RESERVE BANK
OF NEW ZEALAND
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Report for the Minister of Finance on the operation of the prudential regime for Non-bank Deposit Takers

Presented to the House of Representatives pursuant to section 157ZZ of the Reserve Bank of New Zealand Act 1989

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EXECUTIVE SUMMARY

1. Section 157ZZ of the Reserve Bank of New Zealand Act 1989 (the Act) requires the Reserve Bank of New Zealand (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, by 9 September 2013.

2. This report sets out the background to the review, the Bank's conclusions on the operation of the regime to date, and a number of recommended changes to the regime.

General conclusions on the operation of the regime

3. Overall, the Bank considers that the regime has helped to reduce the likelihood of failure in the NBDT sector, and encouraged sounder management of NBDTs. Through these outcomes, we also consider that it has helped to contribute to the objective of a sound and efficient financial system.

4. The Bank continues to support the prudential regulation of NBDTs due to risks that are inherent in entities that carry on the business of borrowing and lending. In particular:

   - It can be especially difficult for investors to assess the risks associated with an entity where it uses monies raised from investors to carry on the business of lending;

   - These types of entities can often raise liquidity risks due to the fact that they often borrow short-term and lend long-term; and

   - Carrying on the business of borrowing and lending means that these types of entities have a high degree of interconnectedness with other participants in the financial system or wider economy.

5. In addition, the Bank considers that the experience of the finance company collapses illustrated the scope for unsound business practices to develop in some parts of the sector in the absence of an appropriate regulatory regime, and the impacts on market confidence that can result from problems in the NBDT sector.

6. We consider that the design of the regime has to reflect the balance that needs to be struck between managing these issues, and not having a serious adverse effect on positive innovation in the financial system and the ability to attract funding to legitimate, but sometimes higher risk, business activity. Our assessment of how that balance should be struck is reflected in the calibration

[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 paragraphs 11 and 106, 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.

of the specific prudential requirements, although we consider that this calibration should be subject to periodic review to ensure it remains appropriate over time.

7. We note that while unlike most other jurisdictions New Zealand does not have a fully integrated regime for banks and NBDTs, we still see the separate banking and NBDT regimes as conceptually linked. In our view the NBDT regime should set out the basic framework for entities that are carrying on the business of borrowing and lending, with those entities then having the option of opting into the banking regime.

8. We also note that the review has highlighted the fact that there are some important conceptual differences between mutuals and finance companies, but we do not consider that the scale of those differences, or the size of the NBDT sector overall, would justify two entirely separate regimes. However, there may be scope for later consideration of differences in the specific prudential requirements that apply under the NBDT regime to entities carrying on banking business (i.e. offering transactional accounts and short-term term deposits) and entities offering longer term debt security type products. The scope for this kind of consideration depends in part on the process for setting prudential standards being changed as recommended later in this report.

Objectives

9. We recommend that the current objectives of the regime be retained, on the basis that while individual NBDTs are unlikely to raise systemic risk, prudential regulation of NBDTs is designed to contribute to the promotion of a sound and efficient financial system. It does this in several ways:

   - By reducing the likelihood of significant problems across the NBDT sector as a whole which could raise systemic issues (for example, by causing a loss of investor confidence in the broader financial system, or reducing the level of funding available to niche markets);

   - By promoting the soundness of a sector that provides valuable diversity and competition in a financial system that is dominated by a large and highly concentrated banking sector; and

   - By reducing the likelihood of any repeat of the finance company collapses, which could result in serious adverse effects to the reputation of New Zealand financial markets.

10. We consider that this conclusion is supported by the value of maintaining alignment with the objectives of the banking regime, given the inter-linkages that we see between the prudential regimes for banks and NBDTs.

Definition of NBDT

11. The core definition of NBDT is currently an entity that “offers debt securities to the public in New Zealand, and carries on the business of borrowing and

lending, or providing financial services, or both". In this context, "financial services" is intended primarily to mean lending like financial services (e.g. factoring or financial leasing), but can extend to other types of financial services that may be offered by a bank.

12. We received very mixed views during the review on the appropriateness of the definition of NBDT continuing to tie into the Securities Act 1978 (Securities Act) concept of "offer to the public" (or the Financial Markets Conduct Act 2013 (FMC Act) concept of "regulated offer"). Generally stakeholders either felt that:

- Only covering these entities makes sense as it reflects well understood securities law concepts and an implied focus on protecting the interests of retail investors; or

- It makes sense to cover a broader range of entities because: 1) some wholesale investors (such as eligible or wealthy persons) are often not truly sophisticated investors able to assess the risks and returns associated with offers of financial products without the benefit of prescribed disclosures; 2) using the Securities Act boundary to define retail and wholesale funded entities creates loopholes for avoiding the NBDT regime; and 3) no longer using the Securities Act boundary is necessary to ensure competitive neutrality between analogous institutions.

13. On balance, we consider that the definition of NBDT should be decoupled from securities law, given the different objectives of securities law and the NBDT regime.[2]

14. This would leave NBDT being defined as an entity that carries on the business of borrowing and lending money, or providing financial services, or both. There are several consequences of this change:

- Further work will have to be undertaken on the appropriate scope of a carve out for wholesale funded entities (although we anticipate that entities funded by their parent or another member of their group, or from overseas sources, would be covered by the carve out. The carve out may also closely align with the scope of securities law if the decision is made to retain trustees as frontline supervisors of NBDTs under an enhanced version of the existing supervisory arrangements);

- It means that it may be useful to define what is meant by borrowing and lending. We propose to define borrowing as offering debt securities, and lending as providing credit as defined by the Credit Contracts and Consumer Finance Act 2003 (the CCCF Act);[3] and

[2] We see the objectives of securities law as being to address information symmetries between issuers and investors, and to ensure that issuers adhere to the terms of the offer of financial products they make to investors. By contrast, the NBDT regime is focused on promoting the soundness of NBDTs in order to avoid risks to the NBDT sector or wider financial system.

[3] The Credit Contracts and Consumer Finance Act 2003 defines credit as right granted by a person to another person to: 1) defer payment of a debt; or 2) incur a debt and defer its payment; or 3) purchase property or services and defer payment for that purchase (in whole or in part).

- It places greater stress on the use of the term “financial services” in the definition of NBDT. Read literally, it would mean that an entity would be an NBDT solely by virtue of being in the business of providing financial services, which is clearly not the intention. Accordingly, we propose to remove reference to financial services in the definition of NBDT.

15. We note that defining NBDT as an entity that carries on the business of borrowing and lending is consistent with the core definitions of deposit taking entities in many other jurisdictions. In many cases foreign jurisdictions either define deposit takers as entities that carry on the business of borrowing or lending, or as entities that take deposits (with deposits being defined as funds taken from the public by an entity that carries on the business of making advances of money or lending to third parties).

16. To better address the boundary issues around the definition of NBDT, we also propose to proceed with a series of carve outs from the definition of NBDT for the following entities:

    - Entities involved in intragroup borrowing and lending (i.e. conduits and reverse conduits);[4]

    - Payment facility providers and other entities that simply hold and transfer funds, rather than investing funds in other business activities such as lending (e.g. payment facility providers); and

    - Crown entities.

17. Where necessary, these carve outs would be designed in a conservative manner to avoid potential loopholes and maintain flexibility in the treatment of new entities or arrangements that might arise in the future.

Supervision of NBDTs

18. During the review we received a very broad range of responses on the appropriate supervisory arrangements for NBDTs. In particular, views on the use of trustees under the regime varied from very positive to very negative.

19. Our analysis of supervisory arrangements for NBDTs in this report has been divided into two parts. Firstly, how effectively trustees have carried out the supervision of NBDTs. Secondly, how efficiently the existing supervisory arrangements have operated.

20. On the first of these points, many commentators have noted deficiencies in some of the supervision provided by some trustees during the finance company collapses, and we agree with the concerns that have been raised about some trustees’ performance during that time. However, we note that there have also been significant variations in performance across the trustee sector, and

[4] The carve out would not apply when the group assessed as a whole is effectively carrying on the business of borrowing from, and lending to, third parties.

trustees are now licensed by the Financial Markets Authority (FMA). We support the licensing of trustees and note that it can be expected to raise standards in the trustee sector over time.

21. On the second point, we think that the existing model creates some significant inefficiencies in the supervision of NBDTs. Those stakeholders who consider that there are problems with the existing model also broadly agreed with this analysis.

22. In particular, the division of supervisory and monitoring functions between trustees and the Bank makes it difficult to apply a uniform risk based approach to supervising NBDTs (especially given that focus of trustees is on the particular issuers they deal with, and they are not tasked with taking a whole of sector view).

23. It also has the potential to detract from role clarity and accountability, and hinder the ability to respond promptly and effectively to emerging issues. This is an especially acute issue in a distress management situation or in the event of significant problems across the sector as a whole. In these situations, the Bank as regulator is likely to be best placed to act quickly and decisively given that it has, or will have, certain powers that trustees lack (such as the ability to issue directions to an NBDT or impose conditions of licence).

24. More broadly, the current division of functions between the Bank and trustees can create a lack of clarity around who is responsible for what matters under the regime. For example, the Bank is probably publicly perceived as being ultimately responsible for the supervision of NBDTs, but the regime means that it is the trustees, rather than the Bank, who are actually responsible for carrying out day to day supervision of key prudential requirements.

25. Licensing of NBDTs under the Non-bank Deposit Takers Bill (the NBDT Bill) is likely to increase some of the efficiency concerns we have with using trustees as frontline supervisors of NBDTs. For example, the advent of licensing will mean that while the Bank makes an assessment of an entity's ability to comply with prudential requirements at the point of licensing, supervision of on-going compliance with key matters like capital and liquidity is largely left in the hands of trustees. This increases the risk of inconsistent approaches to assessing compliance at the point of licensing and on an on-going basis.[5]

26. In addition, the licensing regime provides for a number of extra powers for the Bank, creates a broader range of areas that the Bank will be responsible for monitoring directly (for example, compliance with conditions of licence), and makes licences contingent on, amongst other things, an entity's ability to comply with their Anti-Money Laundering (AML) obligations. It will also provide the Bank with enhanced investigative and crisis management powers (including the ability to issue directions to NBDTs and trustees). Cumulatively, these

[5] This issue becomes even more significant where assessing compliance requirements that are not "bright line" in nature. For example, NBDTs have to have a risk management programme that must adequately address certain types of risk that the entity may be subject to. In this situation, the Bank and trustees may have different interpretations of whether a risk management programme adequately addresses these risks.

matters increase the likelihood that trustees' supervisory role may be crowded out under the licensing regime, and/or that the Bank may override trustees in a crisis situation.

27. In considering options to address the issues we have identified with the current framework for supervising NBDTs, our starting point has been whether it is possible to address these issues by improving the existing model rather than shifting to an entirely new supervisory approach. This reflects the Bank's historical focus on the soundness and efficiency of the financial system, rather than the regulation of specific industry sectors.

28. In respect of the historical issues we have identified with trustee performance, a possible option is to rely on the licensing of trustees by the FMA to improve the quality of trustee supervision over time. This approach could be supplemented by the Bank issuing guidance to trustees about the Bank's expectations of their performance.

29. In addition, it may be possible to mitigate most of the key efficiency issues we have identified through a combination of legislative amendments and the issuance of guidance material. In particular:

- A lack of role clarity and accountability: This issue could be addressed in part by providing in legislation that trustees are responsible for monitoring compliance with all prudential and regulatory requirements under the regime, rather than just those which are contained in the trust deed. Specifically, this means that trustees would also be required to monitor compliance with the credit rating and governance requirements, and conditions of licence under the NBDT Bill (all of which the Bank monitors at the moment). The Bank could also provide publicly available guidance on the scope of the respective roles of the Bank and trustees, and the nature and standard of monitoring expected of trustees.

- The risk of trustees being slow to forward information about actual or potential breaches to the Bank: It may be possible to improve the flow of information from trustees to the Bank by issuing guidance setting out clear expectations about the timely notification of information to the Bank and the nature and standard of monitoring that is expected of trustees.

- Impediments to the ability to respond effectively in a crisis*:* To facilitate the efficient resolution of a distress management situation or problems across the NBDT sector more broadly, legislation could provide the Bank with the power to direct trustees to take, or not to take, action under the trust deed or any enactment in circumstances where an NBDT has been involved in an actual or potential breach.

- Uniform risk based approach to monitoring of the sector*:* To facilitate a more uniform risk based approach to the supervision of the NBDT sector, the Bank could indicate in guidance material the nature and standard of monitoring expected of trustees, and could continue its existing discussions with trustees to coordinate approaches to emerging issues.

30. The Bank considers that these measures would mitigate many of the issues raised by the current regime. However, they may raise a question about the value being added by the on-going use of trustees, given that the scope for trustees exercising autonomous judgement under this model would be more limited than is currently the case.

31. If the government considers that the model proposed above would not adequately address the issues that we have identified, or considers that it may raise other inefficiencies, an alternative option would be to have NBDTs supervised directly by the Bank. It should be noted that the Bank's supervisory remit has historically been centred around risks to the financial system. Supervising NBDTs directly would be a further shift away from this.

32. We note that direct supervision of NBDTs would also require that, amongst other things, the Bank have sufficient resources to carry out the supervisory function. In this respect, it is important to keep in mind that in the event of an NBDT failing in the future, the resource implications for the Bank, both in terms of management time and other resources, are likely to be significant;

33. Accordingly, we recommend that the Government adopt the measures we are proposing in paragraphs 28-29 to improve operation of the existing regime.

34. However, if the Government does not consider that these measures will adequately address the problems we have identified with the existing model, it may wish to consider directing the Bank to take over the frontline supervision of NBDTs, recognising the drawbacks inherent in such an approach.

35. We note that direct supervision of NBDTs by the Bank would result in the investor protection objective of trustees being replaced by the Bank's objective of maintaining a sound and efficient financial system.

36. In addition, it would require that NBDTs generally be exempted from the requirement to have a trustee under the Securities Act. However, NBDTs that issue secured debt would still be required to have a trustee to hold the charge over the security under this model.

Prudential requirements for NBDTs

37. With the exception of aspects of the capital regime and credit rating requirement, we received few major concerns about the current settings of the prudential requirements during the review.

38. With respect to the capital regime, the Bank is satisfied that the existing capital requirements are appropriate, given:

- The simplified nature of the capital regime for NBDTs compared with that applying to registered banks; and

- The different nature of some NBDTs' business (particularly the fact that they sometimes have a more regional or localised focus, which can make them more susceptible to regional, rather than economy wide, shocks).

39. With respect to the credit rating requirement, we remain of the view that the requirement to obtain a credit rating provides an important level of third party scrutiny of the affairs of prudentially regulated entities like NBDTs, and do not propose changing the threshold for exempting small entities out of the rating requirement at this time.

40. However, we recommend that prudential requirements for NBDTs be set by standards promulgated by the Bank rather than be regulations. The two reasons for this are:

    - That the highly technical nature of the core prudential requirements (capital, liquidity, related party exposures) justifies a bespoke model for setting these requirements; and

    - That this approach provides greater flexibility and responsiveness, and allows us to tailor requirements to subcategories of NBDTs (e.g. mutuals and finance companies) where appropriate.

41. We note that this approach is consistent with that applying under the banking and insurance regimes, and the majority of comparable prudential regimes overseas. We recognise that this approach raises accountability issues, and as a result propose that:

    - The Bank have an obligation to consult with affected parties, and consider any submissions received, before making or amending a standard; and

    - That the standards be subject to additional publication and parliamentary disallowance requirements, like the solvency standards made under the Insurance (Prudential Supervision) Act 2010 (IPSA).

42. We note that the Bank would also retain the current power in the NBDT Bill to impose conditions of licence, but that conditions would be used primarily in respect of matters that were unique to particular NBDTs. Standards would be used for those matters that applied to all NBDTs or a class of NBDTs.

Disclosure requirements for NBDTs

43. There were mixed views expressed during the review as to the appropriateness of applying Securities Act disclosure requirements to particular NBDTs.

44. We do not recommend that a separate disclosure regime for NBDTs be established at this time, as we consider that many of the concerns raised about the existing disclosure requirements will be adequately addressed under the new disclosure regime established by the FMC Act.

45. However, we recommend that if the regime includes a significant number of entities that are not covered by the Securities Act or FMC Act as a result of the changes we are recommending to the definition of NBDT, a power to prescribe disclosures that must be made by NBDTs be included in legislation.

Offences and penalties

46. During the review the majority of stakeholders supported the idea of making greater use of civil penalties under the regime to ensure that remedies are proportionate to the seriousness of the breach. However, a significant minority queried how significant the benefits of a shift towards the use of civil penalties would actually be. Some stakeholders also noted that one of the main effects of shifting to a greater use of civil penalties would be that they would be easier for the regulator to enforce than criminal penalties.

47. We recommend that the offence and penalty regime applying to NBDTs should make use of civil and administrative remedies, as well as criminal offences. In particular, we propose that the penalty regime be based on three tiers:

- Criminal offences for reckless or intentional breaches;
- Civil pecuniary penalties for other breaches of significant requirements; and
- Infringement notices that can be directly issued by the Bank for breaches of minor obligations under the regime.

48. We also recommend that the Bank be given the power under legislation to accept enforceable undertakings from NBDTs.

49. The purpose of these changes is to provide a more graduated set of remedies for responding to breaches by NBDTs, given the current choice is between issuing a censure or warning, or taking criminal proceedings for offences that generally carry large fines or terms of imprisonment. The approach we are recommending broadly aligns with the penalty regime established under the FMC Act.

Crisis management

50. During the review the majority of stakeholders supported the adoption of a statutory management regime in principle, but additional information was sought on how this would work (and especially what the threshold would be for when statutory management could be used).

51. A minority of stakeholders questioned whether a statutory management regime was necessary given the size of the sector and the other resolution options that are available.

52. We recommend that a tailored statutory management regime be established for NBDTs. This would assist in dealing with those cases where the failure of an NBDT could cause significant harm to the NBDT sector or wider financial

system, or where the NBDT may have been operating fraudulently or recklessly. It also means that the Bank would have the power to recommend that an NBDT be placed into statutory management, rather than the Financial Markets Authority (FMA), which currently has this power under the Corporations (Investigations and Management) Act 1989 (CIMA).

53. However, we propose that this power only be available where the Bank is satisfied that the affairs of the NBDT cannot be adequately addressed through liquidation, voluntary administration or receivership. This would make it clear that statutory management would be a tool of last resort. It also broadly aligns with the approach taken under the statutory management regime in IPSA.

SECTION ONE: Introduction

54. Section 157ZZ of the Act require the Bank to carry out a review of the operation of the prudential regime for NBDTs, and to prepare a report on this review for the Minister of Finance, before 9 September 2013.

55. The following report sets out the background to the review, the Bank's conclusions on the operation of the regime to date, and recommendations for a number of important changes to the current legislation governing the regime.

The nature of the NBDT sector

56. The NBDT sector currently comprises approximately 58 entities, although only slightly less than 40 of these entities are typical NBDTs, such as building societies, credit unions, and finance companies.[6] Amongst other things, the sector sometimes acts as a provider of higher risk lending and provides an alternative source of term deposit and savings account type products.

57. The sector has changed substantially over the last 15 years. For eight years from 1998, the NBDT sector grew faster than the banking sector. This change began as NBDTs exploited niche markets that are 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.

58. 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.

59. A significant cause of this contraction has been 45 finance companies entering into liquidation, receivership or moratoria between 2006 and 2011. 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

[6] The remainder are technically NBDTs, but are currently exempt from most of the prudential requirements (for example, charitable and religious organisations).

exacerbated by an inability to attract new funds. Appendix 1 sets out the full list of the 45 failed finance companies.

60. In addition, from 2007 to 2012, three large institutions left the sector and were registered as banks.[7]

61. 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 history of the sector in the last 15 years also highlights the scope for significant changes in the size of the sector over time.

History of the NBDT regime

62. The current prudential regime for 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 (Companies Act), the Building Societies Act 1965 (Building Societies Act), 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, the FMC Act and the Financial Service Providers (Registration and Disputes Resolution) Act 2008 (the FSP Act).

63. Part 5D of the Act, and the associated regulations, provide 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.

64. As debt issuers under the Securities Act and FMC Act, most NBDTs are required to enter into a trust deed with a trustee licensed under the Securities Trustees and Statutory Supervisors Act 2011 (STSS Act). An NBDT's trustee 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.[8]

65. Because the regime relies upon trustees acting as the frontline supervisor of NBDTs, the Bank currently carries out a less direct monitoring role. Trustees

[7] 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.

[8] 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.

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 of the Act. They also regularly provide data to the Bank on the NBDTs they are responsible for supervising.

66. The NBDT 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 NBDT Bill.

67. 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[9] 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.

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

69. Our analysis of the operation of the prudential regime for NBDTs to date has been informed by the fact that certain parts of the regime, such as licensing, and increased crisis management powers for the Bank, will be introduced by the NBDT Bill.

Scope and objectives of the review

Scope of the review

70. The review clause was originally included in Part 5D on the recommendation of the Finance and Expenditure Select Committee, when it considered the Bill that established Part 5D of the Act.[10] In discussing why it chose to recommend that a review clause be included, the Committee noted that it considered that such a review was desirable:

"……given the novelty of some features of the regime, such as the use of trustees, and that the threshold for the credit rating requirement would be set by delegated legislation."

71. In discussing the review clause, the Minister with responsibility for the Bill noted at its second reading that:

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[9] This will be changed to the FMC Act before the NBDT Bill is enacted.

[10] See page 9 of the select committee report on the Reserve Bank of New Zealand Amendment Bill (No.3) at: http://www.parliament.nz/en-nz/pb/sc/documents/reports/48DBSCH_SCR4096_1/reserve-bank-of-new-zealand-amendment-bill-no-3-174-2

"Given that much of the effect of the bill can only be determined once regulations are in place, the select committee suggested that the regime be required to be reviewed within 5 years of commencement, but with the results of the review to be reported to Parliament. This will provide members of Parliament with the opportunity to assess the regime and potentially revisit some of its features."

72. In light of this context, we have interpreted the scope of the review broadly, and have treated it as encompassing all aspects of the current framework for the prudential regulation of NBDTs. To the extent possible, we have also looked at both the legislation underpinning the regime, and how relevant entities such as trustees have carried out their roles under the legislation.

73. Section 157ZZ of the Act specifically states that the report on this review must include recommendations to the Minister on whether any amendments to the legislation are necessary or desirable. In analysing the operation of the regime to date, we have therefore looked closely at whether amendments to the legislation may be appropriate.

74. Overall, we see the objectives of the review being primarily to ensure that:

- The rationale for the regime remains valid;
- The objectives of the regime remain correct, and that the regime achieves those objectives;
- The regime operates efficiently (both in terms of minimising compliance costs and ensuring clarity of, and accountability for, regulatory roles); and
- The regime is enduring (in that it will not require fundamental changes in the foreseeable future, but will still have the flexibility required to reflect changing circumstances in the market).

75. The first three objectives are largely self-explanatory, but we think the final objective is also important. The regulation of NBDTs has been developing over the last 5-6 years, and it is important to provide clarity to industry about the final shape of the regulatory regime for the NBDT sector for the foreseeable future.

76. As discussed further below, the Bank also considers that the regime has achieved its basic objectives thus far, and the level of regulation provided for under the regime is, at a high level, broadly appropriate. Much of the discussion in the remainder of this report is therefore focused on measures to improve the efficiency of the regime, address technical issues that the operation of the regime has raised, and to ensure that the regime is able to deal with future changes in the market and the NBDT sector.

The structure of this report

77. The first part of this report discusses the underlying rationale for the regulation of NBDTs and our general conclusions on structure and effectiveness of the

existing regulatory model. The report then discusses the various parts of the regime in more detail, focusing on the effectiveness and appropriateness of each aspect of the regime, and the whether changes to these areas would be appropriate.

78. For the purposes of this analysis, we have divided the report up into the following parts:

- Objectives of the regime;
- Definition of NBDT;
- Supervisory arrangements for NBDTs
- Prudential requirements for NBDTs;
- Disclosure requirements for NBDTs;
- Crisis management powers; and
- Offences and penalties.

79. The report concludes by summarising our views on the operation of the regime to date and the changes we are recommending.

General conclusions on the prudential regime for NBDTs

Stakeholders' comments

80. With some exceptions, stakeholders generally felt that the regime had achieved its core objective of reducing the likelihood of failure within the NBDT sector. However, there were extremely mixed views on most of the specific matters canvassed during the review.

81. A number of stakeholders noted that the NBDT sector includes a great deal of diversity, and that there were particularly significant differences in the nature and operation of credit unions and building societies on one hand, and finance companies on the other. In their view, a one size fits all regulatory model could be problematic given the different characteristics of the entities that come within the regime.

82. Many stakeholders also commented on the reduction in the size of the sector since 2006, and the value of the NBDT sector in providing diversity in the financial system, competition to the dominant banking sector, and a source of funding for niche markets.

83. General observations were also made about the appropriateness of a prudential regime for such a small sector, and whether the Bank would want to

take on the potential moral hazard associated with directly supervising the NBDT sector.

The Reserve Bank's conclusions

The place of NBDTs in the financial system

84. The Bank acknowledges the comments of stakeholders on the value of the NBDT sector in providing diversity in the financial system, competition to the dominant banking sector, and a source of funding for niche markets.

85. The Bank's core objective is to promote the maintenance of a sound and efficient financial system, rather than the promotion of a specific part of the system, such as NBDTs.

86. However, we acknowledge that a well functioning NBDT sector contributes to the objective of ensuring a sound and efficient financial system. In particular:

    - It contributes to efficiency through providing competition to the dominant banking sector and a source of funding for niche markets (which will often, but not always, be higher risk);

    - It contributes to soundness by helping to ensure an appropriate level of diversity across the financial system (i.e. by ensuring that the financial system is not inappropriately reliant on a single class of entities).

Effectiveness of the existing regulatory regime

87. Overall, we consider that the regime has helped to reduce the likelihood of failure in the NBDT sector, and encouraged sounder management of NBDTs. Through these outcomes, we also consider that it has helped to contribute to the objective of a sound and efficient financial system.

88. While the just under 39 core participants in the sector currently only have combined assets of approximately $4.4 billion (of which UDC Finance Limited accounts for approximately $2.15 billion),[11] we continue to support the prudential regulation of NBDTs due to:

    - The inherent risks raised by entities that carry on the business of borrowing and lending. In particular:

        - o The fact that these entities have a significant degree of interconnectedness with other participants in the economy;

        - o The liquidity risks associated with an entity that may borrow short-term and lend long-term; and

[11] These figures are determined under the existing definition of NBDT. They are likely to change to a limited extent if the recommended changes to the definition of NBDT discussed later in this report are adopted.

  - The risks to investors associated with taking retail deposits which are then used, in some cases, to engage in riskier forms of lending; and

- The experience of the finance company collapses, which has illustrated:

  - The scope for unsound business practices to develop in some parts of the sector in the absence of an appropriate regulatory regime; and

  - The impacts on market confidence that can result from the failure of individual NBDTs and/or systemic problems in the NBDT sector.

Conceptual differences between different types of NBDT and the appropriateness of a unitary NBDT regime

89. We note that there may be merit in some of the points raised by stakeholders about the conceptual differences between mutuals and finance companies, but we do not consider that the scale of those differences, or the size of the NBDT sector overall, would justify two entirely separate regimes. However, there may be scope for later consideration of differences in the specific prudential requirements that apply under the NBDT regime to entities carrying on banking business (i.e. offering transactional accounts and short-term term deposits) and entities offering longer term debt security type products. The scope for this kind of consideration depends in part on the change to the mechanism for setting prudential requirements that is recommended later in this report.

Relationship between the prudential regimes for NBDTs and banks

90. Unlike many other jurisdictions New Zealand does not have a fully integrated regime for banks and NBDTs. However, we still see the separate banking and NBDT regimes as conceptually linked. In our view the NBDT regime should set out the basic framework for entities that are carrying on the business of borrowing and lending, with those entities then having the option of opting into the more intensive banking regime.

91. This philosophical approach has implications for the design of certain aspects of the NBDT regime, such as its objectives. These implications are discussed in more detail later in this report.

SECTION TWO: Objectives of the prudential regime

Current objectives of the NBDT regime

92. The current objectives of the NBDT regime in Part 5D of the Act 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.

93. These objectives are the same as those applying under the banking regime. However, they also need to be read in conjunctions with the matters that the Bank must have regard to in exercising its powers. These matters are:

- the desirability of consistency in the treatment of similar institutions, regardless of matters such as their corporate form;
- the importance of recognising:
    - o that it is not the purpose of the Act to eliminate all risk in relation to the performance of NBDTs or to limit diversity among NBDTs; and
    - o that depositors are responsible for assessing risk in relation to potential investments and for their own investment choices;
- the desirability of providing depositors with adequate information to enable them to assess risk in relation to potential investments and to distinguish between higher-risk and lower-risk NBDTs;
- the desirability of sound governance of NBDTs;
- the desirability of effective risk management by NBDTs;
- the need to avoid unnecessary compliance costs;
- the need to maintain competition within the NBDT sector.

Stakeholders' views on the objectives

94. There were highly divided views about the underlying rationale for prudential regulation of NBDTs, and whether the objectives of the regime should focus solely on the soundness and efficiency of the financial system, or also consider impacts in the NBDT sector.

95. Generally stakeholders either felt that a focus on financial system impacts makes more sense for a prudential regulation regime, or that a greater focus on sector impacts better reflects the current size and composition of the sector.

96. A small number of stakeholders suggested that the objectives of the regime should reflect a mix of financial system and NBDT sector impacts. For example, that the objectives of the regime should be to promote the maintenance of a sound and efficient financial system, and public confidence in the NBDT sector. Generally these stakeholders thought that a degree of alignment with the objectives in the banking regime was appropriate, but that the size and characteristics of the sector also supported the objective of promoting public confidence in the NBDT sector, or avoiding significant damage to the sector that could result from the failure of an NBDT.

97. Some stakeholders also suggested that the regime should have a more explicit focus on encouraging the growth of the sector, given its declining size over

recent years. Others also suggested that the objectives should better reflect the importance of ensuring diversity in the financial system, and the importance of not applying a one size fits all approach to the regulation of different types of NBDT.

The Bank's view on the objectives

98. The Bank supports the retention of soundness and efficiency as fundamental objectives of the NBDT regime. The meaning of soundness and efficiency in the context of a prudential regime were discussed in the Reserve Bank of New Zealand Bulletin article *Understanding financial system efficiency in New Zealand.*[12] We continue to subscribe to the meanings given to "soundness" and "efficiency" in that article.

99. In summary, "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.

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

101. However, we note that individual participants in the sector are unlikely to be large enough to raise risks to the soundness of the entire financial system by themselves. As was noted earlier, the sector currently has assets of $4.4 billion (of which $2.15 billion is in UDC Finance Limited).

102. We note that this conclusion would not be materially altered even if a significant number of non-deposit taking finance companies were included within the sector. The entire non-deposit taking finance company sector has assets of approximately $9 billion, with only two entities we are aware of with assets in excess of $1 billion (GE Capital Ltd and Toyota Finance NZ Ltd).

103. However, the Bank considers that a sound and efficient NBDT sector contributes to the objective of a sound and efficient financial system given that:

- It is possible that significant problems across the NBDT sector as a whole could raise systemic issues (for example, by causing a loss of investor confidence in the broader financial system, or by reducing the level of funding available to niche markets);

- NBDTs provide valuable diversity and competition in a financial system that is dominated by a large and highly concentrated banking sector;

[12] 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.

- Any repeat of the finance company collapses would be like to have significant adverse effects on the reputation of the New Zealand financial markets.

104. In light of these factors, we think that it would be appropriate to retain the existing objectives of the regime, notwithstanding the fact that individual NBDTs are unlikely to raise systemic risks by themselves.

105. We consider that this conclusion is supported by the value of maintaining alignment with the objectives of the banking regime, given the inter-linkages that we see between the prudential regimes for banks and NBDTs.

Recommendation

That the existing objectives of the NBDT regime be retained.

SECTION THREE: Definition of NBDT

The current definition of NBDT

106. The core definition of an NBDT in Part 5D of the Act, 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.

Analysis of the existing definition

107. The core definition of NBDT has several different parts that 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 Act, 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 Act of “making a regulated offer”.

108. 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.[13] 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 is unlikely to create the same prudential risks);

- 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.

109. When this definition was originally proposed, it was noted that a substance over form approach to the definition was preferable in that it ensures consistency in the treatment of entities carrying out common functions, and is broadly consistent with overseas approaches.[14]

Examples of overseas definitions

110. At a high level the second limb of the definition of NBDT is not dissimilar to the approaches taken in many other jurisdictions to defining banks and other deposit taking institutions. To illustrate this point, it is useful to consider the definition adopted in some comparable overseas jurisdictions.

Australia

111. In Australia, the Banking Act 1959 requires that only Authorised Deposit Takers carry on banking business. Banking business is defined as:

- a business that consists of banking within the meaning of paragraph 51(xiii) of the Constitution; or

- a business that is carried on by a corporation to which paragraph 51(xx) of the Constitution applies and that consists, to any extent, of:

    - o both taking money on deposit (otherwise than as part-payment for identified goods or services) and making advances of money; or

    - o other financial activities prescribed by the regulations for the purposes of this definition.

112. Paragraph 51 of the Constitution of the Commonwealth of Australia sets out the matters which the Commonwealth Parliament can legislate in respect of.

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[13] 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.

[14] Pages 9-10, Review of Financial Products and Providers: Non-bank Deposit Takers at: http://www.med.govt.nz/business/business-law/pdf-docs-library/past-work-and-older-topics-pdfs/review-of-financial-products/non-bank-deposit-takers-.pdf

113. Paragraph 51(xiii) covers "banking, other than state banking, also state banking extending beyond the limits of the state concerned, the incorporation of banks, and the issue of paper money". "Banking" in this context broadly means carrying on the business of borrowing and lending money, and may extend to carrying on other "bank-like" financial services.[15]

114. Paragraph 51(xx) covers "foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth".

United Kingdom

115. In the United Kingdom, any person that carries on the regulated business of accepting deposits is required to be authorised, and to have permission to carry on that regulated activity.[16]

116. A deposit for these purposes is defined as:

> "Rights under any contract under which a sum of money (whether or not denominated in a currency) is paid on terms under which it will be repaid, with or without interest or a premium, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it."[17]

117. However, to qualify as a bank, an institution must not only have permission under Part 4 of the Financial Services and Markets Act 2000 to carry on the regulated activity of accepting deposits, but must also carry on the business of granting credits on its own account.

118. The definition of "bank" does not include a building society or credit union.[18] However, banks, building societies and credit unions are collectively treated as "Deposit Taking Institutions".[19]

Singapore

119. In Singapore, the Banking Act defines a business as a "deposit taking business" if:

- in the course of the business, money received by way of deposit is lent to others; or

- any other activity of the business is financed, wholly or to any material extent, out of the capital of or the interest on money received by way of deposit.[20]

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[15] See for example, *Melbourne v Commonwealth ("State Banking Case")* (1947) 74 CLR 31.
[16] Section 19, and clause 4, Schedule 1, Financial Services and Markets Act 2000.
[17] Clause 22, Schedule 2, Financial Services and Markets Act 2000.
[18] Sections 2 and 91, Banking Act 2009, Definition of "bank" glossary, PRA Handbook.
[19] Definition of "deposit taking institution", glossary, PRA Handbook.
[20] Section 4A(7), Banking Act (Chapter 19).

120. Deposit taking business can only be carried out by certain persons, including banks, cooperative societies, and finance companies.

121. Banks are entities that carry on banking business, which is defined as the business of receiving money on current or deposit account, paying and collecting cheques drawn by or paid in by customers, the making of advances to customers, and includes such other business as prescribed.

122. Finance companies are companies that carry on financing business, which is defined as the business of borrowing money from, or lending money to, the public.[21]

Conclusions on overseas definitions

123. The examples of Australia, the United Kingdom and Singapore are broadly representative of the different regimes we have considered. Overall, banks and deposit taking institutions are typically defined as entities that carry on the business of borrowing and lending or which carry on the business of taking deposits (with deposits generally defined as funds borrowed by an entity that is in the business of lending or making advances of money to third parties). Generally these definitions also have a significant number of exemptions for entities that technically come within the definition, but who are not in substance carrying on the business of a bank or other deposit taking entity.

Key boundary issues for the definition of NBDT

124. In light of this context, the review identified two major issues with the definition of NBDT. The first issue is whether the retail funded entity focus of the regime is correct, and if so, whether we are correctly identifying those entities that are retail funded for the purposes of the regime (this issue essentially comes down to whether the regime should continue to define an NBDT as an entity that offers debt securities to the public under the Securities Act, or makes a regulated offer of debt securities under the FMC Act). The second issue is whether there are more efficient ways of dealing with some of the more difficult boundary issues associated with the definition

125. A number of stakeholders raised concerns with us about the extent to which entities may be using alternative business structures to avoid the definition of NBDT while still in substance carrying on the business of an NBDT.

126. The examples cited were generally either:

- Certain types of managed investment schemes;
- Peer-to-peer lenders; or
- Entities funded by wholesale investors.

[21] Section 2, Finance Company Act (Chapter 108).

127. In respect of certain atypical types of managed investment schemes, and peer-to-peer lenders, we are confident that at present there are sound conceptual reasons for treating them separately from NBDTs. We also note that there are (or in the case of peer-to-peer lenders, will be) alternative regulatory regimes that apply to these entities. We will continue to monitor developments in these areas though.

Stakeholders' comments

128. During the review we received sharply divergent views from stakeholders on whether the definition should continue to only cover entities that are also covered by the scope of securities law. Stakeholders generally either felt:

- that only covering these entities makes sense as it reflects a well understood securities law concepts and an implied focus on protecting the interests of retail investors; or

- that it makes sense to cover a broader range of entities because: 1) some wholesale investors (such as eligible or wealthy persons) are often not truly sophisticated investors able to assess the risks and returns associated with offers of financial products without the benefit of prescribed disclosures; 2) using the scope of the Securities Act and FMC Act to define retail and wholesale funded entities creates loopholes for avoiding the NBDT regime; and 3) no longer defining NBDTs by reference to the scope of the Securities Act or FMC Act is necessary to ensure competitive neutrality between analogous institutions.

129. However, there was broad consensus that the greater use of carve outs from the definition of NBDT would help to address some of the difficult boundary issues raised by the existing definition. This reflected the view of many stakeholders that the definition of NBDT is too broad, and captures a range of entities that were not intended to be covered by the policy. It also reflects the views of some stakeholders who felt that the experience of seeking an exemption had been difficult and/or time consuming.

Should the definition of NBDT continue to rely on an entity making an offer of debt securities covered by securities law?

Implications of the reliance on securities law concepts in the definition

130. 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.[22]

131. Section 3 of the Securities Act provides that the phrase "offers securities to the public" must be construed to include:

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

- 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.

132. 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.

133. 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 either Part 5D of the Act or the NBDT 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 NBDT Bill).

134. 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 regime. 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).

135. The FMC Act does not use 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 Act. An offer of securities requires disclosure under the FMC Act if at least one of the people to whom the offer is made is not exempt under Schedule 1 of the FMC Act.

136. The exemptions in Schedule 1 of the FMC Act 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.

Potential problems associated with relying upon securities law concepts in the definition

137. The Bank has some reservations about defining NBDT by reference to the scope of securities law, given the different objectives of the NBDT regime and the Securities Act and FMC Act.

138. In particular, the exemptions in the Securities Act and FMC Act 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.

139. In a prudential regime, we consider that the focus is not primarily on information asymmetries, but on the extent to which the failure of an entity might create risks to the soundness of a sector or the wider financial system.

140. In addition, relying on securities law concepts in the definition of NBDT creates a number of issues under the existing regime:

- It means that the Bank is forced to design bespoke arrangements under exemptions for entities such as the Public Trust that are not required to have a trustee under securities law. Some of the practical difficulties of doing this are illustrated by the approach that had to be taken to the treatment of the Public Trust under the regime. In particular, this required the Bank to apply prudential requirements to the Public Trust directly under an exemption, and monitor compliance with those requirements in the absence of a trustee; and

- An entity that carries on the business of offering debt securities solely to persons who are exempt under section 5 of the Securities Act, and that carries on the business of lending, is technically an NBDT, but we do not regulate any entities that come within this category as NBDTs, and the long term status of these entities is currently unresolved.

141. Overall, given the different objectives of securities law and the NBDT regime, we think it would be appropriate to no longer define NBDT by reference to the scope of the Securities Act and FMC Act. This would mean removing the first limb of the definition of NBDT (making an offer of debt securities to the public in New Zealand). It also has a number of other consequences for the definition.

142. Firstly, it places considerable strain on the use of the term financial services in the definition, as on a literal reading, it means an entity could be an NBDT

solely by carrying on the business of providing financial services. Financial services has generally been taken to mean either the types of financial services that may be provided by a bank, or lending-like financial services (e.g. factoring or financial leasing), but this is insufficiently clear when the definition will determine which entities must automatically comply with the NBDT regime.[23] In addition, to date the Bank has not needed to rely on an entity carrying on the business of providing financial services in order to come within the definition of NBDT, which suggests that the reference to financial services may be unnecessary.

143. As a result, we think that it would be appropriate to remove the reference to "financial services" and define what is meant by "borrowing" and "lending". We think that a suitable definition of "borrowing" for these purposes would be issuing debt securities.[24] A suitable definition of "lending" could be based upon the definition of credit in the CCCF Act, and be providing a right to another person to:

- defer payment of a debt; or
- incur a debt and defer its payment; or
- purchase property or services and defer payment for those products or services (in whole or in part).

144. Secondly, it means that the definition would expand to cover wholesale as well as retail funded entities. We recommend that the Bank carry out further work on the appropriate scope of a carve out for wholesale funded entities.

145. However, at a minimum we consider that this carve out should cover entities that are funded by their parent entity or other members of their corporate group. These entities are effectively carrying on the business of lending their own money rather than money borrowed from third parties, so do not raise the same kinds of prudential risks (i.e. the only persons who would directly suffer financial loss as a result of these entities failing are their owners).

146. In addition, we think that entities that are funded through offshore sources should generally not come within the scope of the definition. This is because we think that the risk to the New Zealand financial system from the failure of this kind of entity is generally less than would be caused by the failure of a domestically funded entity.

147. In carrying on further work on the scope of a wholesale carve out, our focus would therefore be on whether some or all of the entities that are primarily

[23] Although the banking regime requires that the Bank be satisfied that an entity carries on the business of borrowing and lending and/or providing financial services in order to be registered as a bank, the lack of precision in what is meant by "financial services" in that context does not create a problem because the banking regime is an opt-in regime rather than a regime that requires entities coming within a definition to automatically comply with a particular set of rules.

[24] Although certain "debt-like" building society shares would also need to be included within this definition.

funded by domestic wholesale investors should be covered by the regime. This is a matter that the Bank proposes to carry out further consultation on.

148. However, we also note that the scope of this carve out will be influenced by the approach that is ultimately taken to supervisory arrangements for NBDTs. If the decision is made to retain trustees as frontline supervisors of NBDTs under an enhanced version of the current supervisory arrangements, then the Bank will probably seek to ensure that most or all of the entities that are outside the scope of securities law are also covered by the carve out for wholesale funded entities.

Recommendations

That the existing definition of NBDT be changed to define an NBDT as a person who carries on the business of borrowing and lending money.

That the Bank carry out further work on the appropriate scope of a carve out for wholesale funded entities.

That the definitions of borrowing and lending in paragraph 143 be adopted for the purposes of this definition of NBDT.

Treatment of boundary issues associated with the current definition

149. The current definition of NBDT is relatively broad and creates a number of boundary issues as a result of it catching a significant number of entities that are not traditional types of NBDTs like finance companies, credit unions, and building societies. These boundary issues 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.

150. To date the Bank has generally dealt with these boundary issues by exempting entities from some or all of the prudential requirements in Part 5D of the Act, usually subject to conditions.[25] 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.

151. However, the existing reliance on exemptions imposes additional compliance costs on entities that the Bank has a relatively small regulatory interest in. In particular, most exemptions are subject to conditions that may include a requirement for the exempt entity to report to the Bank periodically on their status, or to disclose their exemption to investors.

[25] Although a small number of entities have also been declared out of the definition of NBDT as a result of their operating solely overseas or their being brought within the definition of NBDT solely as a by-product of being a building society or credit union, despite the fact that they do not offer debt securities to the public in New Zealand or carry on the business of borrowing and lending or providing financial services, or both.

152. 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 a financial or other return on the amounts they hold on a person's behalf, or purport to manage financial risk on a 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

- Reverse funding conduits (holding companies): For these purposes, a reverse funding conduit is a parent entity that carries on the business of borrowing and lending, but which lends exclusively to its subsidiaries, that do not themselves carry 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.

153. The Bank has recently been considering whether it would be appropriate to declare some or all of these entities out of the definition of NBDT, given that they are generally exempted from most, or all, of the prudential requirements (which is generally an indication that they are not carrying on the business or a typical NBDT, or that they raise special policy considerations that in some cases might justify their exclusion from the prudential regime).

154. With this in mind, we propose that carve outs from the definition of NBDT be provided for the following classes of entity:

- Funding conduits;

- Reverse funding conduits;

- Payment facility providers; and

- Crown entities.

155. Where necessary, these carve outs would be designed in a conservative manner to avoid potential loopholes and maintain flexibility in the treatment of new entities or arrangements that might arise in the future.

Recommendation

That carve outs from the definition of NBDT be provided for:

- Funding conduits (as defined in paragraph 152);
- Reverse funding conduits (as defined in paragraph 152);
- Payment facility providers (as defined in paragraph 152); and
- Crown entities.

SECTION FOUR: Supervisory arrangements for NBDTs

Current supervisory arrangements for NBDT

156. Under securities law, all issuers of debt securities to the public are required to have a trustee, whose role is currently 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); and
   - exercise reasonable diligence to ascertain whether or not the assets of the borrowing group[26] 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.

157. 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.

158. The duties of trustees set out in the Securities Regulations 2009 make trustees the 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.

159. 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.

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[26] 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).

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

161. Under the NBDT Bill the Bank is also the agency responsible for licensing NBDTs, making suitability assessments of actual or potential directors and senior officers of NBDTs, and deciding whether to approve significant changes in the ownership of individual NBDTs.

Which trustees are involved in the NBDT sector?

162. The following table sets out the trustees currently involved in the NBDT sector.[27]

Trustee	**Credit Union or Building Society**	**Finance Company**	**Total**
Foundation Corporate Trustee	16	4	20
Trustee Executors Limited	7	3	10
Covenant Corporate Trustee	0	6	6
Guardian Corporate Trustee	0	2	2
Maori Trustee	1	0	1
	24	15	39

163. It is noteworthy that only three trustees operate within the sector to any significant degree. Amongst the larger trustees the Public Trust and the Permanent Trustee also have no current NBDT appointments at all.

General observations on the options available for supervising NBDTs

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

- Continuation of the status quo;

- An enhanced trustee supervision model (which might provide trustees with extra powers, give the Bank greater control over the actions of trustees in carrying out their supervisory role, or involve the adoption of various

[27] These numbers do not include those NBDTs that have gone into receivership or liquidation since 2007, and a range of entities that are currently exempt from most, or all, of the requirements of the NBDT regime.

mechanisms for strengthening co-operation between trustees and the Bank); or

- Direct supervision of NBDTs by the Bank.

165. While the original Review of Financial Products and Providers (RFPP) discussion document on the regulation of NBDTs proposed a two tier regime, with finance companies and small deposit taking entities supervised by trustees, and credit unions and building societies and larger deposit taking entities supervised by the Bank, we have reservations about a model that applies fundamentally different supervisory approaches to different parts of the sector.[28]

166. In addition, an analysis of the appropriate supervisory arrangements for NBDTs also has to take into account the relatively small size of the sector and the fact that if a bank was ever deregistered it would be regulated as an NBDT.

Stakeholders' comments

167. Stakeholders expressed sharply divided views on the merits of trustees' supervision of NBDTs, with views ranging from very positive to very negative. With some exceptions, credit unions and building societies were more likely to have a negative view of trustees' performance, and finance companies were more likely to argue that the existing trustee arrangements work adequately.

168. Our impression is that these views were informed by entities' recent experience of dealing with certain trustees, and differences in the nature of business being undertaken by most credit unions (which carry on banking type business) and finance companies (which generally offer longer term debenture type products). It also reflects the focus of some NBDTs on the costs of the trustee model, and of other NBDTs on a preference to retain a model which they are familiar with and consider works adequately.

169. Some stakeholders expressed scepticism that a government regulator would do a better job in the circumstances, noted that actual or perceived issues with trustee performance would be addressed under the STSS Act, and questioned whether the area merited an increased level of involvement by the Bank or whether the Bank wanted to take on the moral hazard associated with directly supervising NBDTs.

170. Other stakeholders argued that the existing supervisory arrangements were unnecessarily complicated, not cost effective, and ran the risk of a lack of clarity and accountability around the roles of trustees and the Bank.

171. There were also strongly divergent views on the relative cost effectiveness of the status quo and alternatives such as direct supervision of NBDTs by the Bank. Some stakeholders suggested that direct supervision would be likely to be more cost efficient on the basis that that it would streamline reporting

[28] However, this does not necessarily preclude the possibility of having slightly different substantive requirements applying to different subcategories of NBDT, such as mutuals and finance companies.

obligations and the Bank does not have the same commercial imperatives as trustees to make a profit on its activities. Other stakeholders considered that the fact that the Bank was not subject to the same competitive pressures as trustees meant that direct supervision could not be assumed to be a more cost effective option.

How effective have trustees been in carrying out their role?

The original rationale for using trustees as frontline supervisors of NBDTs

172. The original discussion document issued in 2006 as part of the 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,[29] 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 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;

[29] The functions of the Securities Commission were taken over by the Financial Markets Authority in 2011.

- 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.[30]

173. 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 this might potentially have been a higher cost option than direct supervision by the Bank, it reflected stakeholders' familiarity with trustee supervision compared to supervision by the Bank at that time.

Developments since 2006

174. Perceptions of trustee supervision have changed appreciably since 2006 as a result of approximately 45 finance companies entering into liquidation, receivership or moratorium since that time. These entities had combined deposit liabilities of approximately $6 billion and approximately 170,000 investors. As noted earlier, a full list of these finance companies is contained in Appendix 1.

175. In a report on the finance company collapses that occurred up to February 2009, the Registrar of Companies noted a series of failings in the industry. Most significantly:

- The extent to which certain trustees were involved in failed finance companies raised questions about the quality of their due diligence when accepting new appointments, and in particular, the extent to which they accepted circumscription of their powers in relatively weak and ineffective trust deeds;

- That in his view certain trustees were slow to detect adverse financial issues that were developing in many of their clients, were timid in their responses to issues they had identified, and lacked the internal capability to deal with widespread failures within their client list; and

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[30] 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

- That breaches were not promptly identified or reported by the trustees. In particular, the Registrar generally received notification of breaches on, or about the date of, the appointment of a receiver.[31]

176. In 2009, Cabinet agreed to the implementation of a licensing regime for trustees in response to concerns about the performance of some trustees, especially their role in the finance company collapses. The Cabinet paper proposing that a licensing regime be established noted that there were a number of problems with the existing trustee supervision model. Most significantly:

    - A lack of capability in some trustees;
    - Weak trust deeds;
    - The potential for some trustees to lack the necessary independence from the issuers they supervise; and
    - A lack of mechanisms for holding trustees to account for poor performance.[32]

177. Issues with weak trust deeds in the NBDT sector have largely been addressed through the current NBDT regime requiring trust deeds to contain mandatory terms relating to capital, liquidity, and related party exposures.

178. The STSS Act, which provides for the licensing of trustees, has also been in force since October 2011. All trustees have had to be licensed under that Act since October 2012.

179. Notwithstanding these measures, we note that as late as September 2011, the report of the Auditor-General on the implementation of the Crown Retail Deposit Guarantee Scheme noted on-going industry concerns with the capabilities of some trustees.[33]

The Bank's general view of the performance of trustees under the NBDT regime

180. The Bank has historically had reservations about the internal capability of some trustees, and is aware of a small but significant number of instances where trustees have been slow in conveying information to the Bank.

181. The Bank also considers that the experience of the finance company collapses raises legitimate questions about how effective the supervision provided by some trustees would be in the event of significant problems across the NBDT sector. In this respect, we note that since the prudential regime in Part 5D of

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[31] Pages 10-11, Finance Company Failures – Observations of the Registrar of Companies, Appendix B, 2007/08 Financial Review of the Ministry of Economic Development at: http://www.parliament.nz/resource/0000075654

[32] See paragraph 13 of the Cabinet paper *Improving the supervision of issuers by trustees* available at: http://www.med.govt.nz/business/business-law/pdf-docs-library/current-business-law-work/securities-trustees/cabinet-paper-licensing-of-trustees.pdf

[33] Paragraph 4.35, Page 60, Report of the Auditor-General, *The Treasury: Implementing and Managing the Crown Retail Deposit Guarantee Scheme* at: http://www.oag.govt.nz/2011/treasury

the Act was fully in force (i.e. December 2010) the NBDT sector has been relatively stable, so the role of trustees and the Bank under the existing supervisory model has not been tested under stress.

Conclusion on the effectiveness of trustees to date

182. In our view, there is clear historical evidence that some trustees have not carried out their supervisory functions effectively in the past, and we share many of the concerns that have been expressed about the capability and performance of some trustees.

183. However, this historical background needs to be balanced against the long term effects of the licensing of trustees.

184. The Bank supports the licensing of trustees, and considers that that it is likely to raise standards in the trustee sector over time. We also consider that trustee performance in the NBDT sector can be improved through on-going monitoring of trustees by the Bank and issuance of guidance material on expected trustee practice in the NBDT sector.

185. However, while these measures can be expected to raise trustee performance over time, it is difficult to estimate just how significant an impact they will have over the long term, especially given that trustees have only been required to be licensed since 1 October 2012.

How efficient is the current supervisory framework?

General efficiency concerns

186. The existing model leaves trustees responsible for supervising NBDTs' compliance with certain matters, and the Bank responsible for supervising NBDTs' compliance with other matters, and monitoring the NBDT sector more broadly.

187. This division of supervisory and monitoring functions between trustees and the Bank makes it difficult to apply a uniform risk based approach to supervising NBDTs, given that feedback we have received indicates that trustees may use different approaches to the collection and analysis of information, and may be less well placed than the Bank to assess where risks lie across the entire NBDT sector, given that it is not trustees' role to monitor the sector as a whole.

188. It also has the potential to detract from role clarity and accountability, and hinder the ability to respond promptly and effectively to emerging issues. This issue is particularly acute in a distress management situation, or in the event of problems arising across the NBDT sector as a whole.

189. More broadly, the current division of functions between the Bank and trustees can create a lack of clarity around who is responsible for what matters under the regime. For example, the Bank is probably publicly perceived as being ultimately responsible for the supervision of NBDTs, but the regime means that

it is the trustees, rather than the Bank, that are actually responsible for carrying out day to day supervision of key prudential requirements.

190. Licensing of NBDTs under the NBDT Bill is likely to increase some of the efficiency concerns with using trustees as frontline supervisors of NBDTs. For example, the advent of licensing will mean that while the Bank makes an assessment of an entity's ability to comply with prudential requirements at the point of licensing, supervision of on-going compliance with key matters like capital and liquidity is largely left in the hands of trustees. This runs the risk of inconsistent approach to assessing compliance at the point of licensing and on an on-going basis.[34]

191. In addition, the licensing regime provides for a number of extra powers for the Bank, creates a broader range of areas that the Bank will be responsible for monitoring directly (for example, compliance with conditions of licences), and makes licences contingent on, amongst other things, an entity's ability to comply with their AML obligations. It will also provide the Bank with enhanced investigative and crisis management powers (including the ability to issue directions to NBDTs and trustees). Cumulatively, these matters increase the likelihood that trustees' supervisory role may be crowded out under the licensing regime, and/or that the Bank may override trustees in a crisis situation.

192. In considering the likelihood of this occurring, it is worth setting out the respective functions of the Bank and trustees under the licensing regime in full.

Functions of trustees	**Functions of the Bank**
Negotiating the terms of the trust deed	Licensing NBDTs.
Monitoring compliance with non-prudential terms in the trust deed	Imposing conditions of licence.
Monitoring an NBDT's post licensing compliance with capital, related party and liquidity requirements.	Conducting suitability assessments of directors and senior officers.
Approving and reviewing the NBDT's risk management programme.	Approving change of ownership transactions.
Report to the Bank on any instances of an NBDT's insolvency, and any instances of non-compliance by an NBDT that they become aware of (including non-compliance with other aspects of the Act or regulations, the	Monitoring compliance with conditions of licences, and credit rating and governance requirements.

[34] This issue becomes even more significant where assessing compliance requirements that are not "bright line" in nature. For example, NBDTs have to have a risk management programme that must adequately address certain types of risk that the entity may be subject to. In this situation, the Bank and trustees may have different interpretations of whether a risk management programme adequately addresses these risks.

trust deed, and the terms of the offer of securities).	
	Exercising investigative powers.
	Exercising direction powers.
	Taking enforcement action.

Who is best placed to carry out supervisory functions?

193. Trustees have existing industry knowledge and experience with monitoring compliance with the terms of trust deeds. Conversely, the Bank has experience in carrying out prudential supervision of banks, and the licensing of insurers (some of which are very small entities).

194. There is a theoretical argument that the entity responsible for licensing NBDTs should also be responsible for the supervision of NBDTs, so as to ensure consistency of approaches when assessing NBDTs at the point of licensing and on an on-going basis. This is not, by itself, necessarily a conclusive factor though.

Possible implications of changing the definition of NBDT

195. The proposal discussed earlier in this paper to change the definition of NBDT so that it no longer requires an entity to “offer debt securities to the public in New Zealand” might potentially have the effect of meaning that some NBDTs would come outside the scope of the Securities Act or FMC Act, and therefore not be required by legislation to have a trustee.

196. One argument for using trustees to carry out the frontline supervision of NBDTs is based on the fact that NBDTs are already required to have a trustee, and this approach leverages off existing arrangements. If this argument no longer applies, it is harder to see why supervisory arrangements would be designed this way. Likewise, having some NBDTs supervised by trustees and some supervised directly by the Bank increases the risk of inconsistency in supervisory approaches, and may raise questions of competitive neutrality across NBDTs.

197. As a result, we consider that any significant broadening of the definition of NBDT would potentially require changes to the supervisory arrangements for NBDTs.

Conclusion on the efficiency of the existing framework

198. We consider that there are strong arguments for concluding that the existing regime creates some inefficiencies through the division of functions between the Bank and trustees.

199. In particular, it has the potential to complicate the ability to respond quickly and effectively in a crisis, it provides less role clarity, and it generally reduces the

extent to which it is possible to implement a consistent, uniform model of supervision across the sector.

200. Broadening the definition of NBDT so that it includes a significant number of entities that do not come within the scope of securities law would also affect the analysis of supervisory arrangements, in that it could no longer be said that using trustees to supervise NBDTs leverages off existing arrangements that all NBDTs are subject to in any case.

Options for addressing issues identified with the current supervisory arrangements

Potential mechanisms under the existing supervisory arrangements for addressing the issues that have been identified

201. In considering options to address the issues we have identified with the current framework for supervising NBDTs, our starting point has been whether it is possible to substantially address these issues by improving the existing model.

202. In respect of the historical issues we have identified with trustee performance, a possible option is to rely on the licensing of trustees by the FMA to improve the quality of trustee supervision over time. This approach could be supplemented by the Bank issuing guidance to trustees about the Bank's expectations of their performance.

203. In addition, it may be possible to mitigate most of the key efficiency issues we have identified through a combination of legislative amendments and issuance of guidance material.

A lack of role clarity and accountability

204. This issue could be addressed in part by providing in legislation that trustees are responsible for monitoring compliance with all prudential and regulatory requirements under the regime, rather than just those which are contained in the trust deed. Specifically, this means that trustees would also be required to monitor compliance with the credit rating and governance requirements, and conditions of licence under the NBDT Bill (all of which the Bank monitors at the moment).[35] The Bank could also provide publicly available guidance for trustees on the scope of the respective roles of the Bank and trustees, and the nature and standard of monitoring expected of trustees. Making this guidance publicly available would also help to clarify public understanding of the respective roles of the Bank and trustees under this model.

The risk of trustees being slow to forward information about actual or potential breaches to the Bank

[35] We note that section 97 of the FMC Act requires the trustee of a debt issuer to supervise the issuer's compliance with their "issuer obligations" which include obligations placed on the issuer by Part 5D of the Reserve Bank of New Zealand Act 1989. This may de facto make trustees responsible for monitoring an NBDT's compliance with credit rating and governance requirements in any case.

205. It should be possible to improve the flow of information from trustees to the Bank by issuing guidance setting out clear expectations about the timely notification of information to the Bank and the nature and standard of monitoring that is expected of trustees.

Impediments to the ability to respond effectively in a crisis situation

206. To facilitate the efficient resolution of a distress management situation or problems across the NBDT sector more broadly, legislation could provide the Bank with the power to direct trustees to take, or not to take, action under the trust deed or any enactment in circumstances where an NBDT has been involved in an actual or potential breach.

Uniform risk based approach to monitoring of the sector

207. To facilitate a more uniform risk based approach to the supervision of the NBDT sector, the Bank could indicate in guidance material the nature and standard of monitoring expected of trustees, and could continue its existing discussions with trustees to coordinate approaches to emerging issues.

Conclusion on potential measures to improve the operation of the existing regime

208. The adoption of these changes would essentially mean moving from a model that is based on leveraging off existing arrangements that NBDTs are subject to under securities law, to a model where trustees are effectively being used as the Bank's agents in the day to day supervision of NBDTs. The Bank considers that these measures would mitigate many of the issues raised by the current regime. On the other hand, they may raise a question about the value being added by the on-going use of trustees, given that the scope for trustees exercising autonomous judgement under this model would be more limited than is currently the case.

The alternative option for supervisory arrangements

209. If the government considers that the model proposed above would not adequately address the issues that we have identified, or considers that it may raise other inefficiencies, and alternative option would be to have NBDTs directly supervised by the Bank. It should be noted that the Bank's supervisory remit has historically been centred around risks to the financial system. Directly supervising small NBDTs directly would move the Bank further from that.

210. We note that direct supervision of NBDTs would also 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. In this respect, it is important to keep in mind that in the event of an NBDT failing in the future, the resource implications for the Bank, both in terms of management time and other resources, are likely to be significant;

- 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;

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

- that the trustee industry adjust to the loss of NBDT business.[36]

211. In addition, given that the licensing of trustees has only been in place since 1 October 2012, a shift away from the use of trustees in the NBDT sector could be seen as suggesting a lack of confidence in the long term success of licensing and other measures to improve trustee performance.

212. In the discussion that follows, we note some of the implications of direct supervision of the NBDTs by the Bank, if the government chose to proceed with that option instead.

Issues arising out of direct supervision of NBDTs by the Bank

213. The existing role of trustees involves an explicit investor protection objective. This investor representation function developed out of:

- the need to have a third party monitor the performance of management in following through on the promises made to investors under the terms of the offer (especially given that debt holders do not have the rights that theoretically allow shareholders to monitor the performance of an entity and its management); and

- in the case of secured debt issues, the fact that the trustee holds the charge over the security on behalf of investors.

214. As noted earlier, the trustee's primary duty is to exercise due diligence to identify any breaches of the trust deed or terms of the offer and to take all actions it is empowered to take to remedy the breach.

215. Outside of legislation, as a by-product of this investor protection role the trustee also negotiates with the NBDT the content of the trust deed and the terms of the offer, and checks the prospectus. In the context of secured debt issues, this will typically involve also negotiating matters relating to:

- the process for approving significant transactions or changes in the business of the issuer;

- the terms of guarantees by related parties of the issuer;

[36] As noted earlier there are only three trustee companies with a significant degree of involvement in the NBDT sector. Specifically, Foundation Corporate Trustee, Covenant Corporate Trustee, and Trustee Executors Limited.

- the ability to allow for new prior charges over the security; and
- the process for calling and holding meetings of debt holders.

216. If the Bank was responsible for the direct supervision of NBDTs, the explicit investor protection objective of trustees' would be replaced by the Bank's focus on maintaining a sound and efficient financial system. However, under this model the Bank would still exercise a degree of oversight over matters like major transactions and guarantees involving related parties, where this was necessary to achieve the objective of maintaining a sound and efficient financial system.

217. In respect of finance companies and a small number of building societies that issue secured debt (normally in the form of longer term debentures), there is also a separate question around who would hold the charge over the security if the Bank directly supervised these entities.

218. It is likely that NBDTs would be exempted from the securities law requirement to have a trustee if they were supervised directly by the Bank, although NBDTs issuing secured debt would probably still be required to appoint a trustee to hold the charge over the security. The role of this trustee would be solely to enforce the charge in the event of default, after having consulted with the Bank on their intention to do so.

219. A likely consequence of this is that those trustees would still need to monitor the NBDT so as to identify when an NBDT may have failed to repay investors, but that this monitoring might be less intensive than what trustees are currently required to do (given that their existing role requires them to monitor compliance with the terms of the offer and the trust deed, and report to the Bank on breaches of other requirements that they become aware of). Under this model the Bank would probably also require the power to direct trustees in the event of an NBDT failing to repay investors, if agreement cannot be reached with the trustee on whether or not the charge should be enforced.

220. It is possible that over time this model might result in a gradual reduction in the number of NBDTs issuing secured debt, given that this would avoid the need for these entities to retain a trustee while also being supervised by the Bank.

Conclusion on options for NBDT supervision

221. In light of our analysis of this issue, we recommend that the Government adopt the measures to improve operation of the existing regime outlined in paragraphs 201-208.

222. However, if the Government does not consider that these measures will adequately address the problems we have identified with the existing model, it may wish to consider whether it wants to direct the Bank to take over the frontline supervision of NBDTs, recognising the drawbacks inherent in such an approach.

Recommendation

That the Government adopt the measures to improve the operation of the existing regime outlined in paragraphs 201-208.

That if the Government does not consider that the above recommendation adequately addresses the problems in the existing model, the Government consider whether to direct the Bank to take on the frontline supervision of NBDTs.

SECTION FIVE: Prudential requirements for NBDTs

Current prudential requirements

223. Part 5D of the Act requires that NBDTs comply with the following obligations:

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

224. At the moment these requirements are set through a variety of 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 deeds (in the case of capital, liquidity and related party exposure requirements).

Stakeholders’ general comments on the prudential requirements

225. Stakeholders were largely satisfied with the current prudential requirements for NBDTs, and generally felt that they are a codification of good business practice.

There was a broad consensus that the matters that should be subject to prudential regulation were covered by the current requirements – that is, there were no requirements that stakeholders thought should be added or removed. However, some stakeholders raised concerns regarding specific aspects of certain requirements, which are discussed below.

Analysis of specific prudential requirements

Credit rating

226. 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.

227. The credit rating requirement is intended to strengthen the incentives for NBDTs to develop and maintain sound governance and risk management practices. The requirement to have a credit rating also allows the Bank to have a less intrusive supervisory approach as rating agencies provide an additional level of oversight, providing the market with an independent evaluation of an entity's financial condition.

228. 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.

229. This exemption was originally provided for due to concerns that the cost of obtaining a credit rating could be unduly burdensome for small NBDTs. At the time the exemption was drafted, the direct and indirect costs to an entity of obtaining a credit rating amounted to an average of 20% or more of after-tax profits for entities with consolidated liabilities of under $20 million. As the costs of obtaining a credit rating and the overall profitably of NBDTs have not materially changed since that analysis was carried out, these figures are likely to remain broadly accurate.

230. Some stakeholders were concerned that the cost of obtaining a credit rating creates a material disincentive for growth in the sector. They argued that the methodology used in credit ratings makes it too difficult for small entities to obtain a good rating, and means that the rating does not provide useful information for investors. Although it is more difficult for small entities to obtain high ratings, this is due to the concentration risk of such businesses and the lack of substantial parental support – factors that are highly relevant to an entity's probability of default.

231. The Bank remains of the view that credit ratings provide an important independent assessment of an entity's creditworthiness and are an integral part of market discipline. For this reason we would not recommend a change to the credit rating exemption threshold at this time, but will keep this matter under review.

Director independence requirements

232. 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.

233. 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.

234. The Bank considers that an adequate level of independent representation on the board is critical to ensure sound corporate governance.

235. When the governance requirements for NBDTs were designed, they were consistent with those in the banking regime. However, since the changes to the governance requirements in the banking regime in 2010, and the introduction of a prudential regime for insurers, the requirements in the NBDT sector are now different than the expectations in those sectors. In particular, both the banking and insurance regimes require at least half of the board to be independent, although their rules for who can qualify as an independent director are slightly less strict.

236. Director independence could be argued to be particularly important in the NBDT sector as the lack of large institutional investors means that there is a risk of lack of independent oversight of managerial decisions. Furthermore, the typical size of NBDTs means it is not uncommon for individuals to acquire a significant influence over them. This significant influence would enable an individual to act in their own interests rather than those of the company – especially if there are no independent directors to oversee those decisions.

237. For these reasons, we consider that the retention of the current governance requirements is essential. While the level of independent representation required on the board of an NBDT is less than that applying to banks or insurers, we acknowledge that the costs associated with increasing this requirement may be prohibitive for some NBDTs. Accordingly, we think the current governance requirements should be retained. However, we note that should the Bank have the power to set prudential requirements via standards (see the discussion below), we may consider the appropriateness of increasing the number of independent directors larger or higher risk NBDTs are required to have on their board.

238. Some stakeholders raised concerns that the criteria to be considered independent are too stringent as they do not allow directors of an NBDT to be considered independent if they are also directors of a guaranteeing subsidiary

of the NBDT. The Bank agrees that a person should be able to qualify as independent despite being a director of a guaranteeing subsidiary, so long as they meet all of the other requirements to be classed as an independent director (i.e. so long as they have no other personal or financial interests in any member of the group). The Bank may recommend that this issue be addressed via a supplementary order paper to the NBDT Bill.

239. In addition, some mutuals expressed concern that the director independence requirements are too onerous given that their directors are elected from their members. They argued that the importance of independent representation was less in this case as there is no practical separation between the investors in, and managers of, the mutual. We note this concern, but consider that independent directors often still play a valuable role in this situation (for example, by adding external corporate expertise to the deliberations of the board). Accordingly, we do not propose any changes to this requirement at present.

Risk management programme

240. Part 5D of the Act requires every licensed NBDT to have a compliant risk management programme. It also sets out the requirements for risk management programmes, including what procedures must be covered. These relate to credit risk, liquidity risk, market risk and operational risk.

241. 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.

242. The risk management programme must:

- Be in writing; and
- Set out the procedures that the NBDT will use for effectively identifying and managing the following risks:
  - credit risk;
  - liquidity risk;
  - market risk;
  - operational risk; and
- Set out appropriate documentation and record-keeping requirements; and
- Describe the steps that the NBDT will take to ensure that the programme remains current, which must include procedures for-

  - o regular review of the programme to systematically identify deficiencies in the effectiveness of the programme; and

  - o obtaining trustee approval to amendments to the programme that are necessary to address such deficiencies; and

- 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).

243. If the trustee is not satisfied that the risk management programme meets the requirements of Part 5D:

- 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.

244. 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.

245. No issues were raised during the review about the requirement to have a risk management programme.

Capital

246. Capital represents the financial commitment of the owners to a business. It is required to absorb any 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 NBDTs maintain a minimum ratio of capital relative to the credit, operational and market risk that the NBDT assumes.

247. Part 5D of the Act allows for regulations to be made for the purpose of imposing a requirement that 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; and

- specify a definition of capital for that purpose.

248. Part 5D of the Act also 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.

249. 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.

250. During the review a number of stakeholders expressed concern that the NBDT capital regime was unduly onerous when compared to the banking regime. In particular, some stakeholders argued that the risk weights that apply to NBDTs under the capital requirements are considerably higher than those that apply to banks. They expressed concern that this gave banks an unfair competitive advantage over NBDTs and argued that the same risk weights should apply to in both the NBDT and banking regimes.

251. One of the primary reasons for differences between the banking and NBDT regimes is the greater likelihood of concentration risk in the NBDT sector, with many NBDTs having a high degree of exposure to particular regions. This makes them vulnerable if there were to be a collapse in asset values in that area.

252. Since 2009 the Bank has published a technical paper on our website that explains the derivation of these risk weights and the rationale behind any differences from the banking regime.[37] This document explains the risk-based rationale behind any differences from the banking regime.

253. In addition, there are a broad range of reasons why direct comparisons of risk weights under the two regimes is potentially misleading. For example, NBDTs are not required to account for off-balance sheet exposures. More detail on the difference between the regimes and the rationale behind these variations is provided in the paper cited above.

254. As a result, we do not propose any changes to the capital regime at this time, but will keep this matter under review.

Restrictions on related party exposures

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[37] http://www.rbnz.govt.nz/regulation_and_supervision/non-bank_deposit_takers/3799546.pdf

255. A related party exposure arises when a financial institution advances funds to an associated organisation. Having a cap on exposures to related parties limits the scope and ability of owners, and their related interests, to extract benefits from the NBDT.

256. 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 NBDT 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 financial position, and affect the position of creditors.

257. Part 5D of the Act provides for the making of regulations imposing a requirement on NBDTs and trustees to ensure that trust deeds include a maximum limit on exposures to related parties.

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

- Provide that the maximum limit on exposures to related parties is relative to
    - the capital of an individual licensed NBDT; or
    - the capital of the borrowing group of which a licensed NBDT is part;
- 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;
- Require every licensed NBDT and trustee to ensure that trust deeds include a specified maximum limit on exposures to related parties; and
- 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.

259. 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 on the definition of related parties.

260. Most stakeholders did not comment directly on the effectiveness of the related party exposures provisions. However, a few suggested that the difference in business models between mutuals and finance companies should justify a different application of the limit on exposures to related party transactions. In particular, they thought that exposures made on arms-length / commercial

terms with certain related parties should not be included in the calculation of aggregate related party exposures for mutuals. This was argued on the basis that the business models of these mutuals presuppose that their directors will also be members of the mutual and transact with it.

Liquidity requirements

261. Part 5D of the Act 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.

262. The Regulations require every NBDT and its trustee to ensure that the NBDT's trust deed includes liquidity requirements, including at least one quantitative liquidity requirement. Quantitative liquidity requirements in the trust deed must be appropriate to the characteristics of the NBDT's business, and take into account the liquidity of the NBDT and the liquidity of any borrowing group.

263. No issues were raised during the review in relation to this requirement.

Recommendation

That no changes be made to the prudential requirements at the current time.

That the prudential requirements should be reviewed periodically to ensure they remain fit for purpose.

Mechanism for setting prudential requirements

264. As noted earlier, prudential requirements for NBDTs are largely set in regulations, with a small number of requirements being set directly in Part 5D of the Act.

265. We think that there is a good case for considering whether regulations are the most appropriate mechanism for setting prudential standards, given:

- the highly technical nature of certain prudential standards (for example, capital requirements);

- the importance of responsiveness to changing circumstances in setting prudential requirements; and

- the value of being able to tailor requirements that apply to specific classes of entities in a diverse NBDT sector.

266. 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).

267. 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 licence or standards set by the Bank under IPSA. Generally, standards, conditions of licence or other broadly analogous instruments are used to set these kinds of requirements in other countries as well.

268. 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 be slightly weaker, as these requirements are of a significantly less technical and specialist nature. Nevertheless, there may be circumstances where the ability to modify these requirements over the short term is desirable. It is also preferable for the prudential requirements to all be contained in the same instruments, rather than being divided between regulations and standards.

269. With the advent of licensing under the NBDT Bill, there is the option of potentially setting some or all prudential requirements through conditions of licence. However, we think that the use of standards would be preferable, given that they must be published in the New Zealand Gazette and are subject to the Parliamentary disallowance procedure set out in the Legislation Act 2012. We also think that any power to set standards should also be accompanied by a requirement for the Bank to consult with affected parties, and have regard to any submissions they may make.

270. Stakeholders were broadly supportive of setting prudential requirements via standards or conditions of licence. They agreed that this would provide flexibility for the Bank to vary conditions where appropriate in particular circumstances. Furthermore, stakeholders thought it would allow the Bank to

better respond if changing market conditions necessitated a change. They noted this is consistent with the approach taken in the banking and insurance sectors. Stakeholders also saw advantages in specifying less technical requirements in standards or conditions as this would avoid the complexity of a prudential regime that is part-defined in regulation and part-defined through standards.

271. Those stakeholders that expressed concerns regarding this approach felt that it could create a lack of transparency. They also felt that there could be a risk of a loss of competitive neutrality if there was too much disparity in the conditions imposed on different entities, which could in turn make the Bank susceptible to questions of fairness.

272. However, we consider that these concerns can be adequately addressed through the consultation, publication and Parliamentary oversight requirements we are proposing.

Recommendation

That prudential requirements for NBDTs be set via standards made by the Bank.

That the Bank be required to consult with affected stakeholders prior to making prudential standards, and that these standards be required to be published in the New Zealand Gazette and be subject to the parliamentary disallowance procedures in the Legislation Act 2012.

That the Bank retain the power in the Non-bank Deposit Takers Bill to impose conditions of licences on individual NBDTs.

Requirement to carry on business in prudent manner

273. At present there is no requirement that the business of an NBDT be conducted in a prudent manner. However, in order to grant a licence under the NBDT Bill the Bank must be satisfied that the applicant would be able to comply on an on-going basis with the NBDT Bill, any associated regulations and any proposed conditions of the licence.

274. Both the Act and IPSA empower the Bank to consider the ability of an entity to conduct its business in a prudent manner both at time of application and at reviews thereafter.[38] Matters the Bank can typically have regard to when making this determination include:

a. Whether financial and human resources are appropriate for the size and nature of the business (e.g. capital and concentration of business);

b. Internal controls;

[38] Section 78, Reserve Bank of New Zealand Act 1989, and Section 20, Insurance (Prudential Supervision) Act 2010.

c. The size and type of risks entered into;

d. Separation of the business or proposed business from other business and from other interests of any person owning or controlling the entity;

e. The nature and extent of related party transactions; and

f. Risk management systems and policies or proposed risk management systems and policies.

275. While the NBDT Bill enables the Bank to consider many of these matters at the point of licensing, and impose conditions of licence relating to many of these matters on an on-going basis, there are certain matters, such as an entity's financial and human resources, or internal controls, that the Bank has no express power to impose conditions in relation to. We may consider at a later point whether the Bank should be able to apply conditions relating to these matters as well.

SECTION SIX: Disclosure requirements for NBDTs

Status quo

Background

276. Part 5D of the Act does not contain provisions for setting general disclosure requirements for NBDTs. When Part 5D of the Act 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.[39]

277. In 2011, the Bank and the Ministry of Economic Development[40] 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. However, this work has not been progressed due to the pressures of other priorities in the interim.

Disclosure requirements under the Securities Act

278. 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 investors before they subscribe to the security.

279. 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

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[39] See paragraph 75 of the Cabinet paper *Review of Financial* Products *and Providers: Regulation of Non-bank Deposit Takers* at: http://www.rbnz.govt.nz/regulation_and_supervision/non-bank_deposit_takers/sector_review/3116779.pdf

[40] Now part of the Ministry of Business, Innovation and Employment.

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 when the following year's annual financial statements are completed. At any time over the life of the prospectus, if the disclosure becomes false or misleading, the prospectus must be updated.

280. 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.

281. The investment statement is designed to provide a more accessible set of disclosures for a "prudent, non-expert investor". 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.

282. 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 Act

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

284. 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 Act for financial products, including debt securities. It is anticipated that the FMC Act and related regulations will be in force by the first half of 2014, with a transitional period to follow.

285. The FMC Act 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 of Companies 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.

286. 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.

287. 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.

288. 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.

289. 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 audit reports, or links to them; and

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

290. 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.

291. 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

292. 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 NBDT Bill.

293. The review identified a number of potential problems with the existing disclosure requirements for NBDTs. 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.

294. During the review we also considered the possibility of setting out a separate disclosure regime for NBDTs based on a scaled down version of the existing bank disclosure regime. Amongst other things, this would involve an exemption from securities law disclosure requirements in respect of basic debt products issued by NBDTs, and a philosophical shift from a product based disclosure regime to an entity based disclosure regime. As such, it would place more emphasis on 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.

Stakeholders' comments

295. Broadly speaking most stakeholders agreed with the conclusion that NBDTs should be required to make prescribed prudential disclosures. However, there was a clear division of views between finance companies, who thought that these disclosures should be made under the securities law regime, and mutuals, who thought that a separate standalone disclosure regime should apply to NBDTs.

296. The views of mutuals were affected by the "bank-like" nature of the products that they offer (e.g. transactional accounts and short term term deposits), and a concern that the securities law disclosure framework is not designed to accommodate these kinds of products. For example, it requires that investors receive a copy of a prospectus or investment statement before subscribing to a savings account offered by a credit union. This contrasts with the treatment of banks under the FMC Act in particular, given that banks are not required to prepare a product disclosure statement or make disclosures on the register in respect of debt securities that they offer.

Analysis of options for disclosure requirements for NBDTs

297. We consider that tailored prudential disclosures should be prescribed for NBDTs. However, for the moment, the Bank is satisfied that these can be adequately integrated into the new disclosure regime being established under the FMC Act.

298. Securities law disclosures appear to work appropriately for finance companies raising funds from the public. In respect of credit unions and building societies offering basic “bank-like” products, there is potentially a stronger case for a separate continuous disclosure type regime akin to the regime that applies to banks. However, we note that the disclosure regime that is established under the FMC Act comes closer to this model due to the way it requires that disclosures be made on an on-going basis on the Register of Securities Offers.

299. However, should the recommended changes to the definition of NBDT be adopted, we propose that a regulation making power allowing for prescribed disclosures by NBDTs be provided for. The greater the number of entities covered by the definition of NBDT but not the FMC Act, the more important it will be to have this power, so as to ensure that these entities can be required to make disclosures if appropriate.

Recommendations

That prudential disclosures for NBDTs be integrated into the disclosure regime established by the Financial Markets Conduct Act for the moment.

That a separate regulation making power be provided for to mandate disclosures by NBDTs, should the recommended changes to the definition of NBDT be adopted and result in a significant number of entities outside the scope of securities law being covered by the NBDT regime.

SECTION SEVEN: Crisis management powers

Current crisis management powers

300. The NBDT Bill provides for the Bank to have powers to direct NBDTs to take certain action where:

- An NBDT or associated person 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 is failing, has failed, or is likely to fail, to comply with the NBDT 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.

301. 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 NBDT 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;

- 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).

302. There is no tailored statutory management regime available for NBDTs under the NBDT Bill. However, we note that NBDTs continue to be subject to the statutory management regime applying to all entities under CIMA. 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.

303. Whether the Bank should have the power to place an NBDT into statutory management was originally considered as a part of the RFPP. The resulting Cabinet paper recommended that the Bank should have the power to make a recommendation to the Minister that an NBDT be placed into statutory management by a provision similar to that for banks in the Act.[41]

304. However, when the NBDT Bill was drafted this position was reversed as it was not considered necessary to have a separate regime to that available in CIMA due to the limited systemic risks NBDTs raise relative to banks. Nevertheless, it was noted in the associated Cabinet paper that this decision would be considered again as part of the review of the operation of the regime required under Part 5D of the Act.[42]

Operation of statutory management regimes under other legislation

[41] http://www.rbnz.govt.nz/regulation_and_supervision/non-bank_deposit_takers/sector_review/3116779.pdf
[42] http://www.rbnz.govt.nz/regulation_and_supervision/non-bank_deposit_takers/4448903.pdf

305. At the moment, there is a generic statutory management regime under CIMA that applies to all entities, and separate bespoke statutory management regimes for banks and insurers under the Act and IPSA respectively.

306. Under all of these regimes, statutory management 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 other key features of these regimes are that:

- An entity may be placed into statutory management where it is insolvent or likely to become insolvent, or generally where it is being operated in a fraudulent manner, or 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;

- 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.

Gaps in current resolution mechanisms

307. There are four formal resolution procedures provided for under the Companies Act and the Receiverships Act 1993 (Receiverships Act) for dealing with the insolvency of an entity: receivership, a compromise with creditors, voluntary administration, and liquidation. These resolution options are also available to deal with failure or default situations caused by matters other than outright insolvency.

308. While these resolution options will be sufficient in most cases, we see three problems associated with solely relying on them to resolve the affairs of a failed NBDT. Specifically:

- They are all private resolution options, which regulatory agencies play little or no role in;

- They do not allow for problems within an entity to be dealt with pre-emptively where the entity may be being run fraudulently or recklessly; and

- They are focused on the repayment of creditors and may not allow for a resolution to be managed in such as way as to minimise the adverse impacts on the NBDT sector or wider financial system.

309. The statutory management regime in CIMA largely fills these gaps, but statutory management under CIMA is triggered by a recommendation of the FMA. The statutory management regime in CIMA also lacks certain features, like the power to issue directions to the statutory manager, which are found in the Act and IPSA.

310. On the grounds of administrative efficiency, we think there is a strong argument that a statutory management regime for NBDTs that can be initiated by the Bank should be provided for.

Stakeholders' views on the appropriateness of a bespoke statutory management regime for NBDTs

311. Stakeholders were broadly supportive of the introduction of a statutory management regime administered by the Bank. They noted that the Bank is likely in a better position to quickly and effectively respond to a distress event, given the Bank's objectives. Stakeholders also thought that it would provide clarity in process, roles and responsibilities in the event of a crisis, and help to facilitate a more efficient response by the Bank.

312. Those stakeholders that were against the proposal queried whether the Bank should have such powers given the failure of an NBDT arguably raises less systemic risks than the failure of a registered bank. However, we consider that this point does not take into account the potential for growth in the sector, or the fact that NBDTs could already be placed into statutory management under CIMA.

Statutory management regime for NBDTs

313. Given the fact that we consider that the absence of a statutory management regime leaves a gap in the available resolution options, and we think there are sound reasons for statutory management to be integrated into the other powers that the Bank has as prudential regulator, we recommend that a separate statutory management regime be established for NBDTs.

314. Under this model:

- An entity would be placed into statutory management by an order in council made on the advice of the Minister of Finance given in accordance with the advice of the Bank;

- The threshold for placing an NBDT into statutory management would be:
    - o where the failure of an NBDT may result in significant harm to the financial system; or
    - o where the NBDT is being operated fraudulently or recklessly;
- However, the Bank could only recommend that an NBDT be placed into statutory management when it has reasonable grounds to believe that the affairs of the entity cannot be adequately resolved under the Companies Act, Friendly Societies and Credit Unions Act, Building Societies Act, or the Receiverships Act (this is important to ensure that statutory management is only used where absolutely necessary); and
- Other aspects of the statutory management regime would be largely the same as under the statutory management regime in IPSA, including the power to direct the statutory manager.

315. If the recommendation to establish a separate statutory management regime for NBDTs is supported, the Bank will carry out further work on the detailed design of this regime.

Recommendation

That a tailored statutory management regime be provided for NBDTs.

SECTION EIGHT: Offences and penalties

Current offences and penalties under the NBDT regime

316. At present the NBDT Bill contains four levels of penalty that apply to offences committed by NBDTs, their directors and trustees. These broadly reflect the existing offences under Part 5D of the Act 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.

317. The exclusive use of criminal penalties is consistent with the approach taken under other regulatory regimes the Bank administers, with the exception of the AML regime.

318. To date the Bank has taken two criminal prosecutions against NBDTs and has issued a censure to a trustee in respect a failure to promptly report a breach that led to one of the prosecutions. The prosecutions and censure relate to breaches of the governance requirement to have two independent directors.

319. Given the importance of having a graduated range of remedies available to ensure that breaches can be dealt with proportionally, the Bank sees merit in looking again at where the use of criminal, civil and administrative penalties may be appropriate under the NBDT regime.

Criminal penalties, civil penalties, and infringement notices

Criminal and civil penalties

320. Traditionally, criminal offences and penalties have been used where the state is upholding certain norms of behaviour on behalf of society as a whole, whereas civil remedies have been the remedies that are available in disputes between private parties. This distinction has increasingly broken down in corporate law due to an increasing reliance on civil remedies (especially civil pecuniary penalties) by regulators looking to enforce the requirements of financial market and corporate regulatory regimes.

321. 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; and

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

322. There are several rationales for the use of civil penalties, including:

- that a criminal conviction is less likely to be effective where the breach is committed by a corporate entity rather than a private individual;

- that civil penalties are often more proportionate responses to minor or technical breaches; and

- that the standard proof and procedural requirements associated with civil penalties are more appropriate for certain types of offending (for example, in some contexts it can be problematic to try to impart traditional criminal law concepts like intention and recklessness to corporate entities, and strict liability[43] may not be appropriate).

Infringement notices

323. Infringement notices are fines that can be applied directly against organisations that are in breach of legislative obligations, without the need to go to court (although they can be appealed in court). However, they can only be provided for where there is a special type of statutory offence (called an infringement offence) that also applies to the breach.

324. Because an infringement notice can be issued without going to court, the maximum level of fine that can be issued under an infringement notice is usually low (i.e. under $5,000), and will always be below the maximum fine that may be awarded under the relevant infringement offence. In addition, no conviction can be entered as a result of the prosecution of an infringement offence.[44]

325. For small and relatively insignificant infractions, the threat of an infringement notice is more likely to provide sufficient incentive to comply with legal obligations. Infringement notices may also be more effective in a risk-based regulatory environment where non-compliance is focused on preventing harm. Criminal sanctions are often more appropriate where there has been actual harm caused by regulatory non-compliance.

326. Some example of infringement notices used in a financial sector context include:

- the power to issue an infringement notice with a fine of up to $7,000 for a failure to file financial statements under the Financial Reporting Act 1993 (the related infringement offence carries a fine of up to $100,000);[45] and

[43] A strict liability offence is an offence for which there is no requirement to prove a mental element (like intent on or recklessness), but for which a defence is available.
[44] Section 375, Criminal Procedure Act 2011.
[45] This infringement notice regime is carried across into the Companies Act by the Financial Reporting Bill, which is currently before Parliament.

- the various infringement notice provisions in the FMC Act.

Should the regime rely solely on criminal penalties?

327. The Bank considers that the objectives of a well functioning penalty regime should be to:

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

    - provide a swift and effective response to breaches of requirements under the NBDT regime; and

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

328. Regulatory compliance is most likely to be achieved where the requirements of the regulatory regime are enforced using a wide range of sanctions. This 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 hierarchy 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.[46]

329. At present, the only options available to the Bank where an NBDT breaches a requirement are to issue a censure or proceed with criminal charges, which can make it difficult to respond proportionally to an NBDT that breaches its requirements. As a result, we think that there is a case for providing a more graduated series of potential remedies for breaches, and that this should include both civil penalties and infringement offences and notices. In this context, infringement offences and infringement notices would likely only apply to breaches of less significant obligations, and where we do not consider there is a need for remedies involving a criminal conviction. Infringement notices would especially help to incentivise compliance in situations where a technical breach has occurred and the cost of going to court would outweigh the benefit.

330. A regulatory regime that provides for a wide range of sanctions will ensure that penalties are proportionate to the severity of the infraction. If a regulator can only access criminal sanctions then it may be less likely to take prosecutions as frequently, which is likely to encourage the regulated community to consider the risk of being caught and punished lower, in turn reducing the effect of the regulatory regime. It is also important to keep criminal law as a last resort and only for the most serious infractions so as to not dilute the social blame that comes with criminal sanction.

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

331. From a design perspective, we would envisage that a revised offence and penalty regime for NBDTs would be structured as follows:

- criminal penalties would apply in those cases where the breach was reckless or intentional, and would carry terms of imprisonment and possibly the largest fines;

- civil penalties would apply in those cases where the breach was not intentional or reckless, and might carry proportionately lower maximum fines; and

- the available civil penalties would not include compensation orders, given that the objectives of the prudential regime are focused on systemic soundness and efficiency, and there is no explicit investor protection objective; and

- infringement notices would be available to detail with the most minor infringements.

Proposed penalty tiers

332. The table below sets out in more detail the three categories of offences and penalties we are proposing, and includes an example of what type of offence may be appropriate in each category. These categories should reflect a more proportionate range of response to contraventions of the law by NBDTs.

Proposed categories	**Nature of breach**	**Explanation**
Infringement notices/offences	This category includes violations of basic compliance obligations whereby the breach will not have serious consequences, e.g. failure to promptly provide statistical information on request.	These would be reserved for strict liability offences where behaviour has resulted in simple clear-cut breaches of the law. The Bank would have the ability to issue an infringement notice in respect of these offences and the penalty level would be a minor fine.
Civil pecuniary penalties	Civil liability would be available for more serious breaches, e.g. breach of the requirement to have a current credit rating.	Civil liability would be used for behaviour that is not sufficiently serious to warrant the use of serious criminal offences. This category will provide for deterrence and the penalty will be a significant fine.
Criminal offences	The most severe contraventions of prudential requirements would be	Criminal responsibility for the most severe contraventions of prudential requirements where

	reserved for criminal offences, e.g. failure of an NBDT to comply with the requirements of its licence under the NBDT Bill.	the behaviour has been reckless or intentional. Conviction will result in the potential for a significant term of imprisonment, which should provide strong deterrent effect and an effective punishment.

Penalty levels

333. At present the tiers of penalty in the Act and the NBDT Bill are set in accordance with the regulatory regime for banks. Given the relative difference in the size of these sectors there is a question around whether the penalty levels in the Act and the NBDT Bill are set too high.

334. The NBDT sector poses a lower systemic risk to the financial system than the banking sector, in large part due to its significantly smaller size. In this way the NBDT sector is more analogous to the insurance sector.

335. IPSA sets penalties at a lower level reflecting the differing risks associated with the insurance and banking sectors, with typical penalty levels between $500,000 and $1,000,000, and/or terms of imprisonment of up to 2 years. The Bank believes it would be more appropriate for the levels of penalty under the NBDT regime to be set closer to the levels in IPSA to better reflect the damage that might be caused by an NBDT seriously breaching a requirement.

Enforceable undertakings

336. Enforceable undertakings are agreements entered into between the regulator and a regulated entity, and which bind the regulated entity to take certain action to address actual or potential breaches. Enforceable undertakings must be in writing, and can be enforced in court by the regulator.

337. The regulator may accept an enforceable undertaking instead of taking alternative action. To achieve this, it is usual for the regulated entity to promise to stop the alleged contravention, take action to address future occurrences of similar breaches, and/or rectify any negative effect the conduct may have. Accordingly, an enforceable undertaking aims to:

- prevent similar breaches in the future;
- change the organisation’s compliance culture; and
- correct the effect of the breach.

338. The Bank considers that enforceable undertakings may be an appropriate option for the Bank to have available to deal with more minor breaches by NBDTs.

Recommendations

That the offence and penalty regime applying to NBDTs should make use of civil and administrative remedies, as well as criminal offences. In particular, that the penalty regime be based on three tiers:

- Criminal offences for reckless or intentional breaches;
- Civil pecuniary penalties for other breaches of significant requirements; and
- Infringement notices that can be directly issued by the Bank for breaches of minor obligations under the regime.

That the levels of penalties be reduced in line with the levels in the Insurance (Prudential Supervision) Act 2010.

That a power be provided for in legislation for the Bank to accept enforceable undertakings.

SECTION NINE: Conclusion

339. Overall, the Bank considers that the regime has helped to reduce the likelihood of failure in the NBDT sector, and encouraged sounder management of NBDTs. Through these outcomes, we also consider that it has help to contribute to the objective of a sound and efficient financial system.

340. We also continue to support the prudential regulation of NBDTs, due to the risks inherent in an entity that carries on the business of borrowing and lending, and the damage that problems in the sector can cause to public confidence in the financial system.

341. 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. The regime was also fully implemented just after most of the finance company collapses occurred. As such, it has not been placed under significant pressure.

342. 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;

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

- Ensure that the regime is able to accommodate changes to the industry over time.

343. In this respect, the key changes we are proposing to the regime are:

- Changing the definition of NBDT so that it is based on the overarching concept of an entity that carries on the business of borrowing and lending, and providing the ability to actively manage the boundary issues this definition raises through the use of carve outs from the definition;

- Changing the supervisory regime for NBDTs to ensure that risks in individual NBDTs and the sector as a whole can be managed in a more coherent way, and to improve the ability to effectively respond in a crisis situation; and

- Setting certain prudential requirements through standards 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.

344. Other changes recommended in this report such as the use of civil penalties in the enforcement regime, and the establishment of a tailored statutory management regime, also help to support these objectives.

APPENDIX ONE: Finance companies that failed between mid-2006 and mid-2011

	Entity name	Failed date[47]	Deposit liabilities ($m)	Estimated number of depositors
1	**National Finance 2000**	May 06	22	2,000
2	**Provincial Finance**	May 06	296	11,000
3	**Western Bay Finance**	August 06	48	
4	**Bridgecorp**	July 07	459	14,367
5	**Bridgecorp Investments**	July 07	30	1,334
6	**Nathans Finance**	August 07	174	7,082
7	**Propertyfinance Securities**	August 07	80	3,000
8	**Five Star Consumer Finance**	August 07	55	2,130
9	**LDC Finance**	September 07	20	1,200
10	**Beneficial Finance**	October 07	24	750
11	**Clegg & Co Finance**	October 07	15	496
12	**Geneva Finance**	November 07	1,450	3,000
13	**Capital + Merchant Finance**	November 07	167	7,500
14	**Numeria Finance**	December 07	4	500

[47] Failed date indicates that date that the entity first entered into liquidation, receivership or moratorium.

15	**Boston Finance**	February 08	48	1,600
16	**Capital + Merchant Business Investments**	February 08	2	60
17	**Lombard Finance & Investments**	April 08	111	3,900
18	**Kiwi Finance**	April 08	2	42
19	**OPI Pacific Finance**	April 08	450	1,200
20	**Fairview New Zealand**	May 08	7	797
21	**Belgrave Finance**	May 08	20	1,000
22	**North South Finance**	June 08	78	6,925
23	**Compass Capital**	August 08	15	500
24	**Dominion Finance Group**	September 08	177	5,937
25	**Chancery Finance**	October 08	17	1,374
26	**All Purpose Finance**	November 08	5	336
27	**St Laurence**	December 08	250	9,431
28	**Hanover Finance**	December 08	464	13,000
29	**Hanover Capital**	December 08	24	
30	**United Finance**	December 08	67	
31	**Dorchester Finance**	December 08	197	7,800

32	**Strategic Finance**	December 08	350	15,000
33	**Orange Finance**	December 08	50	2,500
34	**Mascot Finance**	March 09	68	2,511
35	**Structured Finance (NZ)**	May 09	32	172
36	**Strata Finance**	September 09	1	
37	**Vision Securities**	March 10	29	953
38	**Rockforte Finance**	May 10	3	77
39	**Viaduct Capital**	May 10	8	110
40	**Mutual Finance**	July 10	9	340
41	**South Canterbury Finance**	August 10	1,580	35,000
42	**Allied Nationwide Finance**	September 10	128	4,500
43	**Equitable Mortgages**	December 10	192	
44	**Finance and Leasing**	January 11	17	227
45	**NZF Money**	July 11	19	1,007
	Total		$5,954m	170,658 investors

APPENDIX TWO: Process for conducting the review

In carrying out the review that Bank has sought information and feedback on the operation of the regime to date, and potential changes to the regime from three main sources:

- Release of a public discussion document;
- Discussions with an industry advisory group
- Other discussions with interested stakeholders.

Release of a public discussion document

The Bank released the discussion document *Review of the Prudential Regime for Non-bank Deposit Takers* for public consultation between 3 April 2013 - 17 May 2013. Submissions were received on the discussion document from:

- New Zealand Association of Credit Unions
- Financial Services Federation
- Trustee Corporations Association
- UDC Finance Limited
- General Finance Limited
- Nelson Building Society
- Waiarapa Building Society
- Foundation Corporate Trustee
- New Zealand Law Society
- Russell McVeigh
- Franks & Ogilvie
- Chapman Tripp
- ANZ
- BNZ
- David G Mayes, University of Auckland
- Wesleyan Society

- Archdiocese of Wellington
- Roman Catholic Bishops of New Zealand
- Kingdom Resources Trust
- Baptist Savings
- Telecom
- Foodstuffs (Wellington)
- Public Trust
- Travellex Limited

Discussions with industry advisory group

At the beginning of 2013, the Bank established an advisory group on industry expects to discuss aspects of the regime and potential changes. The membership of this group comprised:

- One credit union and building society representative;
- One finance company representative;
- One trustee representative; and
- An independent barrister.

The group met on 5 occasions, and discussed all aspects of the regime, as well as providing feedback on the Bank's proposals as they were developed.

Other discussions with interested stakeholders

In addition to the consultation noted above, the review has been discussed separately with a number of organisations, including:

- The New Zealand Association of Credit Unions;
- The Financial Services Federation;
- The Trustee Corporations Association;
- The Financial Markets Authority;
- The Treasury; and

- The Ministry of Business, Innovation and Employment.

APPENDIX THREE: Current Deposit Takers under Part 5D of the Reserve Bank of New Zealand Act 1989

1	Alliance Credit Union
2	Aotearoa Credit Union
3	Asset Finance Limited
4	Avanti Finance Limited
5	AWHI Credit Union
6	Broadlands Finance Limited
7	Catholic Development Fund Christchurch
8	Caxton Employees Credit Union
9	Christchurch Emergency Services Credit Union
10	Credit Union Auckland
11	Credit Union Bay Health
12	Credit Union Baywide
13	Credit Union Central
14	Credit Union Lakeland
15	Credit Union South (trading as NBCU South)
16	FE Investments Limited
17	Fisher & Paykel Credit Union
18	Fisher & Paykel Finance Limited
19	Finance Direct Limited
20	First Credit Union
21	Fundzi Limited
22	General Finance Limited
23	GFNZ Group
24	Gold Band Finance Limited
25	GPG Finance
26	Heretaunga Building Society
27	Insurance Australia Group Limited
28	International Building and Investment Society
29	Interpayment Services Limited
30	Just Dollars Trust
31	Kingdom Resources Trust
32	Liberty Financial Limited
33	Lutheran Laymen’s League of NZ (Inc)
34	Medical Securities Limited
35	Mutual Credit Finance Limited
36	Napier Building Society
37	Nelson Building Society
38	New Zealand Baptist Savings & Development Society Incorporated
39	New Zealand Employees Credit Union
40	New Zealand Firefighters Credit Union
41	Police and Families Credit Union
42	Presbyterian Savings and Development Society
43	Prometheus Finance Limited
44	Public Trust
45	Quaker Investment Ethical Trust
46	Scripture Union
47	Steelsands Credit Union
48	TCNZ Finance Limited
49	The Bible Society Development (NZ) Inc

50	The Stewards’ Foundation (NZ)
51	Transpower Finance Limited
52	Travelex Card Services Limited
53	UDC Finance Limited
54	United Credit Union
55	Wairarapa Building Society
56	Wellington District Manchester Unity Credit Union
57	Wesleyan Investment Foundation
58	Westforce Credit Union

APPENDIX FOUR: Consolidated recommendations

Objectives

That the existing objectives of the NBDT regime be retained.

Definition of NBDT

That the existing definition of NBDT be changed to define an NBDT as a person who carries on the business of borrowing and lending money.

That the Bank carry out further work on the appropriate scope of a carve out for wholesale funded entities.

That the definitions of borrowing and lending in paragraph 143 be adopted for the purposes of this definition of NBDT.

That carve outs from the definition of NBDT be provided for:

- Funding conduits (as defined in paragraph 152;
- Reverse funding conduits (as defined in paragraph 152);
- Payment facility providers (as defined in paragraph 152); and
- Crown entities.

Supervisory arrangements for NBDTs

That the Government adopt the measures to improve the operation of the existing regime outlined in paragraphs 201-208.

That if the Government does not consider that the above recommendation adequately addresses the problems in the existing model, the Government consider whether to direct the Bank to take on the frontline supervision of NBDTs.

Prudential requirements

That no changes be made to the prudential requirements at the current time.

That the prudential requirements should be reviewed periodically to ensure they remain fit for purpose.

That prudential requirements for NBDTs be set via standards made by the Bank.

That the Bank be required to consult with affected stakeholders prior to making prudential standards, and that these standards be required to be published in the New Zealand Gazette and be subject to the parliamentary disallowance procedures in the Legislation Act 2012.

That the Bank retain the power in the Non-bank Deposit Takers Bill to impose conditions of licences on individual NBDTs.

Disclosure

That prudential disclosures for NBDTs be integrated into the disclosure regime established by the Financial Markets Conduct Act for the moment.

That a separate regulation making power be provided for to mandate disclosures by NBDTs, should the recommended changes to the definition of NBDT be adopted and result in a significant number of entities outside the scope of securities law being covered by the NBDT regime.

Crisis management

That a tailored statutory management regime be provided for NBDTs.

Offences and penalties

That the offence and penalty regime applying to NBDTs should make use of civil and administrative remedies, as well as criminal offences. In particular, that the penalty regime be based on three tiers:

- Criminal offences for reckless or intentional breaches;
- Civil pecuniary penalties for other breaches of significant requirements; and
- Infringement notices that can be directly issued by the Bank for breaches of minor obligations under the regime.

That the levels of penalties be reduced in line with the levels in the Insurance (Prudential Supervision) Act 2010.

That a power be provided for in legislation for the Bank to accept enforceable undertakings.