RESERVE BANK OF NEW ZEALAND
TE PŪTEA MATUA

Consultation Document: Review of the Prudential Regime for Non-bank Deposit Takers

The Reserve Bank invites submissions on this consultation document by 5pm on 17 May 2013

Submissions and enquiries should be addressed to:

Richard Dean
Manager, Operational Policy
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140
Email: richard.dean@rbnz.govt.nz and ashley.tomlinson@rbnz.govt.nz

Please note a summary of the submissions may be published. If you consider that any part of your submissions should properly be withheld on the grounds of commercial sensitivity or for any other reason, you should indicate this clearly.

April 2013

Ref #5188478

CONTENTS

SECTION ONE: Introduction

1. Section 157ZZ of the Reserve Bank of New Zealand Act 1989 (the Act) and clause 86 of the Non-bank Deposit Takers Bill (the Bill) require the Reserve Bank (the Bank) to carry out a review of the operation of the prudential regime for non-bank deposit takers (NBDTs),[1] and to prepare a report on this review for the Minister of Finance, before 9 September 2013.

2. The following discussion document has been prepared as a part of the process of carrying out this review. It aims to seek industry feedback on the operation of the prudential regime to date, and on a number of potential changes to the regime we are considering.

Background: The nature of the NBDT sector

3. The NBDT sector currently comprises approximately 68 entities, although only 42 of these entities comprise typical NBDTs, such as building societies, credit unions, and finance companies.[2] Amongst other things, the sector acts as a provider of higher risk lending and provides an alternative source of term deposit and savings account type products.

4. The rationale for prudentially regulating NBDTs is that they are institutions that are in the business of borrowing and lending money and have a high degree of interconnectedness with other parts of the economy as a result.

5. The sector has changed substantially over the last 15 years. From around 1998, the NBDT sector grew faster than the banking sector. This change began as NBDTs exploited niche markets unattractive to banks. The growth of the sector was also largely funded by retail investors, some of whom sought higher-yielding and longer-term fixed interest investments than those offered by banks.

6. At its height, the retail and non-retail non-bank lending sector had total assets of about $25 billion and accounted for nearly 8 percent of total lending intermediated by financial institutions. Today, the sector is about half that size, and accounts for just 3 percent of total intermediated lending.

7. A significant cause of this contraction has been over 20 finance companies entering into liquidation, receivership or moratoria since 2006. These failures occurred largely because of underlying solvency problems caused by factors such as poor asset quality, excessive related party lending, and inadequate credit management. These solvency problems were also often exacerbated by an inability to attract new funds.

[1] Part 5D of the Reserve Bank of New Zealand Act 1989 refers to Deposit Takers, whereas the Non-bank Deposit Takers Bill refers to NBDTs. The definitions of Deposit Taker and NBDT both use the same core definition discussed below in paragraph 44, although there are some minor technical differences in the definitions. For example, the definition of deposit taker expressly includes building societies and credit unions, and the definition of NBDT expressly excludes entities in receivership or liquidation. For simplicity, this paper refers to both deposit takers under Part 5D and NBDTs under the Non-bank Deposit Takers Bill, as NBDTs.
[2] The remainder are technically NBDTs, but are currently exempt from most of the prudential requirements (for example, charitable and religious organisations).

8. In addition, from 2007 to 2012, three large institutions left the sector and registered as banks.[3]

9. Today the majority of NBDTs are relatively small, with assets in many cases of well under $100 million. However, there are a small number of current market participants with assets well in excess of this figure.

The regulatory regime for NBDTs

10. The current prudential regulation of NBDTs is set out in Part 5D of the Act. This forms an important part of the broader regulatory environment which NBDTs operate in. This broader environment includes:

    - Legislation governing the establishment, legal form, governance and winding up of different types of NBDTs. For example, the Companies Act 1993, the Building Societies Act 1965, and the Friendly Society and Credit Unions Act 1982; and

    - Legislation governing offers of securities by NBDTs, and the broader conduct of NBDTs in financial markets. For example the Securities Act 1978 (the Securities Act), Financial Markets Conduct Bill (the FMC Bill) and the Financial Service Providers (Registration and Disputes Resolution) Act 2008 (the FSP Act).

11. Part 5D provides for a number of specific prudential requirements for NBDTs. These include the requirement to have a credit rating, maintain a capital ratio of at least 8 percent, and maintain a limit on aggregate related party exposures of no more than 15 percent of capital. There are also other requirements relating to governance, liquidity and risk management.

12. As debt issuers under the Securities Act, most NBDTs are required to enter into a trust deed with a trustee licensed under the Securities Trustees and Statutory Supervisors Act 2010. The trustee of the NBDT is responsible for the frontline monitoring of the NBDT's compliance with its trust deed (and in particular the prudential requirements contained in the trust deed). The trustee is also responsible for approving the NBDT's risk management programme.[4]

13. Because the regime relies upon trustees acting as the frontline supervisor of NBDTs, the Bank currently carries out a less direct monitoring role. Trustees have obligations under the Act to report to the Bank the actual or potential insolvency of an NBDT or breach of an obligation under Part 5D. They also regularly provide data to the Bank on the NBDTs they are responsible for supervising.

---

[3] Specifically, Southland Building Society (registered as SBS Bank in 2008), PSIS (registered as Co-operative Bank in September 2011) and Heartland Building Society (registered as Heartland Bank Limited in December 2012). Heartland Building Society was itself formed through a merger of three other NBDTs during this period as well.

[4] Although NBDTs that are not required to have a trust deed under the Securities Act are exempt from the requirement to have their risk management programme approved by their trustee.

14. The Bill, which is currently before the House, provides for a licensing regime for NBDTs, fit and proper testing of NBDTs directors and senior officers, and enhanced investigation powers for the Bank. It also re-enacts the content of Part 5D of the Act, which will be repealed by the Bill.

15. Amongst other things, the licensing regime will require that, before granting a licence, the Bank must be satisfied of the applicant's ability to comply on an on-going basis with the requirements of the Act, regulations made under the Act, and any proposed conditions of their licence. It also sets out a number of other matters that the Bank must have regard to when considering an application for a licence. These include the applicant's ability to comply on an on-going basis with the Securities Act and the Anti-Money Laundering and Countering the Financing of Terrorism Act 2010 (the AML/CFT Act), and whether the applicant's ownership, incorporation and ownership structures are appropriate having regard to the size and nature of its business.

16. The Bill is currently awaiting the Committee of the Whole House stage of the Parliamentary process. After the Bill comes into force, existing NBDTs will have 12 months to obtain a licence.

17. We note that the timing of the Bill means that the review will need to be completed before the date on which all NBDTs will be required to be licensed. As a result, the review is largely focusing on NBDTs' experience with the operation of Part 5D of the Act, although we also take into account the impact of the Bill when discussing potential changes to the regime.

The structure of this discussion document

18. The remainder of this discussion document is divided into the following sections:

    Section 2 discusses the current objectives of the prudential regime and proposes a number of options for possible changes to those objectives;

    Section 3 discusses the current definition of NBDT, and proposes a number of options for possible changes to the definition;

    Section 4 discusses the current supervisory arrangements for NBDTs and proposes a number of options for changes to those arrangements;

    Section 5 discusses the current prudential requirements applying to NBDTs and proposes that some prudential requirements be set by conditions of licences or standards in future, rather than via regulations as at present;

    Section 6 discusses the current disclosure requirements applying to NBDTs under the Securities Act and the FMC Bill, and seeks views on the possibility of a separate disclosure regime for NBDTs, in the same way that we currently have a separate disclosure regime for registered banks;

Section 7 discusses the Bank's new crisis management powers for NBDTs under the Bill, and proposes that these be supplemented by a separate statutory management regime for NBDTs;

Section 8 discusses the current offence and penalty regime under the Bill, and asks whether a more graduated range of remedies should be available to address breaches of requirements by NBDTs;

Section 9 discusses other new aspects of the regime established under the Bill, such as the threshold for licensing, the rules around changes of ownership and the process for making suitability assessments of directors and senior officers.

19. The Bank invites submissions on this discussion document by 5pm on 17 May 2013. We encourage stakeholders to use the template at the end of this document to structure their submission. This will assist in the processing of submissions, and make it easier for the Bank to understand and take into account feedback provided on this discussion document.

SECTION TWO: Objectives of the prudential regime

Current objectives of the NBDT regime

20. The current objectives of the NBDT regime in Part 5D and the Bill are:

- To promote the maintenance of a sound and efficient financial system; and
- To avoid significant damage to the financial system that could result from the failure of an NBDT.

Issues identified with the current objectives

21. The Bank is responsible for promoting the maintenance of a sound and efficient financial system. The meaning of the phrase "a sound and efficient financial system" is discussed in the Reserve Bank of New Zealand Bulletin article *Understanding financial system efficiency in New Zealand.*[5]

22. As discussed in that article, "soundness" is about promoting resilience in individual financial institutions and in the financial system at large, so as to minimise any disruption to economic activity.

23. By contrast, "efficiency" has three main elements: technical efficiency, allocative efficiency and dynamic efficiency. Allocative efficiency refers to the degree to which the financial system helps direct an economy's resources towards sectors with high returns and withdraw them from sectors with poor prospects. Technical efficiency refers to the provision of financial products and services at least cost. Dynamic efficiency refers to improvements in allocative

[5] See C. Bloor and C. Hunt, 'Understanding financial system efficiency in New Zealand', Reserve Bank of New Zealand: *Bulletin,* Vol. 74, No.2, June 2011

efficiency and cost effectiveness over time, or innovations in the way the various functions of the financial sector are performed.

24. We continue to support the soundness and efficiency objectives of the NBDT regime. In this context, the Bank pursues soundness by obliging NBDTs to meet a transparent set of prudential requirements designed to promote financial resilience, sound governance, and effective risk management practices in NBDTs. Technical and dynamic efficiency are largely pursued by minimising or avoiding excessive compliance costs in the prudential regulation of the NBDT sector. Allocative efficiency is largely pursued by ensuring effective disclosure of matters relating to the financial soundness of different NBDTs.

25. However, we note that the Bank regulates the banking, NBDT and insurance sectors in varying degrees of emphasis on economy wide and sectoral risk. The current objectives of the Bill are focused on the impact to the financial system, which are similar to the objectives of the prudential regime for registered banks.

26. As entities carrying on the business of borrowing and lending money, or providing financial services similar to those offered by banks, NBDTs carry out bank-like activities, therefore supporting the idea that the objectives of the bank and NBDT regimes should be aligned. However, the nature of the NBDT sector has changed since the NBDT regime was originally designed. In particular, the sector has shrunk in size, and the overall financial exposure that the rest of the economy has to the sector is correspondingly much smaller.

27. As a result, there may be a case to consider adjusting the objectives of the NBDT regime so that they are focused on the effects on the NBDT sector alone or varying degrees of impacts in the NBDT sector and financial system.

Q1. Do you agree with the issues identified with the objectives of the regime? Are there other issues that we should be considering?

Analysis of options for objectives for the NBDT regime

28. We see three potential options for the objectives of the NBDT regime. These are:

- Option One: Maintaining status quo which focuses on the effects in the financial system. These objectives are:
  - To promote the maintenance of a sound and efficient financial system; and
  - To avoid significant damage to the financial system that could result from the failure of an NBDT.
- Option Two: Adopting objectives which focus on impacts in the NBDT sector. These objectives would be:

  - o To promote the maintenance of a sound and efficient NBDT sector; and
  - o To promote public confidence in the NBDT sector.

- Option Three: Adopting objectives which focus on varying degrees of impacts in the financial system and NBDT sector. These objectives would be:
  - o To promote the maintenance of a sound and efficient financial system; and
  - o To avoid significant damage to the NBDT sector that could result from the failure of an NBDT.

29. The objectives set out in Option One apply to registered banks. The purpose of regulating banks focuses on systemic soundness and efficiency, rather than the financial health of individual banks, because banks cover the vast bulk of the financial system, provide liquidity to the wider economy and are important because of their core position in the payments system.

30. We consider that the NBDT sector's size, liquidity provision and other activities, should be considered in determining if distress or failure in this sector would pose a risk of significant harm to the financial system as a whole.

31. In terms of size, the New Zealand financial system is bank-dominated and the NBDT sector, which forms part of the broader non-bank lending sector, represents less than 3.4 percent of the financial system's assets.[6] The distribution of the financial system assets by sector is laid out in the table below[7]:

Sector	2000	2005	2007	2009	2012
Banks	71.5%	74.0%	76.3%	80.5%	81.2%
Non-bank lending institutions	4.0%	7.6%	7.1%	5.1%	3.4%
Funds under management	24.5%	18.4%	16.6%	14.4%	15.4%

32. We note that the current objectives of the Bill were agreed in 2007. The proportion of non-bank lending sector assets in the financial system grew from 4.0 percent in 2000 to 7.6 in 2005.

33. However, as noted earlier, the size of the NBDT sector has been declining since 2005, primarily due to the collapse of some domestic finance companies. In December 2012, the Bank also approved an application by a non-bank deposit taker, Heartland Building society, to be a registered bank. As Heartland had itself been formed through a merger of three NBDTs, and was one of the

[6] As at 31 December 2012.
[7] Reserve Bank of New Zealand: *Financial Stability Report*, November 2012 (p. 53)

two largest NBDTs at the time, this also substantially reduced the size of the sector, and the average size of NBDTs.

34. The distribution of NBDTs measured by total assets is laid out in the table below:[8]

Total assets	Number of NBDTs
Up to $50 million	31
Up to $100 million	2
Up to $200 million	5
UP to $500 million	3
Up to $1 billion	0
Over $1 billion	1

35. In terms of liquidity, New Zealand households and firms that are seeking to borrow typically borrow from a domestically registered bank. The Bank's statistics show that the banking system accounts for 95 percent of intermediated credit.[9] The other providers of credit are NBDTs, non-deposit taking finance companies and foreign bank lending not captured in domestic credit statistics.

36. In terms of activities, most NBDTs do not generally offer a broad range of activities, issue debt and equity securities in the capital markets, or operate across borders. NBDTs have a predominantly domestic deposit base, and do not have the same mix of equity, bank loans and wholesale funding available to banks. They provide credit to niche sectors of the economy, particularly consumer finance, property sector finance, motor vehicle and industrial equipment finance, and finance to small and medium-sized enterprises. They are not core players in the payments system.

37. We consider that while NBDTs are generally relatively small and offer a more restricted range of products to the public, the failure of an NBDT is less likely to cause significant damage to the financial system, and it is more difficult to see failure of distress in the NBDT sector having large scale effects on the soundness and efficiency of the financial system as a whole.

38. Option Two considers adopting for the NBDT regime objectives that mirror those of the prudential regime for licensed insurers. Distress or failure in the insurance sector is not viewed to pose a risk to the soundness and efficiency of the financial system as a whole. This is because insurance is not a significant source of intermediation or payment system functions, and there are only limited interconnectedness and exposures between insurers and other parts of the financial system.

39. The objective of "promoting policyholder confidence" is also used in the insurance sector to encourage participation in the insurance sector, having regard to the financial security and risk management opportunities provided by

[8] These numbers exclude those NBDTs that are currently exempted from most, or all, of the prudential requirements.
[9] Reserve Bank of New Zealand: *Financial Stability Report*, November 2012 (p. 30)

insurance to individuals and companies. Insurance enables households and firms who are least able to withstand unforeseen events carrying weighty financial consequences to transfer those risks to parties who are more able to manage the risks and withstand the events. This objective does not imply insulating policyholders from loss, or providing an assurance to policyholders or others that all insurers are of equal risk.

40. We have reservations about applying the objectives set out in option 2 to the NBDT regime. It could be argued that insurers are not primarily in the business of borrowing and lending money, and as such, they perform a distinct role in the financial system and are less interconnected (compare to banks and NBDTs) with other participants in the financial system. In this sense, the failure of a licensed insurer is generally less likely to directly affect the wider financial system.

41. Option Three has the benefit of continuing the focus on maintaining a sound and efficient financial system, recognising the functions played by NBDTs in the financial system and maintaining alignment with the objectives of the regime for registered banks. However, it also acknowledges that the failure of an NBDT is unlikely to cause significant damage to the financial system as a whole, but may cause significant damage to the NBDT sector.

Conclusion on the objectives of the NBDT regime

42. The Bank does not currently have a firm view on which of the three options canvassed above would be appropriate, and would welcome submitters' views on this issue.

Q2. Which of the three options for the objectives of the NBDT regime that we have identified do you think is preferable? Are there other potential objectives for the NBDT regime that you think we should be considering?

SECTION THREE: Definition of NBDT

The current definition of NBDT

43. The core definition of an NBDT in Part 5D and the Bill, is a person that:

- offers debt securities to the public in New Zealand; and
- carries on the business of borrowing and lending money, or providing financial services, or both.

44. We note that there are some differences in the carve outs from this core definition in Part 5D and in the Bill (for example, the carve outs in the Bill include entities in liquidation).

45. The core definition of NBDT has several different parts which serve distinct purposes. The first part of the definition requires that the entity must be offering debt securities to the public in New Zealand. This has the effect of limiting the definition of NBDT to entities covered by the Securities Act (i.e. entities that make retail offers), because the phrase “offers debt securities to the public in New Zealand” must be interpreted in accordance with the term “offer securities to the public” in the Securities Act. This will not materially change once the Securities Act is repealed by the FMC Bill, as the intention is to amend the definition of NBDT to replace the concept of “offer to the public” with the broadly analogous concept from the FMC Bill of “making a regulated offer”.

46. The second part of the definition requires that the entity must be carrying on the business of borrowing and lending money, or providing financial services, or both. This part of the definition serves several purposes:

- The first part, “carrying on the business of borrowing and lending money”, describes the basic function that distinguishes an NBDT from a corporate issuer.[10] The entity must be “carrying on the business” of borrowing and lending, to ensure that the definition does not cover entities who are only incidentally involved in borrowing and lending (given that this latter type of borrowing and lending activity will not result in a high degree of direct interconnectedness with the rest of the economy);

- The second part, “or providing financial services, or both”, is largely designed to ensure activities that are similar to lending, but not lending, are also picked up by the definition (e.g. factoring, financial leasing). Financial services in this context can also extend to the types of other financial service that might be provided by banks.

47. We consider that, as a starting point, entities carrying on the business of borrowing and lending should be treated as NBDTs where they are not already registered banks. Entities carrying on the business of borrowing and lending will inevitably have a high degree of interconnectedness with other participants in the economy, and will often offer essential transactional accounts to unsophisticated investors. Taken together, we consider that these are the fundamental reasons why NBDTs should be prudentially regulated.

Q3. Do you consider that the current definition of NBDT accurately describes who should be covered in the regime?

Q4. Are there any parts of the current definition of NBDT that you consider are unnecessary or problematic?

Issues identified with the current definition

[10] A corporate issuer is an entity that raises funds for purposes other than carrying on the business of borrowing or lending money, or providing financial services, or both.

48. There are two major issues with this definition that we have identified. The first is the breadth of the current definition and how the Bank has dealt with some of the difficult boundary issues associated with it. The second issue is whether the definition should continue to rely upon an entity having to have made an offer of debt securities regulated under the securities law in order to come within the scope of the regime.

Treatment of boundary issues associated with the current definition

49. In respect of the first of these points, the current definition of NBDT is relatively broad and creates a number of difficult boundary issues, which can be managed in one of two ways – either through exempting entities from some or all of the prudential requirements, or through declaring entities not to be NBDTs.

50. To date the Bank has relied upon exempting entities from some or all of the prudential requirements in Part 5D of the Act, usually subject to conditions. At present there are six class exemptions and nine individual exemptions in force, and approximately half of the sector is subject to at least one exemption.

51. One benefit of dealing with boundary issues through the use of exemptions is that the Bank can maintain some oversight of entities that carry out NBDT type functions, but which are not necessarily traditional types of NBDTs like finance companies, building societies and credit unions. One cost of this approach is the application of additional compliance costs to entities that the Bank has a relatively small regulatory interest in.

52. Some examples of entities that are currently caught by the definition, but which are not traditional types of NBDT include:

- Payment facility providers: Payment facility providers effectively hold funds on behalf of persons and then make those funds available to those persons either directly, or in a specified form (such as the equivalent amount in a foreign currency). They do not aim to provide creditors with a financial or other return on the amounts they hold on creditors behalf, or purport to manage financial risk on another person's behalf;

- Funding conduits: Funding conduits are wholly owned subsidiaries that are in the business of borrowing and lending, but which lend exclusively, or almost exclusively, to their parent entity. In this situation, the parent entity is effectively carrying out the role of a corporate issuer (i.e. an entity raising funds for purposes other than carrying on the business of borrowing and lending), the only material difference being that it is raising funds through a subsidiary; and

- Holding companies: For these purposes, a holding company is a parent entity that carries on the business of borrowing and lending, but which lends exclusively to its subsidiaries, who do not themselves carrying on the business of borrowing and lending. In substance, the group is also essentially carrying on the business of a corporate issuer in this situation.

53. With the advent of NBDT licensing, the Bank has been considering whether it would be appropriate to declare some of these entities out of the definition of NBDT, given that it may make little sense to licence them if they are not subject to any of the substantive prudential requirements.

54. The potential shift to a greater use of declarations would have the effect of reducing the level of compliance costs that are applied to entities that the Bank has a relatively low regulatory interest in. However, it does not fully address the need to provide for a range of exceptions to the current definition

> Q5. How effectively do you consider the Bank has been managing boundary issues relating to the definition of NBDT?
>
> Q6. What has your experience (if any) been of the process of applying for exemptions under the current regime?
>
> Q7. Do you agree that the current definition results in an unnecessary number of entities needing to be carved out of the definition?

Use of Securities Act concepts in the definition

55. The current definition of NBDT relies upon an entity having to have made an offer of debt securities to the public in New Zealand. The phrase “offers debt securities to the public in New Zealand” is to be interpreted consistently with the construction of the phrase “offers securities to the public” in section 3 of the Securities Act.[11]

56. Section 3 of the Securities Act provides that the phrase “offers securities to the public” must be construed to include:

    - offering the securities to any section of the public, however selected;
    - offering the securities to individual members of the public selected at random; and
    - offering the securities to a person if the person became known to the offeror as a result of any advertisement made by, or on behalf of the offeror, and that was intended or likely to result in the public seeking further information or advice about any investment opportunity or services.

57. Section 3 of the Securities Act excludes an offer of securities made to certain persons from the definition of “offer of securities to the public”. These include relatives or close business associates of the issuer, habitual investors, and persons required to pay a minimum subscription of at least $500,000.

[11] Clause 4(2), Non-bank Deposit Takers Bill.

58. Section 5 of the Securities Act also exempts certain offers from the disclosure and governance requirements of the Securities Act. However, these section 5 exemptions are not recognised by the definition of NBDT in the Bill (i.e. an exempt offer under section 5 of the Securities Act is still an “offer of debt securities to the public in New Zealand” under the Bill).

59. Many exemptions in section 5 are not relevant to the definition of NBDT (for example, the exemptions applying to offers by the Crown and local authorities). However, there are a number of exemptions in section 5 that would affect the definition of NBDT, if recognised under the Bill. Specifically:

- The exemption for offers to persons who are wealthy (a person is classed as wealthy where an independent Chartered Accountant has verified that they have either net assets of $2,000,000, or had a gross income of at least $200,000 for each of the last two financial years;) and

- The exemptions for persons who are experienced in investing money or in the industry or business to which the securities relate (a person is classed as experienced in investing money, or in the industry or business to which the securities relate where: an independent financial service provider is satisfied on reasonable grounds that as a result of this experience the person is able to assess the merit and risks of the offer, and their own information needs. The person must also sign a written acknowledgement that they will not receive the disclosures that would otherwise apply to them under the Securities Act).

60. The FMC Bill no longer uses the concept of “offers securities to the public”. Instead it uses the concept of “regulated offer”. A regulated offer is any offer of financial products that requires disclosure under the FMC Bill. An offer of securities requires disclosure under the FMC Bill if at least one of the people to whom the offer is made is not exempt under Schedule 1 of the Bill.

61. The exemptions in Schedule 1 of the FMC Bill cover many of the same types of offers that are exempt under sections 3 and 5 of the Securities Act, but the scope of the individual exemptions do not match up perfectly with the exemptions in the Securities Act. In most cases either the exact scope of the exemption and/or the threshold for qualifying for the exemption is different.

62. As noted earlier, the definition of NBDT in the Bill is likely to change from “make an offer of debt securities to the public in New Zealand” to “make a regulated offer of debt securities”.

63. However, we consider that there is a legitimate question around whether the exemptions used in the FMC Bill are appropriate for defining the scope of a prudential regime like we have for NBDTs. In particular, the exemptions in the Securities Act and FMC Bill are designed largely for offers where there is little or no information asymmetry between the issuer and potential investors, or more broadly, where potential investors are considered to be able to obtain the information they require to make an assessment of the merits of the offer without the protections afforded by securities law.

64. In a prudential regime, we consider that the focus is not primarily on information asymmetries, but on the degree of systemic risk posed by an entity, whether at a sectoral or economy-wide level. Systemic risk in this sense may be indicated by one or more criteria, including:

- The size of an entity;
- The level of interconnectedness between the entity and other parts of the economy; and
- The extent to which the entity is carrying out functions which are analogous to other entities within the regulated sector.

65. While we do not think that there are grounds for including all wholesale funded entities in the business of borrowing and lending within the definition of NBDT, we do think that certain exemptions currently in place under securities law may not be relevant to whether an entity raises systemic risks (for example, whether an entity is borrowing from a person who is wealthy, or an experienced investor).

66. We continue to support the retaining exemptions for offers made to:

- Relatives;
- Close business associates,
- Regulated financial market participants, such as registered banks, licensed insurers, managed funds, providers of discretionary investment management services, and licensed intermediary services; and
- Persons under the control of otherwise exempt persons; and
- Large entities.

67. We also continue to support exemptions for offers which are:

- Offers of financial products for no consideration;
- Small offers, as defined under schedule 1 of the FMC Bill;
- Offers by the Crown, local authorities, and certain public entities like the Bank.

68. Our concerns relate primarily to offers made to persons who are classed as wholesale investors for securities law purposes, but who may be heavily affected by the failure of an NBDT, either because of their smaller size and/or the fact that they are not subject to regulatory oversight or controls. In particular:

- Offers to persons who meet investment activity criteria or other measures of investment experience; and

- Offers with a minimum subscription of $500,000 or more.

69. Offers to these types of investor are more likely to raise systemic risks, because the failure of the issuer in these circumstances is more likely to result in the failure of investors in that issuer, and in doing so is more likely to result in a loss of confidence in the system.

70. We note that this is an issue that could also have implications for the nature of supervisory arrangements and disclosure requirements for NBDTs, given that no longer relying on the Securities Act in the definition would mean that we could no longer rely upon the securities law requirements for debt issuers to have trustees and to make securities law disclosures. Moving away from an exclusive focus on retail-funded entities could also significantly widen the definition of NBDT.

> Q8. Do you consider that relying on securities law concepts in the definition of NBDT is appropriate?
>
> Q9. Do you agree that the types of offers we have identified as raising prudential risks, despite being exempt under securities law, should be covered by the definition?

Analysis of options for changes to the definition of NBDT

71. We consider that there are three options for defining NBDTs in future. These are:

- The status quo;

- The status quo with greater use of statutory carve outs;

- Defining NBDTs as entities that carry on the business of borrowing and lending, and/or providing financial services, with greater use of statutory carve outs.

> Q10. Do you agree that we have correctly identified the high level options for the definition of NBDT? Are there any other options you consider we should be looking at?

Option One: Status quo

72. In respect of the issues we have identified, the status quo has a number of advantages. Most importantly, by retaining the link to securities law in the first limb of the definition of NBDT it would tie into a clearly defined boundary between retail and wholesale markets, and enable the regime to continue to leverage off securities law supervisory and disclosure requirements.

73. Boundary issues around the definition could also be addressed more actively through declaring entities out of the definition, given the practical difficulties associated with attempting to licence entities that are subject to few, if any, prudential requirements under the regime. This approach is currently being considered in respect of a number of entities such as funding conduits and payment facility providers.

74. The disadvantages of the status quo are twofold. Firstly, it would retain the need to make extensive use of secondary instruments like declarations and exemptions to deal with various boundary issues relating to the definition that we have identified. Secondly, retaining the link to securities law would mean continuing to recognise all of the exemptions applying under the Securities Act and FMC Bill, which, for the reasons noted earlier, we do not consider are necessarily appropriate for defining the scope of a prudential regime.

> Q11. Do you agree with our assessment of the costs and benefits of the status quo? Are there other costs and benefits of the status quo that we should be considering?

Option Two: The status quo with greater use of statutory carve outs in the legislation

75. This option would be the same as the status quo, but with a series of statutory carve outs in the definition of NBDT to deal with many of the issues that have been identified. These statutory carve outs could cover the following matters:

- Intergroup borrowing and lending: This exemption could cover cases of borrowing and lending activity within a corporate group, so long as no member of the group is engaged in the business of borrowing from, and/or lending to, any persons outside the group;

- Acting as a payment facility provider: This exemption could cover entities that are in the business of borrowing and lending, as a result of their holding funds on behalf of another person and making those funds available to that person either directly or in a specified form, such as the equivalent amount in a foreign currency;[12]

- Borrowing and lending activity with transacting shareholders: This exemption could cover borrowing and lending activity between a co-operative company and its transacting shareholders; and

[12] Note that this is not an exemption simply for entities that are not offering interest on the debt securities that they issue. Instead, it would apply to those entities that are holding the funds they borrow on behalf of investors rather than investing those funds in other business activities.

- Peer to peer lending: This exemption would cover licensed providers of peer to peer lending services under the FMC Bill, as these entities facilitate borrowing and lending activity rather than carry it out directly. They are also subject to an alternative regulatory regime under that Bill.

76. One benefit of this approach would be that it would reduce the need to expressly provide via exemptions or declarations for the treatment of entities that technically come within the definition of NBDT, but which the Bank does not have a significant regulatory interest in. It would also make the application of the regime clearer by ensuring that the legislation expressly indicated the main types of entity that the Bank was not interested in.

77. A potential cost of this approach is a lack of flexibility around defining those entities that are subject to the carve outs.[13] Also, retaining the link to securities law would mean continuing to recognise the exemptions applying under the Securities Act and FMC Bill, which, for the reasons noted earlier, we do not consider are necessary appropriate for defining the scope of a prudential regime.

> Q12. Do you agree with our assessment of the costs and benefits of this option? Are there other costs and benefits of this option that we should be considering?
>
> Q13. Do you agree with the statutory carve outs we are proposing as part of this option? Are there other statutory carve outs that we should be considering?

Option Three: Entities that carry on the business of borrowing and lending, with statutory carve outs

78. This third option is essentially the same as option two, but with it no longer being a requirement to have offered securities to the public in New Zealand (or made a regulated offer of debt securities under the FMC Bill).

79. To address the fact that an entity would no longer be required to have offered debt securities to the public in New Zealand, there would be the need to:

- Clarify what is meant by borrowing; and
- Provide additional exemptions from the definition of NBDT for certain offers that were previously exempted out of the regime as a consequence of the link to securities law.

[13] However, we note that this lack of flexibility could be addressed through a more conservative design of the statutory carve outs and/or using regulations to deem entities to be NBDTs in the rare cases where the statutory carve outs may not be appropriate.

80. With respect to the meaning of borrowing, we consider that this should normally mean issuing debt securities, although we note that there remains a need to treat certain other types of instrument, such as certain types of building society shares, as debt securities for this purpose.[14]

81. The additional exemptions that we consider would be required under this option would be:

- Offers to relatives or close business associates as defined in the FMC Bill,

- Offers to regulated financial market participants, such as registered banks, licensed insurers, managed funds, providers of discretionary investment management services, and licensed intermediary services; and

- Offers to large entities as defined in the FMC Bill (i.e. entities with net assets of over $5 million or turnover of over $5 million)

- Offers of financial products for no consideration;

- Small offers as defined in the FMC Bill; and

- Persons under the control of otherwise exempt persons.

82. We note that the practical effect of this approach would be to decouple the NBDT regime from securities law, with the consequence that it would no longer be possible to rely upon the securities law requirement for NBDTs to have a trustee or to make securities law disclosures. It would also mean that entities that were funded solely from wealthy or experience investors, or who are solely funded from minimum subscriptions over $500,000, would be covered by the definition of NBDT.

83. If the decision was made to shift towards direct supervision of NBDTs by the Bank and/or to establish a parallel disclosure regime for the NBDTs as a consequence of no longer relying upon securities law concepts in the definition of NBDT, we note that this would also require carve outs from securities law requirements for NBDTs along the lines of the carve outs currently applying to registered banks.[15]

84. A significant benefit of this approach would be that it would reduce the need to expressly provide via exemptions or declarations for the treatment of entities that technically come within the definition of NBDT, but which the Bank does not have a significant regulatory interest in. It would also make the application

[14] It may also be necessary to require certain types of non-redeemable preference shares that carry a guaranteed dividend to be treated as debt securities for these purposes. Shares that are redeemable at the option of the investor are already classed as debt securities for the purposes of the Financial Markets Conduct Bill.
[15] These carve outs mean that in respect of debt issues, registered banks are not required to have a trustee or make securities law disclosures.

of the regime clearer by ensuring that the legislation expressly indicated the main types of entity that the Bank was not interested in. Finally, and most importantly, it would also have the benefit of providing a definition of NBDT that, in the Bank's view, would more accurately identify those entities that were likely to raise systemic risks in the NBDT sector.

> Q14. Do you agree with our assessment of the costs and benefits of this option? Are there other costs and benefits of this option that we should be considering?
>
> Q15. Do you agree with the statutory carve outs we are proposing as part of this option? Are there other statutory carve outs that we should be considering?

Conclusion on the definition of NBDT

85. We consider that the existing definition of NBDT has operated reasonably well to date, but that the boundary issues around the definition can now be more effectively dealt with through the greater use of declarations removing entities from the definition of NBDT where the Bank has no regulatory interest in those entities.

86. We also consider that certain key boundaries relating to the definition should be laid out in the Act itself, in order to provide greater clarity around the focus of the regime and to reduce the need to provide for separate exemptions and declarations to deal with these issues.

87. We consider that there are problems associated with continuing to use securities law concepts in the definition of NBDT, in particular that these concepts do not, in our view, correctly identify those entities that are likely to raise systemic risks in the NBDT sector (specifically, entities making offers to persons who are exempt under securities law but are not large and/or subject to regulatory oversight).

88. However, we are conscious of the additional costs that could be created by shifting away from a connection to securities law, and the consequences this would likely have on the supervisory and disclosure requirements applying to NBDTs. For these reasons our preferred option for the definition of NBDT would be either option two (status quo with statutory carve outs) or option three (carrying on the business of borrowing and lending, and/or providing financial services, with statutory carve outs). We are currently neutral on which of these options would be preferable, and are seeking views on this issue.

> Q16. Which of the three options proposed for the definition of NBDT do you prefer? Are there other options we should be considering?

SECTION FOUR: Supervisory arrangements for NBDTs

Current supervisory arrangements for NBDT

89. Under the Securities Act, all issuers of debt securities to the public are required to have a trustee, whose role is set out in Schedule 15 of the Securities Regulations 2009, and is to:

    - exercise reasonable diligence to ascertain whether or not any breach of the terms of the deed or of the terms of the offer of the debt securities has occurred;

    - do all the things that it is empowered to do to cause any breach of those terms to be remedied (except if it is satisfied that the breach will not materially prejudice the security (if any) of the debt securities or the interests of the holders of debt securities).

    - exercise reasonable diligence to ascertain whether or not the assets of the borrowing group[16] that are or may be available, whether by way of security or otherwise, are sufficient or likely to be sufficient to discharge the amounts of the debt securities as they become due.

90. In the case of secured debt, the trustee will also hold a charge over the assets of the issuer that constitute the security. Where the issuer has defaulted on its obligations, the trustee may use this charge to realise the security. Alternatively, the trustee's claim on the security may be the grounds for the trustee placing the issuer into receivership or liquidation.

91. The duties of trustees set out in the Securities Regulations 2009 make trustees the frontline supervisors of matters that relate to the terms of the trust deed. The prudential requirements that must be contained in the trust deed are the NBDT's capital ratio, liquidity policy, and limit on related party exposures. As matters contained in the trust deed, these are the prudential requirements that are directly monitored by the trustee.

92. Trustees must also approve the risk management programme of NBDTs. Trustees are required to report to the Bank an NBDT's actual or potential insolvency or non-compliance with the terms of the trust deed, and can be made to attest that an NBDT is compliant with all of its obligations.

93. The Bank's role also includes, but is not limited to, receiving and acting on information from trustees. All obligations under Part 5D and the Bill can result in criminal sanctions for non-compliance, and the Bank is the agency responsible for bringing enforcement action.

94. Under the Bill the Bank is also the agency responsible for licensing NBDTs, making suitability assessments of actual or potential directors and senior

[16] The borrowing group is the issuer and any guaranteeing subsidiaries of the issuer. To qualify as a guaranteeing subsidiary, a subsidiary must be unconditionally liable to repay the debt securities (either jointly and severally with the issuer and other guaranteeing subsidiaries, or if the issuer fails to repay the debt securities).

officers of NBDTs, and deciding whether to approve significant changes in the ownership of individual NBDTs.

95. The current supervisory regime is unusual internationally, with its reliance upon trustees as frontline supervisors. In theory, a regime based upon the frontline supervision by trustees has the advantage of leveraging off existing arrangements that apply to NBDTs, and making use of trustees' existing knowledge of, and relationships with, NBDTs. It also allows for trustees to negotiate tailored, risk-based, requirements in trust deeds.

96. Conversely, it may add an unnecessary layer of cost into the regime if a trustees' role largely becomes simply conveying information to the regulator who then carries out the actual monitoring and enforcement role. In addition, the model may also result in a lack of clarity in industry about the respective roles of the Bank and trustees, and trustees may have an inherent conflict of interest by being paid by the entities that they are responsible for supervising.

97. However, considerations around the quality of supervision, and the conflict of interest associated with a trustee being paid by the entities that it is responsible for supervising, should both be mitigated by the licensing of trustees under the Securities Trustees and Statutory Supervisors Act 2011.

98. In making an assessment of the effectiveness of current supervisory arrangements we consider that there are two key parts to our analysis. Firstly, how effectively have the current supervisory arrangements achieved the original objectives that were expected. Secondly, how cost efficient are the current arrangements when compared to potential alternatives.

How effective have the current supervisory arrangements been in achieving their objectives?

99. The original discussion document issued in 2007 as part of the Review of Financial Products and Providers (RFPP) described the perceived benefits of trustee supervision of issuers as follows:

- Trustees have a store of regulatory know-how about the industries that they regulate (including existing risk management processes and systems). Such know-how, processes and systems are not easily transferrable to a regulatory body, and there are transitional costs of change;

- Trustees have a specialised knowledge of the businesses and risks faced by the issuers that they monitor. This knowledge allows them to be flexible in their supervision by tailoring constraints on the issuer's business appropriate to the level of risk that the issuer is exposed to;

- Trustees have developed good working relationships with issuers. Issuers trust that trustees will assist in resolving issues that they confront in a confidential and discrete manner. One consequence of this is that trustees are willing to surface issues early before they escalate into a crisis;

- Trustees have developed good working relationships with the Companies Office and Securities Commission, so that potential problems are brought to the attention of these regulators, remedial action is discussed, and regulators are kept informed. Trustees also actively consult with regulators on issues that may be difficult to resolve;

- While funded entirely by issuers, trustees have both reputational and legislative incentives/obligations to act in investors' interests and protect their investments. This inherent tension may work to deliver better market outcomes because trustees are focused on working with the issuer to get the best result for investors;

- Trustees that are commercial entities that are close to the market and are able to detect and (if necessary) act on market "noise" sooner than a regulator may be able to;

- Trustees have a demonstrated capacity to resolve difficulties quietly behind the scenes, protecting investors funds and avoiding large disruptions to the market – which in turn contributes to market confidence;

- Trustees work with issuers to ensure that issuers' products meet minimum standards before they are offered to the market, whereas a regulator is more limited in its ability to do this because of its formal enforcement role, and is therefore more likely to be limited to simply telling the issuer that it does not comply;

- Trustees can act as a collective voice for investors;

- Trustees have a long and favourable track record. There have been few notable cases of institutional failure in the last 15 years attributable to alleged inadequacies with trustees' performance.[17]

100. As was noted in the relevant Cabinet paper, most stakeholders at the time supported leveraging off existing arrangements to make trustees the frontline supervisors of NBDTs under the prudential regime. While for the reasons discussed below this might have been a higher cost option than direct supervision by the Bank, it reflected stakeholders' understanding and familiarity of trustee supervision compared to supervision by the Bank at that time.

101. In light of the expected benefits of using trustees that were identified in the original RFPP discussion document, we think that the following objectives of using trustees as frontline supervisors for NBDTs can be identified:

---

[17] See page 40 of the discussion document *Review of Financial Products and Providers: Supervision of Issuers*, September 2006, available at: http://www.med.govt.nz/business/business-law/past-work-and-older-topics/review-of-financial-products-and-providers/review-of-financial-products-and-providers-related-documents

- To benefit from trustees' existing market knowledge and relationships with issuers in the frontline supervision of NBDTs;
- To benefit from trustees' ability to identify matters at an early stage and resolve them quickly and behind the scenes;
- To benefit from trustees' work with issuers to ensure that products meet minimum standards; and
- To benefit from trustees' ability to act as a collective voice for investors.

102. We would be interested in submitters' views on the extent to which the existing regime has achieved these benefits.

Q17. Do you agree that these were the intended benefits of having trustees act as frontline supervisors under the regime? To what extent to you consider that these benefits of using trustees as frontline supervisors have eventuated?

103. More broadly, there is a question around how effectively trustees have carried out their roles as frontline supervisors and how effectively the Bank has performed its broader monitoring role in respect of the sector.

104. In this respect, we consider that the role of trustees under the regime is to:

- monitor NBDTs' compliance with the trust deed and the terms of the offer;
- identify and report to the Bank actual or potential breaches of trust deeds by NBDTs or actual or potential insolvency of NBDTs; and
- respond to actual or potential breaches of trust deeds by NBDTs, or actual or potential insolvency of NBDTs.

105. The role of the Bank under the regime is to:

- oversee the NBDT sector and the operation of the regime;
- in conjunction with trustees, monitor compliance with a small number of legislative obligations that are not referred to in NBDTs trust deeds; and
- where appropriate, take enforcement action for breaches of statutory obligations by NBDTs and trustees.

Q18. How effective do you consider that trustees have been as frontline supervisors of NBDTs?

Q19. How effective do you consider the Bank has been in its broader role in monitoring the sector?

Q20. Are there other powers that you consider trustees may require in carrying out their role?

How efficient are the current arrangements when compared to potential alternatives?

106. As well as questions around whether the current supervisory arrangements have resulted in an effective level of supervision, and the benefits that were initially anticipated, there is a separate question about how efficient the current arrangements are when compared to potential alternatives.

107. As a general principle, the Bank would not support a level of supervision that is less than that currently provided by trustees. As a result, in assessing the cost effectiveness of various options we have assumed that the level of supervision being provided under each option would be at least that which is currently provided by the existing supervisory arrangements.

108. To assist in our analysis of the cost effectiveness of various options for supervision, we would be interested in feedback on the current fees charged by trustees, the nature of the information sought by trustees from issuers, and the nature and frequency of trustees' interactions with NBDTs. We appreciate that in some cases this information will be sensitive and/or commercially confidential, and are happy to discuss these issues informally with trustees and NBDTs, where these entities may have concerns about providing a formal submission on these matters.

Q21. What fees are currently charged by trustees for their supervision of NBDTs?

Q22. What information is sought by trustees from NBDTs?

Q23. What is the nature and frequency of trustees' interactions with NBDTs?

Options for supervision of NBDTs

109. We note that in our view there are only three feasible options for the supervisory arrangements for NBDTs. These are:

- Continuation of the status quo;

- An enhanced trustee supervision model (which might provide trustees with extra powers and/or give the Bank greater control over the actions of trustees in carrying out their supervisory role); or

- Direct supervision of NBDTs by the Bank.

110. While the original RFPP discussion document proposed a two tier regime, with small entities supervised by trustees, and larger entities supervised by the Bank, we do not consider that the current composition of the industry would support this kind of two tier approach.

111. We also do not consider that there is likely to be a feasible case for any other public agency carrying out a monitoring or supervisory role in respect of NBDTs. The current structure of financial market regulatory agencies in New Zealand is a twin peaks model of separate prudential and market conduct regulators (the Bank and the Financial Markets Authority (FMA) respectively). Cabinet agreed in 2007 that prudential regulatory functions would be consolidated in the Bank,[18] and Cabinet agreed in 2010 that the FMA would not have responsibility for any aspects of prudential supervision.[19] There is no obvious reason to recommend departing from this allocation of responsibility in respect of the prudential regulation of NBDTs.

Q24. Do you agree with the three potential options we have identified? Are there other options you think we should be considering?

Option 1: The status quo

112. The status quo has the advantage of leveraging off the existing arrangements that apply to NBDTs under securities law, and we think has generally provided an adequate sense of when problems have arisen in NBDTs.

113. The status quo may also have achieved benefits by leveraging off the existing relationships between trustees and issuers, and making use of trustees' existing knowledge and expertise.

114. The costs of the status quo are the direct costs to issuers associated with appointing a trustee, and the potential indirect costs of splitting the supervision of NBDTs between trustees and the Bank.

115. We note that the introduction of licensing, and suitability assessments for directors and senior officers, may imply a more active role for the Bank in monitoring the NBDT sector than has been the case to date. This may increase the risks of a lack of clarity about the respective roles of the Bank and trustees.

Q25. Do you agree with our assessment of the costs and benefits of the status quo? Are there other costs or benefits of the status quo that we should be

[18] See the Cabinet paper *Institutional Arrangements for Prudential Regulation*, available under the heading *Arrangements for Prudential Supervision* at http://www.med.govt.nz/business/business-law/past-work-and-older-topics/review-of-financial-products-and-providers/review-of-financial-products-and-providers-related-documents

[19] See the Cabinet paper *Creating a Financial Markets Authority and Enhancing KiwiSaver Governance and Reporting* available at: http://www.med.govt.nz/business/business-law/current-business-law-work/financial-markets-authority

considering?

Option 2: An enhanced trustee supervision model

116. An alternative option would be an enhanced version of the current arrangements which provided trustees and the Bank with additional powers. For trustees, this could include stronger powers to require issuers to provide information. For the Bank these powers could include:

- the ability to direct trustees to take certain actions in respect of NBDTs (such as to require them to seek orders from the court in respect of the NBDT, or to require them to require the NBDT to provide more detailed and/or regular reports to the trustee); and/or

- the power to appoint trustees for NBDTs rather than leaving it to the individual NBDT to choose their trustee.

117. The costs and benefits of this option are largely the same as those of the status quo, except that it could run the risk of making the Bank the de facto supervisor of NBDTs but forcing the Bank to act via the trustee rather than directly. It might also decrease the level of clarity around the respective roles of the Bank and trustees.

Q26. Do you agree with our assessments of the costs and benefits of an enhanced trustee supervisory model for supervising NBDTs? Are there other costs or benefits that we should be considering?

Option 3: Direct supervision of NBDTs by the Bank

118. The third option is direct supervision of NBDTs by the Bank. This would have implications for large parts of the existing regime. Most significantly, it would require:

- that the Bank have the necessary powers to require direct reporting from NBDTs;

- that the Bank have sufficient resources to carry out the supervisory function;

- that prudential requirements be imposed directly by regulations, conditions of licences, or standards rather than (as is currently in the case in some instances) via trust deeds; and

- that licensed NBDTs be exempted from the requirement to have a trustee under the Securities Act/FMC Bill in the same way that registered banks are at present.

119. We think direct supervision is likely, but not certain, to be more cost effective, largely because the Bank does not have the commercial imperative that trustees do to make a profit on their activities. However, this assessment is also based upon our view of the likely resourcing implications for the Bank of direct supervision of NBDTs, given our experience of direct supervision of registered banks and licensed insurers.

120. We think that direct supervision is also likely to result in greater role clarity, in that it would make the Bank the sole entity responsible for monitoring the financial soundness of NBDTs, responding to breaches, and dealing with instances of distressed NBDTs. It also has the advantage of clarifying the treatment of NBDTs that are not currently required to have a trustee under the Securities Act (and FMC Bill), and reflecting the increasing responsibility of the Bank in monitoring aspects of the sector under the new licensing regime.

121. Finally, we note that this approach has the advantage of aligning with existing arrangements for prudentially regulated entities in New Zealand and overseas. This has provided the Bank with a detailed knowledge of the processes and procedures associated with supervising financial institutions.

122. The costs of this approach are the additional resourcing requirements of the Bank, the loss of trustees' existing knowledge of NBDTs and experience of supervision, and the need to manage a transition to direct supervision.

> Q27. Do you agree with our assessment of the costs and benefits of direct supervision of NBDTs by the Bank? Are there other costs or benefits that you think we should be considering?

Conclusion on supervisory arrangements for NBDTs

123. The Bank does not have a firm view on the appropriate supervisory arrangements for NBDTs. However, while the Bank is open to considering possible enhancements to the current model, we see the choice around the appropriate supervisory arrangements for NBDTs as being fundamentally between broadly the same kind of regime as at present and direct supervision of NBDTs by the Bank

> Q28. Do you think that trustees should be retained as frontline supervisors of NBDTs, or do you consider that direct supervision of NBDTs by the Bank is a better option?

SECTION FIVE: Prudential requirements for NBDTs

Current prudential requirements

124. The Bill contains a requirement that NBDTs be licensed. Amongst other things, licensing requires NBDTs to meet a number of prudential requirements which are already set under Part 5D. These prudential requirements are that NBDTs must:

- have a current credit rating;
- have at least two independent directors;
- have a risk management programme;
- maintain the minimum capital in accordance with the regulations;
- disclose their capital ratio in accordance with the regulations;
- ensure that the maximum limit on related party exposures is set in accordance with regulations; and
- comply with liquidity requirements as set in accordance with regulations.

Credit rating

125. A licensed NBDT is required to have a current rating of its creditworthiness, or, if required by regulations, the creditworthiness of its borrowing group. Credit ratings provide a simple way to inform depositors of an NBDT's risk profile, and they facilitate comparison of risks across the sector. The rating is required to be given by an agency approved by the Bank.

126. The credit rating requirement is also intended to strengthen the incentives for NBDTs to develop and maintain sound governance and risk management practices.

127. Currently NBDTs that have a borrowing group with consolidated liabilities of less than $20 million (measured as an average over a 12-month period) are exempt from the credit rating requirement.

Director independence requirements

128. Currently a licensed NBDT is required to ensure its governing body has at least two independent directors. The chairperson of the governing body is also not allowed to be an employee of the NBDT or a related party.

129. The requirements for director independence are that the director:

- is not an employee of either the NBDT or a related party; and
- is not a director of a related party; and

- does not, directly or indirectly, have a qualifying interest in more than 10 percent of the voting securities of the NBDT or a related party.

130. The requirements for director independence in the NBDT sector are consistent with the prudential regulation of the banking and insurance sectors and are in line with other relevant jurisdictions.

Risk management programme

131. The Bill requires every licensed NBDT to have a compliant risk management programme that complies with the Bill. The Bill sets out the requirements for risk management programmes, including what procedures must be covered relating to risk in credit, liquidity, the market and in operational areas.

132. The risk management programme must be submitted to the trustee for approval. Trustees can require a licensed NBDT to have its risk management programme reviewed and reported on within any reasonable time that the trustee may specify.

133. The risk management programme must:

    a. be in writing; and

    b. set out the procedures that the NBDT will use for effectively identifying and managing the following risks:

        a. credit risk;

        b. liquidity risk;

        c. market risk;

        d. operational risk; and

    c. set out appropriate documentation and record-keeping requirements; and

    d. describe the steps that the NBDT will take to ensure that the programme remains current, which must include procedures for-

        a. regular review of the programme to systematically identify deficiencies in the effectiveness of the programme; and

        b. obtaining trustee approval to amendments to the programme that are necessary to address such deficiencies; and

e. be appropriate to the operations of the NBDT, having regard to the factors relevant to the risk referred to in paragraph (b) (for example, the size of the NBDT, its funding structure, the market sector in which it operates, its business strategy, and its relationship with its borrowing group).

134. If the trustee is not satisfied that the risk management programme meets the requirements of the Bill:

- the trustee may require the NBDT to amend the programme and to resubmit the programme to the trustee for approval within any reasonable time that the trustee may specify; and

- the NBDT must amend the programme and resubmit it for trustee approval.

135. A trustee may require a licensed NBDT to have its risk management programme reviewed and reported on, in a specified manner and at the cost of the NBDT, within any reasonable time that the trustee may specify.

Capital

136. Capital represents the financial commitment of the owners to a business. It is required to absorb unexpected and unplanned losses that an entity may be exposed to. As a consequence, institutions that hold higher amounts of capital tend to be more robust than those with lesser amounts. Capital consists primarily of shareholders' equity and retained earnings. Minimum capital ratio requirements aim to ensure that deposit takers, otherwise known as NBDTs, maintain a minimum ratio of capital relative to the credit, operational and market risk that the NBDT assumes.

137. The Bill allows for regulations to be made for the purpose of imposing a requirement that licensed NBDTs and trustees ensure that trust deeds set out the minimum capital that licensed NBDTs, borrowing groups, or both are required to maintain. The regulations may also do any of the following:

- provide that the amount of minimum capital specified in trust deeds must not be less than an amount prescribed in the regulations:

- require that trust deeds define capital for the purpose of calculating the minimum capital required:

- specify a definition of capital for that purpose.

138. Every licensed NBDT must maintain minimum capital of not less than the amount prescribed by a trust deed in compliance with the regulations made.

139. The Bill allows for regulations to be made for the purpose of imposing a requirement that licensed NBDTs and trustees ensure that trust deeds include

a capital ratio, calculated in accordance with a prescribed framework, that the NBDT must maintain.

140. The Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010 (the Regulations) require every NBDT and its trustee to ensure that the trust deed includes a minimum capital ratio requirement that the NBDT must maintain. The minimum capital ratio specified in the trust deed must be at least 8 percent for NBDTs with a credit rating from an approved rating agency. For those without a credit rating from an approved rating agency, the minimum capital ratio specified in the trust deed must be at least 10 percent.

Restrictions on related party exposures

141. Related party exposure is when a financial institution advances funds to an associated organisation. Having a cap on exposure to related parties limits the scope and ability of owners, and their related interests, to extract benefits from the NBDT. This assists to ensure that the minimum capital requirements are not undermined by owners borrowing back their capital investment.

142. Relationships with related parties are potentially open to abuse especially if the related party is accorded preferential treatment. This could take the form of exposures where related parties extract benefits from the relationship that would not otherwise be available, or offered, if there was no connection in the first place. Moreover, there may be a tendency on the part of the deposit taker to be less rigorous or robust in terms of credit decisions and monitoring in such situations. One of the main policy concerns is that such behaviour could lead to an erosion of the NBDT’s capital base and undermine public confidence.

143. The Bill empowers the making of regulations for the purpose of imposing a requirement on licensed NBDTs and trustees to ensure that trust deeds include a maximum limit on exposures to related parties.

144. Regulations made for restrictions on related party exposures may do any of the following:

    a. provide that the maximum limit on exposures to related parties is relative to

        i. the capital of an individual licensed NBDT; or

        ii. the capital of the borrowing group of which a licensed NBDT is part;

    b. provide that the maximum limit on exposures to related parties applies in respect of the exposures of individual licensed NBDTs or any borrowing group of which a licensed NBDT is part;

    c. require every licensed NBDT and trustee to ensure that trust deeds include a specified maximum limit on exposures to related parties;

d. require every licensed NBDT and trustee to ensure that trust deeds include a maximum limit on exposures to related parties that is fixed by agreement between the licensed NBDT and trustee.

145. The Regulations require a limit on aggregate credit exposures of the NBDT, or the borrowing group, to all related parties to be specified in the trust deed. The regulations state that related party exposures should not exceed a maximum limit of 15 percent of capital. The regulations also expand the definition of related parties.

Liquidity requirements

146. The Bill allows for regulations to be made relating to liquidity requirements for NBDTs. The regulations may prescribe one or more of the following:

- assets that qualify as liquid assets for the purposes of the regulations;
- minimum amounts of liquid assets relative to liabilities that must be maintained by licensed NBDTs;
- requirements concerning matching maturity of assets and liabilities;
- requirements in respect of a licensed NBDT that require the liquidity of the borrowing group of which it is part to be taken into account;
- other measures relating to liquidity management, including the management of stress situations.

147. The regulations require every NBDT and its trustee to ensure that the NBDT's trust deed includes one or more quantitative liquidity requirements that are appropriate to the characteristics of the NBDT's business, and that take into account the liquidity of the NBDT and the liquidity of any borrowing group.

Q29. How have you found the prudential requirements have worked to date?

Q30. Do you think the prudential requirements are appropriate for the NBDT sector?

Q31. Are there any prudential requirements that you consider should be added, removed, or amended?

Mechanism for setting prudential requirements

148. At present prudential requirements are set through a range of different mechanisms. Specifically:

- directly in the Act (in the case of requirements relating to governance and risk management programmes);

- directly through regulations (in the case of credit rating requirements); and
- through a combination of regulations and the NBDTs' trust deed (in the case of capital, liquidity and related party exposure requirements).

149. We think that there is a good case for considering further whether we are using the most efficient mechanism for setting prudential standards.

150. In this respect, we note that while most legal requirements are set via the standard process for making primary or secondary legislation (i.e. Acts and regulations), there are many examples of bespoke processes for setting legally binding requirements in areas where such rule setting is highly technical or specialist (for example, the setting of accounting standards by the External Reporting Board).

151. In addition, the NBDT regime is also an outlier in some respects in using regulations to set detailed capital and related party exposure requirements. Such matters are set via conditions of registration for registered banks, and many analogous requirements for licensed insurers (e.g. solvency requirements) are set via conditions of licences or standards set by the Bank under the Insurance (Prudential Supervision) Act 2010 (IPSA). Generally, conditions of licences or other broadly analogous instruments are used to set these kinds of standards in other countries as well.

152. We think that a strong case can be made that the setting of capital, liquidity and related party exposure requirements is of a sufficiently technical and specialist nature to also justify establishing a bespoke process for the setting of those requirements. The case for establishing a bespoke process for the setting of other prudential standards relating to credit ratings, governance requirements and risk management programmes, may however be weaker, as these requirements are of a significantly less technical and specialist nature.

153. With the advent of NBDT licensing, there is the option of potentially setting some or all prudential requirements through conditions of licences. Using conditions of licences to set prudential requirements does result in the loss of the third party oversight provided by the normal processes for making Acts and regulations. However, we think that this can be addressed through the existing requirements in the Bill and in IPSA which require the following when the Bank proposes to add or amend a condition of a licence:

    - that the Bank provide notice of its intention to make the change, and that the notice explains the Bank's reasons for making the change; and
    - that affected entities have the opportunity to make submissions to the Bank on the proposed changes.

154. Alternatively, these requirements could be set by way of standards made by the Bank in a similar way to the solvency and fit and proper standards under the IPSA. These standards are made by the Bank and come into force after their

notification in the New Zealand Gazette. The standards must be tabled in Parliament and can be disallowed by Parliament in certain circumstances.[20] This allows for a greater degree of accountability in making these standards than would otherwise be the case, while still providing the benefits of speed and flexibility.

155. We note that using conditions of licences or standards to set prudential requirements may mean that it is necessary for compliance with those conditions or standards to be monitored directly by the Bank. Alternately, the conditions or standards could require that certain matters be included in trust deeds, which could then be monitored by trustees.

156. We note that the Bank is currently consulting on macro-prudential tools for use in the banking sector.[21] While the setting of prudential standards by conditions or standards makes it easier to adopt macro-prudential tools of this nature, the Bank has no intention to provide for these kinds of tools in the NBDT sector at this time.

Q32. Do you agree that it would be preferable to set capital, liquidity and related party exposure requirements via conditions of licences or standards rather than regulations? Are there other costs or benefits of this option that you think we should be considering?

Q33. Do you think that the other prudential requirements should be set via conditions of licences or standards, or by regulations?

SECTION SIX: Disclosure requirements for NBDTs

Status quo

Background

157. Neither Part 5D or the Bill contain provisions for setting general disclosure requirements for NBDTs. When Part 5D was originally developed, the intention was that disclosures relating to prudential matters would be integrated into the disclosures that NBDTs are required to make under securities law.

158. In 2011, the Bank and the Ministry of Economic Development (now part of the Ministry of Business, Innovation and Employment (MBIE)) consulted on a proposal to include disclosures of prudential matters within the disclosures required under the Securities Act. Submissions received on this proposal raised a number of useful issues in relation to the specifics of the proposal. However, this work has not been progressed due to the pressures of other priorities in the interim.

[20] The Regulations (Disallowance) Act 1989 (which will shortly be superseded by sections 37-47 of the Legislation Act 2012) sets out how the Parliamentary disallowance process works.
[21] See the discussion document *Macro-Prudential Policy Instruments and Framework for New Zealand* available at: http://www.rbnz.govt.nz/finstab/macro-prudential/5166933.pdf

Disclosure requirements under the Securities Act

159. The Securities Act provides for disclosure to potential investors in the form of a prospectus and an investment statement. In general, where an offer of securities is made to the public, a prospectus must be registered and provided to potential subscribers on request, while an investment statement must be provided to the investor before subscribing for the security.

160. The prospectus is the document where all disclosures about an NBDT must be included in full. The disclosures required in the prospectus are a mix of financial and general disclosures. Disclosures within the document can be valid for six, nine or 18 months depending on the type of financial statements referred to in the prospectus. In practice, an issuer is likely to reissue its prospectus after 12 to 15 months based on the following year's annual financial statements when they become available. At any time over the life of the prospectus, if the disclosure becomes false or misleading, the prospectus must be updated.

161. The prospectus, and any updates to it, must be registered with the Registrar of Companies. Prospectuses are therefore available from the Companies' Office website. The FMA may review a prospectus during a post-registration review period, adopting a risk-based approach to selecting those it reviews.

162. The investment statement is designed to provide a more accessible set of disclosures relating to the offer for "prudent, non-expert investors". Amongst other things, it is intended to highlight the risks and returns associated with the offer. As part of making risk related disclosures in an investment statement, NBDTs generally note operational, credit, liquidity and market risks.

163. The FMA may prohibit the distribution of an investment statement if it is likely to deceive, mislead or confuse with regard to any particular that is material to the offer of securities to which it relates or is inconsistent with any registered prospectus referred to in it, or does not comply with the securities law.

Financial Markets Conduct Bill

164. The FMC Bill will shortly replace the Securities Act. A similar obligation to disclose all material matters relating to the offer is contained in the FMC Bill.

165. Late last year, MBIE issued a discussion document setting out detailed requirements on the timing, form and content of initial and on-going disclosure under the FMC Bill for financial products, including debt securities. It is anticipated that the FMC Bill and related regulations will be in force by mid-2014, with a transitional period to follow.

166. The FMC Bill provides that a person must not make a regulated offer of financial products unless the issuer of the products has prepared a product disclosure statement (PDS) for the offer, and supplied to the Registrar the information and documents required for a register entry for the product. The PDS and register of offers replace investment statements and prospectuses in

the Securities Act. A high degree of tailoring of requirements for different kinds of financial products is anticipated.

167. The PDS is intended to be short and standardised in content and presentation. The intention is to enable comparability between similar products and offers, while ensuring that the most relevant information is provided to investors. Other material information must be disclosed in the offer register.

168. The PDS would usually be divided into two parts:

- a key information summary of around one to two pages that summarises the key features of the investment and risks associated with it.

- a more detailed description of information that is essential to an investor's decision.

169. The approach for the PDS for debt securities is to seek to standardise disclosure to maximise comparability and ensure that disclosure is clear, concise and effective. The financial information in the prospectus is likely to include minimum requirements in respect of some of the prudential matters contained in the trust deeds of NBDTs.

170. The offer register will contain the PDS, other information and documents specified by regulations, and all other material information relating to the offer. The information and documents specified by regulations are likely to be material that is either too technical or of not high enough importance to be in the PDS. For example:

- the trust deed for a debt product;

- financial statements and financial information or links to them, along with the relevant auditors' reports; and

- any consents and certificates from the directors required by regulations.

171. Unlisted debt issuers would also be required to disclose on an on-going basis particular changes or events that affect the credit risk associated with the borrower and the debt securities, and therefore the value of the debt security. These changes or events may include:

- changes to the issuers' credit rating;

- changes to guarantors of the issuer; and

- significant changes to the terms of the trust deed.

172. Listed debt issuers would be subject to the continuous disclosure, and so would be exempt from these specific requirements.

Issues identified with existing disclosure requirements for NBDTs

173. At present, the information contained in the prospectus and investment statement does not expressly deal with disclosures relating to an NBDT's compliance with prudential requirements. However, the credit ratings of NBDTs will be disclosed on the public register of NBDTs that the Bank is required to maintain under the Bill.

174. The current lack of on-going disclosure requirements of prudential matters (other than credit ratings under the Bill) represents a potential gap in the NBDT regime. In particular:

- Although investment statements and prospectuses are readily available, information in relation to prudential requirements imposed on the NBDT may not be easily accessible and may be costly to locate.

- Assessing the risk of a deposit in an NBDT involves assimilating and understanding potentially complex information relating to such matters as capital and liquidity. Even if comprehensive and timely financial statements are included in a prospectus, it is unlikely that retail depositors would always have the skills or knowledge needed to identify and evaluate relevant financial data to test compliance with prudential requirements.

- Information on an NBDT's compliance with prudential requirements contained in prospectuses and investment statements is not sufficiently standardised and simple.

175. While these issues may be addressed by the implementation of the disclosure regime in the FMC Bill, and there may be other benefits to leveraging off securities law disclosure requirements, adopting a separate disclosure regime similar to the disclosure regime for registered banks is an alternative option.

The disclosure statement regime for registered banks

176. Section 81 of the Act enables the Bank to recommend information or data to the Governor-General that must be published by any class of registered banks in the manner and with the frequency it specifies. The disclosure requirements for registered banks are made by Orders in Council (the Order).

177. All registered banks are required to publish a disclosure statement every quarter. The content of the disclosure statement required by the Order varies according to whether it covers the full-year accounting period, the half-year accounting period, or one of the first and third quarters of a bank's financial year.

178. A major part of a bank's disclosure statement is taken up with the bank's financial statements prepared in accordance with generally accepted accounting practice. It also contains matters not covered in financial statements, such as credit rating, tier 1 and total capital ratios calculated in accordance with bank minimum capital adequacy requirements, information on

guarantees of the bank's obligations, and the conditions of registration that the Bank has imposed on the bank.

179. A bank's disclosure statement is required to contain certain statements signed by each director of the bank. These must state, among other things, whether the bank has systems in place to monitor and control adequately the banking group's material risks and whether those systems are being properly applied, and whether the bank has complied with its conditions of registration over the period covered by the disclosure statement.

180. A bank must make its disclosure statements readily accessible on its website. A bank must also provide copies of its disclosure statements in printed or other appropriate form, within two working days of receiving a request for copies. Banks must provide copies of their disclosure statement free of charge.

181. To avoid unnecessary duplication of disclosure requirements registered banks are also exempt from most of the disclosure requirements in the Securities Act in respect of offers of simple debt securities.[22] A similar, but slightly broader, set of exemptions from disclosure requirements is carried over into the FMC Bill.[23]

182. A fundamental aspect of this regime is that it is designed to provide on-going disclosures relating to the financial soundness of registered banks, whereas securities law disclosures are primarily designed to provide information about specific offers of securities. The regime also places more emphasis on the disclosure as a form of market discipline, whereas securities law disclosure is more focused on addressing information asymmetries between issuers and investors arising out of specific offers of securities.

Alternative options for disclosure requirements for NBDTs

183. The options considered are:

1. the status quo with no tailored prudential disclosures;

2. integrating prudential disclosures into the disclosures NBDTs are required to make under securities law; or

3. providing a separate disclosure regime for NBDTs (as is the case for banks) which would require a similar set of exemptions from securities law disclosure requirements as currently applied to banks.

Option 1: The status quo with no tailored prudential disclosures

184. This option has the benefit of avoiding compliance costs associated with disclosing additional information to the public. It could be argued that awareness that an NBDT is prudentially regulated may in itself be sufficient

[22] Sections 5 (2B) and 5(2D), Securities Act 1978.
[23] Clause 20, Schedule 1, Financial Markets Conduct Bill

information for investors since all NBDTs must be licensed under the Bill and must meet prudential requirements on an on-going basis.

185. However, being subject to a prudential regime does not mean that all risk of an entity failing is eliminated. Also, NBDTs will be subject to varying degrees of risk due to the nature of their business and how easily they comply with prudential standards. As a result, disclosure of prudential matters may still play a valuable role in informing investors of the relative risk of different NBDTs, and in imposing additional market disciplines on NBDTs.

Q34. Do you agree with the costs and benefits of this option that we have identified? Are there other costs or benefits that we should be considering?

Option 2: Integrating prudential disclosures into the disclosures NBDTs are currently required to make under securities law

186. Option Two has the advantage of aligning to an extent with the proposed disclosures that will be required under the FMC Bill. These proposed FMC Bill disclosures contemplate prescriptive point of sale and on-going disclosure requirements for debt securities that would address many of the existing disclosure gaps we have identified (i.e. the current lack of prescribed disclosures about prudential matters).

187. With some exemptions, this option also has the benefit of consolidating a comprehensive set of comparable information about different offers of financial products available to retail investors.

188. The potential costs of this option are that:

- the prudential disclosures in the FMC Bill may not fully reflect the nature of the underlying prudential requirements that they are based on; and
- it leaves responsibility for the NBDT prudential regime, and NBDT disclosure issues, in separate government agencies, which may make it harder to co-ordinate the relationships between the prudential and disclosure regimes applying to NBDTs.

Q35. Do you agree with the costs and benefits of this option that we have identified? Are there other costs or benefits that we should be considering?

Option 3: A standalone disclosure regime for NBDTs based on the current disclosure statement regime for banks

189. This option would provide a separate disclosure regime for NBDTs as is the case for registered banks. This would enable the Bank to have control over the disclosure requirements of all persons involved in carrying on the business of

borrowing and lending money, and would not leave open the possibility of inconsistent approaches being adopted for different forms of deposit-taking institutions (i.e. banks and NBDTs).

190. The Bank would have control over the content, frequency and timing of on-going information to be disclosed by NBDTs. This would provide a more flexible approach in disclosure regulation where policy changes to the prudential regime could be more easily integrated into the disclosure requirements applying to NBDTs.

191. A separate disclosure regime may also be a necessary consequence of no longer hooking into the existing securities law concepts of “offer to the public” and “regulated offer” in the definition of NBDT. Without a separate disclosure regime, those NBDTs that are making offers that are not covered by securities law, would not be required to make any disclosures at all. This would mean that they would not necessarily be subject to the same market disciplines as other NBDTs, and it would make it harder for investors and analysts to compare the financial soundness of different NBDTs.

192. We note that the compliance cost associated with complying with a bank-like disclosure regime may not be materially different from complying with securities law disclosure requirements.

Q36. Do you agree with the costs and benefits of this option that we have identified? Are there other costs or benefits that we should be considering?

Conclusion on the disclosure regime for NBDTs

193. We think that there is a case for an NBDT to make public disclosures about prudential matters, due to the market disciplines this provides. However, we currently have no set view on which of options two and three would be preferable, and would welcome submitters’ views on this issue. However, should the definition of NBDT no longer rely on securities law concepts, we consider that the establishment of a separate disclosure regime for NBDTs would likely be appropriate.

Q37. Do you consider that a separate disclosure regime for NBDTs would be appropriate, or should prudential disclosures for NBDTs be integrated into the disclosures required under securities law?

SECTION SEVEN: Crisis management powers

Current crisis management powers

194. The Bill provides for the Bank to have powers to direct NBDTs to take certain action in the case of:

- an NBDT or associated person who is unable, or likely to be unable, to pay their debts as they become due in the ordinary course of business;

- an NBDT, an associated person, or any director or senior officer of the NBDT or any associated person who is failing, has failed, or is likely to fail, to comply with the Bill, related regulations, conditions of their licence or securities law requirements; or

- the circumstances of the NBDT or any associated person, or the manner in which the affairs of the NBDT or associated person are being conducted, are prejudicial to the solvency of the NBDT or its ability to comply with the matters in the preceding bullet point.

195. The direction may require the NBDT to do any of the following:

- consult with the Bank, at the times and in the manner specified by the Bank, about the circumstances of the NBDT or any associated person, or about the methods of resolving any financial or other difficulties facing the NBDT or any associated person;

- take any specified action to address any circumstances of financial or other difficulties of the NBDT or any associated person;

- take, or refrain from taking, any specified action to address a failure, or potential failure, by the NBDT or any associated person to comply with the Bill, related regulations, conditions of their licence or securities law requirements;

- ensure that any senior officer or other employee of the NBDT ceases to take part in the management or conduct of the NBDT's business, except with the permission of the Bank and so far as that permission extends;

- suspend or cease carrying on any part of its business;

- carry on its business, or any part of its business, in accordance with the direction; or

- replace its auditors with an auditor approved by the Bank (in which case the NBDT has the power to give effect to the direction despite any enactment, rule of law, or governing document of the NBDT).

196. There is no tailored statutory management regime available for NBDTs under the Bill, which is an issue that the Bank has previously noted that it would consider in the context of the review.[24] However, we note that NBDTs continue to be subject to the statutory management regime applying to all corporations under the Corporations (Investigations and Management) Act 1989 (CIMA).

[24] See paragraph 40 of the 2011 Cabinet paper *Regulation of Non-bank Deposit Takers* at http://www.rbnz.govt.nz/finstab/nbdt/4448840.html .

Under CIMA an entity may only be placed into statutory management by the Governor-General acting in accordance with the advice of the Minister of Commerce given in accordance with a recommendation of the FMA.

Issues identified with the crisis management powers in the Bill

197. We think that there is a potential gap in the existing crisis management powers available to the Bank as a result of the lack of a tailored statutory management regime for NBDTs.

198. The statutory management regimes in CIMA, in the Reserve Bank of New Zealand Act for registered banks, and in IPSA for licensed insurers, are all based on broadly the same model, albeit with some technical differences in the regimes reflecting the different types of entity that they apply to.

199. In summary, this regime involves appointing an independent person to manage the affairs of an entity and giving that person broad ranging powers under legislation to resolve the affairs of that entity. The key features of this regime are that:

- an entity may be placed into statutory management where it is insolvent or likely to become insolvent, being operated in a fraudulent manner, or being operated in a way that is prejudicial to the interests of its creditors, members or beneficiaries;

- the statutory manager is appointed by the Governor-General on the advice of the relevant Minister given in accordance with a recommendation of the relevant regulatory agency;

- with some very minor exceptions, a moratorium is placed on all of the pre-statutory management legal obligations of the entity for the duration of the statutory management (i.e. these claims cannot be enforced during that time);

- the statutory manager is given exclusive powers to manage the entity (including all of the powers that could be exercised by its directors, management, and shareholders or members);

- the statutory manager may suspend payment of pre-statutory management creditors in whole or in part, or pay these creditors in whole or in part; and

- subject to some minor restrictions, the statutory manager may sell any or all of the business undertaking of the entity, place the entity into liquidation, or shift some or all of the business of the entity to a new company established for the purpose of holding that business.

200. The statutory management regimes for banks and insurers also provide a broader range of circumstances for placing an entity into statutory management (for example, a bank can be placed into statutory management when its affairs

are being carried on in a manner that is prejudicial to the soundness of the financial system). The Bank also has the power to direct the statutory manager of a bank.

201. In the context of registered banks and licensed insurers, direction powers and a statutory management regime are the basic legislative options that are available for managing an entity that has failed, or is about to fail.

202. The original decision to not provide for a tailored statutory management regime for NBDTs was based upon the fact that NBDTs are less systemically important than banks, and therefore a more hands-off approach is appropriate for regulating them in certain respects. It was also considered that the failure of an NBDT could normally be adequately dealt with through normal insolvency procedures such as receivership and liquidation, or under the statutory management regime provided for in CIMA.

203. However, we think there may be a case for revising this decision to provide for a tailored statutory management regime that can be initiated by the Bank. This would ensure that the Bank has the full range of options available to deal with the failure of an NBDT. In particular, at present receivership or liquidation may not always be the best resolution options for a distressed NBDT where it raises systemic risks, or the nature of its affairs are unclear.

204. There are a number of benefits associated with having statutory management available as an option. For example, once an entity has failed, statutory management is the only failure resolution option that allows for a regulator to exercise some legal oversight over the resolution of the failure, given that the other options of liquidation, receivership, voluntary administration, or some kind of moratorium arrangement, are all private resolution options, which a public regulatory agency is unable to directly influence once they have been agreed by the relevant parties.

205. Statutory management also provides for a moratorium on creditors' claims, which is not available in a liquidation. This provides for more flexibility managing the orderly reconstruction or winding down of an NBDT where it raises systemic risks and/or its affairs are in an unclear state. In particular, this flexibility can be important in minimising the adverse impacts of an NBDTs failure on its creditors and the broader NBDT and financial sectors.

206. However, while we see the absence of a statutory management regime as a gap in the broader prudential regime for NBDTs, we do not anticipate that it would be used except in exceptional cases. These cases might include where the NBDT raised a systemic risk, or where the nature of the NBDT's affairs raised serious questions about potential wrong doing by the NBDT's directors or senior officers. In the case of an ordinary business failure by an NBDT, we would expect that ordinary failure resolution mechanisms like receivership or liquidation would continue to be appropriate. We note that the threshold for placing an NBDT into statutory management would also have to reflect this approach.

Q38. Do you agree that a tailored statutory management regime for NBDTs should be provided for in legislation?

SECTION EIGHT: Offences and penalties

Current offences and penalties under the NBDT regime

207. Currently Part 5D of the Act and the Bill rely solely on criminal penalties to deal with regulatory non-compliance. There are a range of levels at which criminal penalties are set to reflect the relative seriousness of different breaches. Clauses 63 – 67 of the Bill deal with the offence provisions and set four levels of penalty.

208. The exclusive use of criminal penalties is consistent with the prudential regime for other industries the Bank supervises, with the exception of the AML regime. However, we think there is merit in considering alternative penalty options. In this respect, we note that there are other regulatory regimes that make use of a broader array of penalties which may more accurately reflect the wrongdoing.

Definitions of levels of penalties

209. The Bill contains four levels of penalty that apply to offences committed by NBDT, their directors and trustees. These broadly reflect the existing offences under Part 5D and are set at the following levels:

    1. A level 4 penalty for conviction for an offence against this Act is,—

        a. in the case of an individual, imprisonment for a term not exceeding 18 months, a fine not exceeding $200,000, or both; and

        b. in any other case, a fine not exceeding $2 million.

    2. A level 3 penalty for conviction for an offence against this Act is,—

        a. in the case of an individual, imprisonment for a term not exceeding 12 months, a fine not exceeding $100,000, or both; and

        b. in any other case, a fine not exceeding $1 million.

    3. A level 2 penalty for conviction for an offence against this Act is,—

        a. in the case of an individual, imprisonment for a term not exceeding three months, a fine not exceeding $50,000, or both; and

        b. in any other case, a fine not exceeding $500,000.

4. A level 1 penalty for conviction for an offence against this Act is a fine not exceeding $200,000.

Potential issues with the current offence and penalty regime

210. Given the broad array of offences under the Bill there is a question as to whether criminal liability is always the most appropriate penalty for breaches. An example of an alternative liability regime is the FMC Bill. The FMC Bill includes an array of remedies for contravention of compliance, including:

- infringement notices for minor compliance contraventions;
- civil liability for issuers, directors and other people involved in the contraventions of the Bill in the form of civil pecuniary penalties, as well as compensation orders;
- criminal liability which is available for the more serious contraventions.

Should the regulation of NBDTs make use of civil and administrative penalties?

211. A regulatory regime that provides for a wide range of sanctions allows for penalties to be proportionate to the severity of the breach. If a regulator can only access criminal sanctions then it may be less likely to take prosecutions as frequently, which would encourage the regulated community to consider the risk of being caught and punished to be lower, in turn reducing the effect of the regulatory regime.

212. Criminal penalties may also be disproportionate to the offence both in terms of the impact of the penalty on the offender and the cost to the regulator. Some contraventions, while requiring some form of sanction to maintain the integrity of the regulatory regime, may not be so serious as to justify criminalisation. Civil pecuniary penalties are likely to offer a more balanced response to contraventions that involve no moral culpability.

213. The Law Commission recently consulted on the benefits and difficulties associated with civil pecuniary penalty regimes. Given the review, it is timely to consider the use and availability of such penalties within legislation. Civil pecuniary penalties are monetary penalties that are enforced through non-criminal process. They share a number of common characteristics including:

- they are imposed by the High Court following a civil trial according to the rules of civil procedure and evidence;
- liability is established on the civil standard of proof – that is, the balance of probabilities;
- they involve very substantial maximum financial penalties;

- payment of the penalty is enforced in the civil courts, as a debt due to the Crown;

- neither imprisonment nor criminal conviction can result.

214. The Law Commission's report did not discuss other types of civil penalty, such as:

- administrative penalties;

- infringement notices; and

- management bans.

215. When considering the principles underpinning the penalty regime we consider that the regime should:

- promote compliance with the law and deter conduct that undermines the purposes of the Bill;

- provide a swift and effective response to breaches of the Bill's requirements; and

- be proportionate and not be so strict as to deter conduct that benefits society.

216. "Responsive regulation"[25] holds that regulatory compliance is most likely to be secured where the requirements of the regulatory regime are enforced using a range of sanctions. It assumes that those who are regulated will undertake a cost-benefit analysis approach to their decisions about compliance. A hierarchy of sanctions is thought to work best where the pyramid has enough tiers to be representative of the cost-benefit trade-off and comprises a flexible range of sanctions to counteract the range of factors that might motivate someone to fail to comply. Civil pecuniary penalties are identified as attractive because of their flexibility and because they provide an incentive rather than acting as a strict deterrent.

217. The use of a hierarchy of penalties allows for a more proportionate response to non-compliance.

Systemic importance of NBDTs and level of penalties

218. As discussed earlier in this paper, there is a question around whether NBDTs are likely to raise systemic risks to the financial sector. The doubt in this area stems from the fact that these entities are of a sufficiently small size that the failure of an entity in this sector is unlikely to have an impact on the financial sector as a whole.

---

[25] I Ayres and J Braithwaite *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, New York, 1992).

219. If it is accepted that individual NBDTs are unlikely to raise systemic risks to the financial sector as a whole, there remains a question as to the type and level of penalty that should be imposed on entities within this sector that breach the requirements.

Level of the penalties

220. IPSA makes exclusive use of criminal penalties, though the penalties are generally at slightly lower levels than the Act. This is partly to do with the differing objectives of IPSA to Part 5 and Part 5D of the Act, with IPSA focusing on systemic risks to the insurance sector rather than the financial sector as a whole.

221. If the objectives of the NBDT regime were changed to a focus solely or partially on systemic risks to the NBDT sector, rather than the financial system as a whole, it may be appropriate to consider an alignment in the penalty levels with IPSA rather than the Act.

Q39. How do you think the current offence and penalty regime has worked?

Q40. Do you think a hierarchy of penalties, where there is a more proportionate response to the breach, would be more appropriate?

Q41. Would the use of infringement notices be a better way of ensuring compliance with certain lower level requirements?

Q42. Would the use of civil pecuniary penalties provide for a more proportionate response to some breaches where a conviction may outweigh the wrongdoing?

Q43. Should the level of penalties reflect whether the regime focuses on systemic risk to the NBDT sector or systemic risk to the financial system?

SECTION NINE: Other matters

222. In addition to the other matters canvassed in this discussion document, the Bill also provides for a number of new aspects of the regime. The most significant of these are:

- the process for granting a licence, imposing conditions on a licence and cancelling a licence;
- the process for assessing whether actual or potential directors and senior officers of NBDTs are suitable to carry out their roles; and
- the requirement for changes in ownership in NBDTs to be approved by the Bank.

The process for granting a licence, imposing conditions on a licence and cancelling a licence

223. A licence may be granted under the Bill where:

- the Bank is satisfied that the applicant, if licensed, would be able to comply, on an on-going basis, with the Bill, regulations made under the Bill and any proposed conditions on their licence; and

- the Bank has received a suitability notice for each actual or potential director or senior officer, and the Bank has issued a non-objection notice in respect of any actual or potential director or senior officer who raises suitability concerns.

224. In deciding whether or not to grant a licence, the Bank must also have regard to a range of other matters including the appropriateness of the applicant's ownership structure, and the applicant's ability to comply on an on-going basis with the requirements imposed by securities law and the AML/CFT Act.

225. The Bank may impose conditions on licences relating to a range of matters including the incorporation and ownership structure of the NBDT, prudential obligations such as capital ratios applying to the NBDT, and the credit exposure concentration and other risk exposures of the NBDT.

226. The Bank may add, remove, or amend conditions of licences, subject to the requirements to give affected NBDTs an opportunity to make submissions to the Bank, and the Bank providing at least seven days' notice of the changes, and reasons for the changes in writing.

227. In the most serious cases, the Bank may also remove licences where it is satisfied of one or more matters, including that the NBDT has failed to comply with the Bill, regulations made under the Bill, and any conditions of its licence, or that the Bank is satisfied that the NBDT has failed to comply with the terms of its trust deed.

228. The Bank may only cancel a licence when it has provided the NBDT with its reasons in writing and given the NBDT at least 10 days notice in which to raise objections with the Bank regarding the cancellation of its licence.

Q44. Do you have any views on the provisions in the Bill dealing with the issue and cancellation of licences and the Bank's ability to impose conditions of licences?

The process for assessing whether actual or potential directors and senior officers of NBDTs are suitable to carry out their roles

229. Clause 12(2) of the Bill provides that an application for a person to be licensed as an NBDT must be accompanied by a suitability notice for each director and senior officer, or proposed director or senior officer, of the applicant.

230. A suitability notice is designed to indicate whether the director or senior officer, or proposed director or senior officer, raises any suitability concerns prescribed by regulations made under the Act. In summary, these suitability concerns will cover circumstances where the person:

- has been bankrupt or subject to insolvency related proceedings;
- has been a director or senior officer of, or otherwise exercised a significant influence over, an at-risk, deteriorating or dissolved entity;
- has a criminal record or is subject to an unresolved criminal prosecution for which a conviction may be entered;
- has been involved in professional or occupational malpractice;
- has been involved in regulatory non-compliance by a market participant;
- has a conflict of interest or potential conflict of interest.

231. Clause 14 of the Bill sets out the required content of suitability notices. In particular:

- A suitability notice must certify that a named director or senior officer, or proposed director or senior officer, of an NBDT does not raise any suitability concerns, or does raise one or more suitability concerns.
- If a suitability notice states that the person named in it raises one or more suitability concerns, the notice must also identify the relevant suitability concern or concerns and include any other information required by the Bank to be included in such notices.
- Every suitability notice must be signed:
  - o if the person named is a director or proposed director of the NBDT, by the person himself or herself; and
  - o if the person named is a senior officer or proposed senior officer of the NBDT, by two directors of the NBDT.

232. On receipt of a suitability notice, or where the Bank becomes aware by other means that a person may raise a suitability concern, the Bank may make whatever inquiries it thinks fit to assist in determining whether the person is

unsuitable to act as a director or senior officer of the NBDT. This may include asking the person, or any other person, to supply information or respond to queries.

233. Where a suitability notice does raise one or more suitability concerns, or the Bank becomes aware through other means that a person may raise suitability concerns, the Bank must not issue a licence to the applicant unless, or until, it issues a notice of non-objection in respect of the person. The Bank may only issue a notice of non-objection in respect of the person if, after making inquiries, the Bank is satisfied that the person is not unsuitable to be a director or senior officer of the NBDT. Where the Bank is not satisfied of this, it will notify the applicant that a licence will not be granted to the applicant if the person named in the suitability notice becomes or remains a director or senior officer of the applicant.

234. However, where a suitability notice states that the person does not raise any suitability concerns, the Bank is entitled to rely upon the notice in determining whether the person is unsuitable to be a director or officer of the NBDT. In that event, the Bank may grant a licence to the applicant without needing to issue a notice of non-objection in respect of any actual or potential director or senior officer of the applicant who does not raise suitability concerns.

Q45. Do you have any views on the operation of the suitability assessment process in the Bill at present?

The requirement for changes in ownership in NBDTs to be approved by the Bank

235. The Bill also provides that a person must obtain the written consent of the Bank before giving effect to a transaction that will have the effect of giving a person a level of influence over the NBDT that will provide them with:

- the ability, directly or indirectly, to appoint 25 percent or more of the members of the governing body of the NBDT; or
- a direct or indirect qualifying interest in 20 percent or more of the voting securities issued or allotted by the NBDT.[26]

236. The consent of the Bank is also required in the following circumstances:

[26] A qualifying interest is any of the following:
a) A legal or beneficial ownership of the security;
b) The power to exercise, or control the exercise of, any voting rights attaching to the security;
c) The power to acquire or dispose of the security;
d) The power to control the acquisition or disposition of the security by another person;
e) The powers referred to in points b) to d) under, or by virtue of, any trust, agreement, arrangement, or understanding relating to the security.

- where a person, with the consent of the Bank, already has at least the level of influence described above, an increase in the person's level of influence beyond the level permitted in the existing consent; or

- where a person has at least the level of influence over an NBDT described above at the time the NBDT was licensed, an increase in the person's level of influence beyond the level existing at that time.

237. The Bank has the power to impose terms and conditions on its consent, including specifying the level of influence that a person may have or acquire over a licensed NBDT without the need for further consent.

238. While failure to obtain consent does not invalidate any contract or transfer of ownership resulting from the transaction, a person who fails to obtain the Bank's consent**,** or who fails to comply with the terms and conditions of any consent, commits an offence. On conviction the person may, in the case of an individual, be subject to a term of imprisonment not exceeding three months and/or a fine not exceeding $50,000, or in the case of a body corporate, a fine not exceeding $500,000.

Q46. Do you have any views on the structure of the change of ownership provisions in the Bill?

SECTION TEN: Conclusion

239. This paper is designed to seek views on the operation of the regime to date, and potential changes to the regime in light of the issues we have identified.

240. Overall, the Bank's assessment is that the regime has operated reasonably well to date. The application of the prudential standards in Part 5D of the Act has helped to ensure the soundness of the NBDT sector following the finance company collapses, and the supervisory arrangements applying to the sector have operated adequately, in the sense that they have ensured that the Bank has been made aware of potential risks with current NBDTs reasonably promptly.

241. However, the structure of the non-bank lending sector in New Zealand has changed significantly since the NBDT regime was initially designed. As a result of the finance company collapses, the sector has significantly shrunk in size while other entities have in some cases, moved to fill the funding gap this has created for certain sectors in the economy.

242. The changing nature of the sector in recent years, and our experience of the regime to date, have meant that there are a number of areas where we consider that changes to the regime may be appropriate to:

- reflect the current nature of the second tier lending sector in New Zealand;

- increase the level of efficiency in the existing regime; and

- fill in the remaining gaps in the regime, for example, in relation to disclosure and the range of crisis management options that are available.

243. Some of the more significant changes we consider would be appropriate are:

- adjusting the definition of NBDT to ensure that it better catches those entities that are likely to raise systemic risks in the NBDT sector; and

- setting certain prudential standards through conditions of NBDT licences to provide greater flexibility and responsiveness to changing circumstances, and to enable more direct tailoring of requirements to the circumstances of specific NBDTs, without the need to make such extensive use of exemptions.

244. While we do not currently have firm views on the matter, we also consider that there is merit in considering whether the option of direct supervision of NBDTs by the Bank may be a more efficient mechanism for supervising the sector than the current model involving both trustees and the Bank.

245. Many of the potential changes to the regime discussed in this paper would have the effect of making the NBDT regime more similar to the prudential regime for registered banks. This has some advantages in increasing the level of competitive neutrality with the banking sector, and leveraging off the Bank's experience with the prudential regime for registered banks. We would also welcome views on the extent to which, at a high level, a more "bank-like" regime for NBDTs would be appropriate, or whether it would make more sense to retain more bespoke arrangements for NBDTs as at present.

246. We encourage submitters to provide free and frank feedback on their views of the operation of the regime to date, the proposals in this paper, and other matters that submitters may consider should be changed as a result of the review.

Consultation Document: Review of the Prudential Regime for Non-bank Deposit Takers

Submission by [insert name of submitter]

Section two: Objectives of the prudential regime

No	Questions	Submission
1.	Do you agree with the issues identified with the objectives of the regime? Are there other issues that we should be considering?	[*insert submission]*
2.	Which of the three options for the objectives of the NBDT regime that we have identified do you think is preferable? Are there other potential objectives for the NBDT regime that you think we should be considering?	

Section three: Definition of NBDT

3.	Do you consider that the current definition of NBDT accurately describes who should be covered in the regime?	
4.	Are there any parts of the current definition of NBDT that you consider are unnecessary or problematic?	
5.	How effectively do you consider the Bank has been managing boundary issues relating to the definition of NBDT?	
6.	What has your experience (if any) been of the process of applying for exemptions under the current regime?	
7.	Do you agree that the current definition results in an unnecessary number of entities needing to be carved out of the definition?	
8.	Do you consider that relying on securities law concepts in the definition of NBDT is appropriate?	
9.	Do you agree that the types of offers we have identified as raising prudential risks, despite being exempt under securities law, should be covered by the definition?	
10.	Do you agree that we have correctly identified the high level options for the definition of NBDT? Are there any other options you consider we should be looking at?	
11.	Do you agree with our assessment of the costs and benefits of the status quo? Are there other costs and benefits of the status quo that we should be considering?	

12.	Do you agree with our assessment of the costs and benefits of this option? Are there other costs and benefits of this option that we should be considering?	
13.	Do you agree with the statutory carve outs we are proposing as part of this option? Are there other statutory carve outs that we should be considering?	
14.	Do you agree with our assessment of the costs and benefits of this option? Are there other costs and benefits of this option that we should be considering?	
15.	Do you agree with the statutory carve outs we are proposing as part of this option? Are there other statutory carve outs that we should be considering?	
16.	Which of the three options proposed for the definition of NBDT do you prefer? Are there other options we should be considering?	

Section four: Supervisory arrangements for NBDTs

17.	Do you agree that these were the intended benefits of having trustees act as frontline supervisors under the regime? To what extent to you consider that these benefits of using trustees as frontline supervisors have eventuated?	
18.	How effective do you consider that trustees have been as frontline supervisors of NBDTs?	
19.	How effective do you consider the Bank has been in its broader role in monitoring the sector?	
20.	Are there other powers that you consider trustees may require in carrying out their role?	
21.	What fees are currently charged by trustees for their supervision of NBDTs?	
22.	What information is sought by trustees from NBDTs?	
23.	What is the nature and frequency of trustees' interactions with NBDTs?	
24.	Do you agree with the three potential options we have identified? Are there other options you think we should be considering?	
25.	Do you agree with our assessment of the costs and benefits of the status quo? Are there other costs or benefits of the status quo that we should be considering?	

26.	Do you agree with our assessments of the costs and benefits of an enhanced trustee supervisory model for supervising NBDTs? Are there other costs or benefits that we should be considering?	
27.	Do you agree with our assessment of the costs and benefits of direct supervision of NBDTs by the Bank? Are there other costs or benefits that you think we should be considering?	
28.	Do you think that trustees should be retained as frontline supervisors of NBDTs, or do you consider that direct supervision of NBDTs by the Bank is a better option?	

Section five: Prudential requirements for NBDTs

29.	How have you found the prudential requirements have worked to date?	
30.	Do you think the prudential requirements are appropriate for the NBDT sector?	
31.	Are there any prudential requirements that you consider should be added, removed, or amended?	
32.	Do you agree that it would be preferable to set capital, liquidity and related party exposure requirements via conditions of licences or standards rather than regulations? Are there other costs or benefits of this option that you think we should be considering?	
33.	Do you think that the other prudential requirements should be set via conditions of licences or standards, or by regulations?	

Section six: Disclosure requirements for NBDTs

34.	Do you agree with the costs and benefits of this option that we have identified? Are there other costs or benefits that we should be considering?	
35.	Do you agree with the costs and benefits of this option that we have identified? Are there other costs or benefits that we should be considering?	
36.	Do you agree with the costs and benefits of this option that we have identified? Are there other costs or benefits that we should be considering?	
37.	Do you consider that a separate disclosure regime for NBDTs would be appropriate, or should prudential disclosures for NBDTs be integrated	

	into the disclosures required under securities law?	

Section seven: Crisis management powers

38.	Do you agree that a tailored statutory management regime for NBDTs should be provided for in legislation?	

Section eight: Offences and penalties

39.	How do you think the current offence and penalty regime has worked?	
40.	Do you think a hierarchy of penalties, where there is a more proportionate response to the breach, would be more appropriate?	
41.	Would the use of infringement notices be a better way of ensuring compliance with certain lower level requirements?	
42.	Would the use of civil pecuniary penalties provide for a more proportionate response to some breaches where a conviction may outweigh the wrongdoing?	
43.	Should the level of penalties reflect whether the regime focuses on systemic risk to the NBDT sector or systemic risk to the financial system?	

Section nine: Other matters

44.	Do you have any views on the provisions in the Bill dealing with the issue and cancellation of licences and the Bank's ability to impose conditions of licences?	
45.	Do you have any views on the operation of the suitability assessment process in the Bill at present?	
46.	Do you have any views on the structure of the change of ownership provisions in the Bill?	