' equity to total assets (ie a simple equity ratio).
- Option 2 - A capital ratio based on a broader category of capital (including shareholders' equity and some forms of subordinated debt) in relation to risk-weighted assets and off-balance sheet exposures (such as the international "Basel I" Capital Framework currently applied to banks and other deposit-takers internationally and to banks in New Zealand).
- Option 3 - A capital ratio based on a broader category of capital (including shareholders' equity and some forms of subordinated debt) in relation to risk-weighted assets and off-balance sheet exposures, plus market risk and operational risk exposures (such as a simplified form of the "Basel II" Capital Framework soon to be applied to banks and deposit-takers internationally and to banks in New Zealand).

Preferred option

It is proposed that the details of the capital framework be developed in consultation with stakeholders, particularly RDTs and their trustees, in the course of preparing regulations. Subject to that consultation, the current preference is for Option 3 above – a simplified form of the new Basel II framework. This would ensure that RDT capital calculations are made on a similar basis as for banks, and thereby facilitate comparisons between RDTs and banks. It would also be consistent with the Australian approach and with that proposed in many other countries. A simplified form of Basel II would also provide a relatively comprehensive framework for assessing capital relative to assets and other risk exposures – more so than the alternative options. It would also assist in encouraging better identification and management of risks by RDTs.

Although it is proposed that a simplified version of Basel II would be adopted, the new framework would nonetheless require trustees and RDTs to develop their understanding of the arrangements. This will take time. It will also require some compliance costs for RDTs, potentially including the cost of new or modified information systems, and in some cases an increase in capital. The capital framework may also have implications for the types of lending and other activities conducted by RDTs, including making some forms of business more capital-demanding and therefore potentially more costly.

In order to avoid excessive compliance costs and facilitate a smooth adjustment to the new framework, it is intended that RDTs would be given time to come into compliance and that the Reserve Bank would issue guidelines and provide assistance to RDTs and their trustees to understand the arrangements. A full consultation process will be adopted before any decisions are made on the capital framework.

Restrictions on lending to related parties

Cabinet has agreed that there should be some form of restriction on lending and other business dealings with parties that are related to RDTs (eg entities or persons with the capacity to control or significantly influence the RDT and other affiliated persons or entities). This is because related party lending and other business dealings can be a major source of risk – such as lending on non-commercial terms or effectively denuding the RDT of its capital – to the detriment of depositors.

Alternative Options

The following options for restricting lending and other dealings with related parties have been considered:

- Option 1 – require RDTs to have a limit on related party lending, where the trustee sets the limit, and the exposure is calculated on a basis prescribed in regulation.
- Option 2 – require RDTs to have a limit on related party lending, where a maximum limit is prescribed in regulation.
- Option 3 – no limit, but require disclosure of exposures to related parties.
- Option 4 – require deductions of lending to related parties from an RDT’s capital.

In each of the above options, it would also be a requirement for an RDT’s directors and CEO to attest in offer documents that they are satisfied that lending to related parties is on commercial terms and not contrary to the interests of the RDT’s depositors. It would also be a requirement for related party lending to be publicly disclosed in offer documents. Each option would also involve a standardised definition of related party and standardised measurement of lending and exposure.

All options have benefits and costs. Option 1 provides flexibility for the trustee and RDT to agree on the limit, while still ensuring a consistency of approach in the definition of related party and exposure to related parties. It would avoid the costs associated with a standard limit (ie Option 2), but would create a risk of some RDTs having excessively high limits, to the detriment of depositors. Option 2 overcomes that disadvantage, but would be inflexible and entail compliance and efficiency costs unless applied with exemptions. Applying exemptions would then create moral hazard risks and introduce inconsistency in approach.

Option 3 would rely solely on disclosure and market discipline. It would also place reliance on credit rating agencies to assess the risks associated with related party lending and factor that into the RDT rating. While it would avoid compliance and efficiency costs associated with a limit, it would also create a significant risk of excessive related party lending.

Option 4 would be an effective means of reducing the incentives for related party lending, given that all such lending would have to be deducted from capital for the purpose of determining the capital ratio. However, it would be a harsh treatment of related party lending, presuming, as it does, that any such lending is irrecoverable. (Note, however, that any sensible capital adequacy regime will require deduction of equity investments or subordinated debt exposures to related parties.)

Preferred Option

The preferred option is Option 1, subject to consultation with stakeholders at the time regulations are prepared. Option 1 allows for flexibility across RDTs, while still providing an assurance that trustees will specify a limit at some level on related party exposures, and on the basis of a standardised measurement framework. There is a risk that some RDTs will have excessively high limits, permitting a denudation of capital. That risk is countered to some degree by the proposal for public disclosure by RDTs of their related party exposures and RDT director and CEO attestations as to the nature of related party dealings, and for credit ratings. It is also proposed that the legislation will enable regulations to be made to prescribe a maximum limit on related party exposures if this proves to be necessary.

Credit Ratings – options for reducing compliance costs

Cabinet has agreed that RDTs should be required to have and to disclose a credit rating from an approved rating agency, subject to being satisfied on cost-reduction options, especially for small RDTs.

Alternative options

Three options have been considered for reducing compliance costs for credit ratings:

- Option 1 - Exempting small RDTs from a rating.
- Option 2 - A government subsidy for small RDTs to defray some or all of the costs of a rating; no exemptions.
- Option 3 - All RDTs to be subject to a rating, but on the basis of a concessional rating fee negotiated with rating agencies.

The typical annual fee for a credit rating from one of the major rating agencies for an RDT is around \$30,000, although the fee will vary depending on the rating agency and the size and nature of the RDT. Although this cost is significant in dollar terms, it is generally only a very small proportion of an RDT's revenue or deposit base. However, the cost is proportionately higher for small RDTs, especially when the indirect costs are taken into account, such as management time, data system costs, etc. In the case of very small RDTs, such as some credit unions, the total costs may be substantial relative to their revenue, deposit base and management capacity.

Option 1 would avoid the direct and indirect costs of a rating by exempting small RDTs from the need for a rating. Different size thresholds have been considered, including total assets of \$10 million, \$20 million and \$50 million. The higher the threshold for exemption, the more RDTs would be exempted from the need for rating. For example, a \$10 million total asset threshold would result in approximately 30 credit unions and 10 other RDTs being exempted from the need for a rating. That number increases significantly if the threshold is set at \$20 million. A higher threshold would undermine the effectiveness of mandatory credit ratings by making it more difficult for investors to compare risk/return profiles across RDTs.

Option 2 would require all RDTs to have a rating, but would involve partial or full government-funded subsidies for the direct costs of a rating for small RDTs. Based on a threshold of \$10 million of total assets, and full subsidy for the annual rating fee, the cost to government is estimated at around \$300,000 per annum, with the potential for it to be significantly higher depending on whether credit unions operate as individual entities or in consolidated groups. A subsidy would not insulate small RDTs from the indirect compliance costs of a rating.

Option 3 has been assessed and, although there may be scope for negotiating concessional fees for small RDTs on a package basis, preliminary assessments suggest that the cost savings are unlikely to be substantial. Again, this option would not insulate small RDTs from the indirect compliance costs of a rating.

Under Option 1, depositors of exempted RDTs are denied the benefit of a rating, whereas that is not the case under the other two options. However, there would be scope to provide some protection to depositors under Option 1 by requiring exempted RDTs to disclose the absence of a rating, to

prohibit or restrict alternative ratings and to require some minimum prudential requirements (eg minimum capital adequacy ratios and maximum related party exposure limits).

Preferred Option

The preferred option is to exempt RDTs with total assets of less than \$10 million. This is considered to be the most cost-effective means of reducing compliance costs for small RDTs, while still providing some protection to depositors of exempted RDTs (through the measures referred to above). It will result in most RDTs being required to have a rating, while still enabling very small RDTs to operate without one.

Treatment of credit unions

Cabinet has agreed that credit unions should be subject to the RDT regime on the same basis as other RDTs, subject to being satisfied that compliance costs will not be excessive and that small credit unions will still be able to operate effectively and new ones to be established. On that basis, Cabinet has agreed to the removal of many existing prudential restrictions on credit unions to enable them to operate more flexibly.

Alternative options

The options considered are:

- Option 1 - Require all credit unions to come under the RDT regime on the same basis as other RDTs, with no exemptions (other than the proposed exemption from a credit rating for all RDTs with total assets of less than \$10 million). Under this option, the current prudential restrictions on credit unions under the Friendly Societies and Credit Unions Act (FSCU Act) would be removed, as agreed by Cabinet.
- Option 2 – Require all credit unions to come under the RDT regime, but with exemptions from ratings for small credit unions (eg those with total assets under \$10 million), exemptions from the minimum capital level (subject to compliance with a minimum capital ratio) and exemptions in other areas where appropriate. In the case of credit unions exempted from a rating requirement, there would be a requirement to disclose that they are unrated, prohibitions or restrictions on the disclosure of unapproved ratings and some prudential restrictions – eg a higher minimum capital ratio and possibly restrictions on some types of business. Under this option, the current prudential restrictions on credit unions under the FSCU Act would be removed, as agreed by Cabinet.

The asset threshold for the rating exemption could be set at a higher level than \$10 million – eg total assets of \$20 million or \$50 million.

- Option 3 – Allow credit unions that do not wish to come under the RDT regime (and to enjoy the benefits of fewer constraints on their operations) to remain under the existing regulatory arrangements in the FSCU Act.

In addition to these options, consideration has been given to allowing credit unions to be regulated as a group, rather than individually, if the group involves all member credit unions cross-guaranteeing each other and being subject to effective group control. This remains a possibility, but requires further consideration in the development of the regulatory arrangements. It is proposed that the RDT legislation will empower the making of regulations to enable the RDT requirements to

be imposed on a group basis where group arrangements result in depositor claims on a member credit union being treated as claims on a *pari passu* basis on the assets of all other members of the group.

Option 1 would be consistent with the principle of competitive neutrality – ie regulating all RDTs on the same basis. Under this option, credit unions would have the benefit of an exemption from the rating requirement if they have assets under \$10 million, but would otherwise be subject to all the standard RDT requirements. However, given the small size of many credit unions and their mutual nature, it is not practicable to apply all RDT requirements –especially the minimum capital amount of \$2 million – to credit unions. This would force many credit unions to close or merge, and impede the establishment of new ones, to the detriment of the credit union movement and the market niches to which they cater.

Option 2 has the merit of exempting credit unions from the minimum capital amount, provided that they have a minimum capital ratio (ie capital relative to assets and other exposures) prescribed by regulation, and would therefore enable small credit unions to continue and new ones to be established. The rating exemption would apply to small credit unions and the threshold could be applied at total assets of \$10 million or at a higher level. With a \$10 million threshold, around 30 of the 50 credit unions would be exempted from the need for a rating. If the threshold is set at \$20 million, around 40 credit unions would be exempted. A \$50 million threshold would result in all but around 4 or 5 of the credit unions being exempted. If exempted, credit unions would need to be subject to some prudential restrictions – and hence costs - in order to maintain a reasonable level of depositor protection.

Option 3 would enable those credit unions that wish to remain under existing FSCU Act restrictions to do so, while those that wish to enjoy more operational freedom could come under the RDT regime as per Option 1. This option has the disadvantage of introducing greater regulatory complexity. It would also be inconsistent with the principle of competitive neutrality.

Preferred Option

The preferred option is Option 2, with a total asset threshold of \$10 million for ratings exemptions, given that it preserves the ability of small credit unions to remain in operation and new ones to be established, keeps compliance costs relatively low and enables credit unions to be brought into the RDT regime on a broadly competitively neutral basis.

Implementation and Review

Legislation will be required to implement the RDT arrangements. The legislation is likely to take the form of an amendment to the Reserve Bank of New Zealand Act. An initial amendment, scheduled for introduction in 2007, would implement the credit rating and other prudential requirements, among other matters. A second amendment bill, also to the RBNZ Act, is proposed to be introduced in March/April 2008, and would implement the remaining RDT measures, such as the licensing regime and fit and proper requirements.

A separate bill is required to remove restrictions under the FSCU Act. A transition period of 12 to 24 months is being considered, and there will be scope for temporary exemptions from regulatory requirements under the proposed arrangements to enable effective transition.

Implementation of the arrangements will include the development of appropriate and transparent coordination arrangements between the Reserve Bank, Securities Commission and trustees. Regulations made under the RBNZ Act would be subject to full consultation with stakeholders.

Consultation

Stakeholder Consultation

In 2006, the review of RDT regulation was subject to extensive consultation with stakeholders, including many RDTs, industry associations, trustees and consumer bodies. The decisions made by Cabinet in June this year were publicly released and appear to have been well received by most stakeholders. In developing the further details of the proposals, as set out in the current Cabinet paper, there has been limited consultation with stakeholders, including trustees and credit unions.

Given that the detailed regulatory requirements are intended to be set out in regulations, there will be thorough consultation with stakeholders at the time those regulations are prepared.

Government Departments/Agencies Consultation

This paper was prepared by the Reserve Bank. The following government agencies have been consulted on the proposals in this paper: Ministry of Economic Development, Treasury, Ministry of Justice, Securities Commission and PCO. DPMC has also been consulted.