
New legislation for regulation of non-bank deposit takers

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This article provides a broad overview of the regulatory framework for non-bank deposit takers and the role of the Reserve Bank of New Zealand as the sector's prudential regulator. This new responsibility is embodied in the amendments made to the Reserve Bank of New Zealand Act and passed by Parliament in September 2008.

The new regime requires non-bank deposit takers to comply with minimum prudential standards to be issued by the Reserve Bank. These standards will comprise the core prudential regime for the sector, and include credit rating, capital, and liquidity requirements, and restrictions on related party exposures.

1 Introduction

On 3 September 2008, Parliament passed the Reserve Bank Amendment Act (the Amendment Act). The new legislation empowers the Reserve Bank as the prudential regulatory authority for non-bank deposit takers (NBDTs), by introducing a new part (Part 5D) into the Reserve Bank of New Zealand Act 1989 (the Act). The Reserve Bank's added responsibility over NBDTs is in line with its purpose of promoting the maintenance of a sound and efficient financial system, and avoiding significant damage to the financial system if a deposit taker fails.

The rest of this article explains the main elements of the new legislation.

The bill amending the Reserve Bank Act was first presented to Parliament in November 2007 after Cabinet decided to adopt a new regulatory framework for NBDTs. Box 1 sets out the key provisions of the Amendment Act. The law changes followed from a 2005 review of the regulatory framework of non-bank financial institutions that concluded that reforms were needed to address weaknesses in the system that could potentially undermine public confidence.²

Aside from non-bank deposit takers, it is expected that the Reserve Bank will in due course be the prudential regulator and supervisor of insurance companies. Consultations are thus under way with the insurance industry and other

interested stakeholders in preparation for the introduction of a bill in 2009 laying out the regulatory regime for the insurance sector. With this added responsibility, the Reserve Bank will be the single prudential regulatory authority for the New Zealand financial system.

Unlike the banking regime, where the Reserve Bank is both the regulator and supervisor of registered banks, for the NBDT sector the Reserve Bank is the regulator only, and trustee corporations are the supervisors. As well as making the Reserve Bank the prudential regulator of the NBDT sector, the legislation provided trustees with certain powers to amend trust deeds and places a number of obligations on trustees.

2 Origin of the legislation

The NBDT sector plays an important role in the financial system. NBDTs complement banks and often service a particular niche market. With an appropriate incentive structure and a well-designed regulatory framework, non-bank deposit takers can assume a vital role in the financial system, thereby contributing to overall economic development.³

Banks and NBDTs accept deposits from, and make loans to, different sectors of the economy. In both cases, the underlying promise is to pay back the amount owed to the depositor at the nominal value plus interest. In this sense, deposits are said to be 'capital certain'. Because risks arising from the deposit taker's loans and investments are pooled

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² This review can be found at: <http://www.rbnz.govt.nz/finstab/banking/supervision/1498932.html>. The review was produced for the Minister of Finance by a working group comprising Reserve Bank, Treasury, and Ministry of Economic Development officials.

³ Carmichael and Pomerleano (2002).

Box 1

Key provisions of the Amendment Act

The main elements of the Amendment Act relate to the role of the Reserve Bank as the prudential regulator of NBDTs. In this capacity, the Reserve Bank is responsible for developing prudential standards for the non-bank regulatory regime. Trustees, on the other hand, will continue with their role as supervisors of NBDTs.

As prudential regulator, the Reserve Bank will introduce: regulations on minimum capital and capital ratio requirements; restrictions on related party exposures; liquidity requirements; and credit-rating requirements. The legislation also includes governance and risk management requirements for deposit takers. The governance requirement provides that the governing body of the NBDT must have at least two independent directors and that the chairperson should not be an employee of the deposit taker or of a related party. The risk management requirement is for all NBDTs to have a risk management programme and take all practicable steps to comply with that programme.

As it will take some time for deposit takers to comply with the new requirements, the Act imposes certain commencement dates:

- Credit-rating requirements come into force on 1 March 2010.
- Risk management requirements come into force on 1 September 2009.
- Capital, related party, liquidity and governance requirements come into force on dates specified by Order in Council.

The Reserve Bank has the power to require deposit takers to submit reports relating to their business, operation or management. Such reports must be prepared by a qualified person acceptable to the Reserve Bank. The Reserve Bank is also empowered to secure information and documents if there are grounds to suspect that a violation of the Act has been committed.

Supervision of NBDTs is entrusted to trustee companies. As supervisors, trustees are responsible for ensuring that prudential requirements are included in trust deeds. Trustees must also report to the Reserve Bank any actual or possible non-compliance, including any breach of the terms and conditions of trust deeds.

Other provisions introduced by the Amendment Act relate to the Reserve Bank's duty to review the implementation of the policy changes within five years from enactment and provide policy advice to the Minister on matters relating to the Reserve Bank's function and responsibility.

together, the depositors essentially rely on the viability and soundness of the deposit-taking institution in which they have invested their funds for reasonable assurance of getting their money back when their deposit matures. Prudential regulations are put in place by way of minimum standards and requirements for deposit takers to meet, in order to increase the probability that this occurs.

The broad objectives behind the new regulatory framework are to promote a sound and efficient financial system by:

- encouraging sound governance and risk management in registered deposit takers and promoting depositor confidence;
- providing depositors with a clearer basis for distinguishing

between lower-risk and higher-risk registered deposit takers; and

- resolving registered deposit takers' distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.⁴

It is important to note that depositors are responsible for their investment decisions, and will be assisted in their decision by the availability of credit ratings to differentiate deposit takers' financial conditions and risk profiles. This remains the case even though the Government has put in place a retail deposit guarantee scheme (until October 2010).

⁴ See **Review of Financial Products and Providers: Regulation of Non-Bank Deposit-Takers.**

3 What is a non-bank deposit taker?

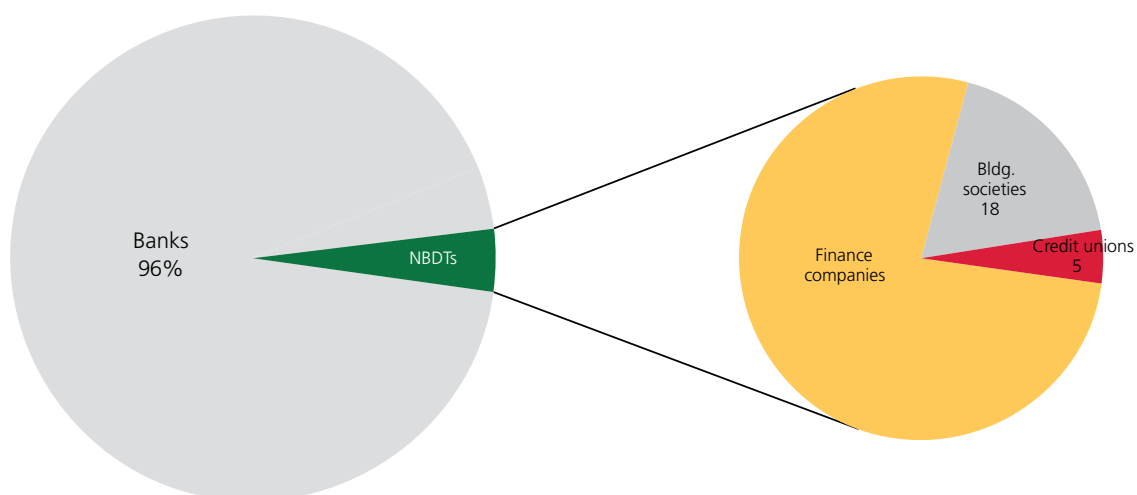
A non-bank deposit taker is defined as a person, other than a registered bank, that offers debt securities to the public within the meaning of the Securities Act, and is in the business of borrowing and lending money, or providing financial services, or both. The NBDT sector comprises finance companies and savings institutions (which include building societies, credit unions and the PSIS Ltd).

Building and friendly societies and credit unions are governed by specific legislation, namely the Building Societies Act 1965 and the Friendly Societies and Credit Unions Act (FSCUA) 1982. Amongst other things, the FSCUA includes requirements that could be characterised as prudential requirements. (Examples of this are limits on the size of deposits, restrictions on borrowing and investing surplus funds, and a number of other similar restrictions.) However, these requirements are expected to be removed in the light of prudential requirements on credit unions that will come into force under Part 5D of the Act.

Finance companies are organised as limited liability companies engaged in the provision of financial services. Finance companies provide a diverse range of financial services such as motor vehicle and vendor finance, property development and commercial finance, consumer finance and other diversified retail lending activities. Savings institutions are engaged in retail financial services, residential mortgage lending and commercial lending as well as personal secured lending. Over recent years the Southland Building Society and the PSIS have been the largest of the savings institutions (although the Southland Building Society has recently become a registered bank).

Figure 1 shows that a substantial portion – 96 percent – of the financial system’s assets held in deposit-taking institutions is held with banks, with the remaining 4 percent held with non-bank deposit takers. Within the non-bank deposit taking sector, finance companies have 77 percent of total assets, building societies 18 percent, and credit unions 5 percent. Finance companies have been experiencing major challenges and difficulties, resulting in a number of these companies going into receivership or moratorium in the past two years.⁵

Figure 1
Assets by type of deposit-taking institution, as at 30 June 2008



Notes: Asset values for finance companies include firms in receivership /moratorium and may not be updated to reflect market conditions.
Southland Building Society (SBS) became a registered bank on 7 October. Its assets are treated as registered bank assets at 30 June 2008 for purposes of this chart.
Building societies group includes PSIS Limited.

⁵ See *Financial Stability Report* publications for analysis of the state of the non-bank financial sector.

4 Scope of prudential regime for NBDTs

Prudential measures outlined in the Amendment Act will be implemented through regulations recommended by the Reserve Bank or by way of direct imposition on the deposit taker by legislation or Order in Council. In general, the Reserve Bank may carry out its prudential function by issuing regulations on the following matters:

- designating entities to be covered or not covered by the regime (defining a deposit taker beyond those already included in legislation, and exempting entities from the regime);
- requiring credit ratings;
- imposing minimum capital and a minimum capital ratio requirement;
- restricting associations with related parties; and
- setting liquidity requirements.

The Act also obliges the deposit taker to have and comply with a risk management programme that sets out the procedures for the identification and management of credit risk, liquidity risk, market risk, and operational risk. The programme should ensure that there are records and procedures in place to enable the NBDT to measure and monitor these risks. In this connection, the Reserve Bank may issue guidelines relating to the risk areas to be covered by the risk management programme. The risk management programme is required to be in place by 1 September 2009.

Although the Reserve Bank is responsible for prudential regulation, some elements of the regime approved by Cabinet in 2007 are yet to be enacted. Therefore, future legislation may include the power for the Reserve Bank to license NBDTs and have certain crisis management powers. The licensing requirements are also likely to include fit and proper tests (that is, suitability and integrity criteria for the NBDTs' directors and senior management).

5 Exemption

The Reserve Bank is authorised to grant two types of exemption from the regime. The first type of exemption is where the Reserve Bank declares a person or class of persons not to be a deposit taker, thereby exempting them from all obligations under the regime. The second type of exemption is where the Reserve Bank exempts a deposit taker from a particular or specific requirement or all requirements set in regulation, such as with respect to capital, liquidity, related party, risk management, and governance. Exemptions may either remove the obligation for a deposit taker, or class of deposit takers, to comply with requirements from a given section of the Act, or be given subject to alternative terms and conditions.

Similarly, the Reserve Bank has the power to declare a person or class of persons to be a deposit taker for purposes of the Act. This power exists because it may be possible that some entities are not caught by the definition but are deposit takers in substance.

In exercising these powers, the Reserve Bank needs to be satisfied that any exemption granted is consistent with the maintenance of a sound and efficient financial system and that compliance with the regime by the NBDT or by its trustee would be unduly onerous or burdensome.

6 Credit rating

A key provision of Part 5D of the Act is the requirement for the deposit taker – or the borrowing group to which it belongs – to have a current credit rating from a rating agency approved by the Reserve Bank. The borrowing group in this context means the deposit taker and all its subsidiaries that are unconditionally liable to repay some or all debt securities issued by the deposit taker, or are liable to repay the debt securities if the deposit taker is unable to do so.

The credit-rating regulations will specify the type of rating that may be required – that is, whether it is a short-term or a long-term rating and what the rating refers to (for example, whether it is a rating of a specific financial obligation or a rating of the deposit taker's overall creditworthiness). The regulations will also include a threshold, based on size,

below which NBDTs will not be required to obtain a rating. This reflects the desire to not impose unreasonable costs on very small entities.

The regulations are also likely to prohibit the deposit taker from making any public disclosure of a credit rating other than that which has been secured from an approved rating agency. The Reserve Bank has set clear guidelines, based on international best practice, that a rating agency must meet in order to be qualified to rate non-bank deposit takers. The intent here is to obtain a reasonable degree of assurance that the rating agency will perform up to standard. The criteria are essentially the same as those for approving rating agencies for banks and cover aspects of a rating agency's practices that will enable the Reserve Bank to carry out its approval function. These criteria refer to the following: the independence of the rating agency; adequacy of resources; credibility and objectivity of methodology; consistency and comparability of the rating agency's ratings vis-a-vis industry practice; adequacy of disclosure of information; and other relevant international standards, codes, and recommended practices.

A rating represents an independent assessment of (mainly credit) risk, and can provide investors with a handy tool to compare rated companies. While it is a tool that some investors or depositors will already be able to understand and use as a basis for identifying and comparing risks among different deposit takers, the Reserve Bank intends to undertake an education programme focused on enhancing the public's understanding of the use of credit ratings. Investors must, however, be aware that while ratings are useful for investment decisions, they cannot guarantee or predict future performance. Also, they are generally revised only if it is clear that the risk profile of a rated company has changed and that the change is likely to be permanent.⁶

NBDTs are obligated to secure a credit rating from an approved rating agency beginning 1 March 2010 (unless they are exempted). An NBDT without a rating will also be required to disclose that fact, unless an exemption for this purpose has been secured from the Reserve Bank.

⁶ **Widdowson and Wood (2008) discuss the key issues in using ratings as a tool for investment decision making.**

7 Capital requirements

Capital regulations for NBDTs may include a minimum dollar level of capital that the NBDT has to maintain, rules about the form of capital or the instruments that qualify as capital, and a minimum capital ratio requirement. A capital ratio may be imposed either on the deposit taker or the borrowing group.

Prescribing minimum capital is a basic prudential requirement for banks and other financial institutions. Capital represents owners' funds at risk and demonstrates their commitment to the business. Because capital provides a buffer against losses, owners must be able to meet capital requirements on an ongoing basis.

Owners and senior management will be better motivated to act prudently if there is a sufficient level of capital in relation to the size, nature and type of risks undertaken by the NBDT. Prudential capital standards thus help align incentives of owners, managers and regulators. Work is under way on the regulatory capital model for NBDTs, and the Reserve Bank expects to begin consulting stakeholders in late 2008.

8 Related party exposures

Section 157V of the amended Act provides that the deposit taker and trustee must ensure that a maximum limit on exposures to related parties prescribed by regulation is incorporated in the trust deed. The deposit taker must not exceed its maximum limit. A given maximum limit may be in relation to the capital of the deposit taker, or to the capital of the borrowing group to which the deposit taker belongs.

In simple terms, connected parties are defined as individuals or companies who are either directly or indirectly related by way of ownership or that have the ability to influence or control the institution. Prudential regulations about related party exposures are likely to include the following:

- a definition of 'related party' and 'credit exposure'; and
- a maximum limit on aggregate credit exposures to related parties calculated on the basis of the capital of the deposit taker or the borrowing group.

Related party restrictions are important because any undue

Box 2

Ways through which regulations may be incorporated into trust deeds

Any requirement imposed by regulation must be complied with by the deposit taker and the trustee. By and large, these requirements are to be incorporated in the trust deed, which is a contract between the trustee and the deposit taker and contains covenants intended to ensure that the deposit taker manages its affairs prudently.

Regulation can be issued prescribing a particular requirement such as a capital ratio or a maximum limit on exposures to related parties, or it can prescribe a reference framework to which specific requirements relate.

The deposit taker and the trustee would then negotiate and agree on the amendments necessary to effect the requirements in regulation. It is expected that trustees and deposit takers will reflect individual circumstances in the amendments, such that trust deeds may require, for example, a capital ratio that is more conservative than the regulatory minimum.

If the deposit taker and trustee have not come into any agreement after a reasonable period, the trustee can execute an amendment to the trust deed without the concurrence of the deposit taker. As a last resort, the regulation itself may provide that the certain requirements are deemed to be incorporated or adopted into the trust deed.

influence exerted by insiders on the deposit taker could lead to a potential erosion of the deposit taker's capital base and undermine public confidence.

way deposit takers operate (e.g., by setting minimum capital requirements) while trustees, acting as supervisors, assess the performance and compliance of their respective NBDTs with their trust deed.

9 Liquidity

The objective of liquidity requirements for NBDTs is to ensure that deposit takers are able to manage their liquidity needs and that they have access to sufficient liquidity to meet their payment obligations, particularly during times of stress. For example, the regulation may set minimum levels of liquid assets in relation to liabilities, define what constitutes liquid assets, require maturity matching of assets and liabilities, or impose other measures that will influence the management of the deposit taker's cash flows, including a requirement that consideration be made with respect to the liquidity of the borrowing group. The intention is for NBDTs to be prepared for events that may force them to draw heavily on their available liquidity buffers.

Trustees negotiate and agree on a trust deed, which contains the financial and reporting responsibilities of the deposit taker, consistent with the requirements set by regulation. Box 2 explains how the requirements set by regulation might be incorporated into trust deeds. The trustees monitor the deposit taker's compliance with the trust deed and regularly assess and monitor the NBDT's business operations and performance to ensure that depositors are adequately protected. Trustees are expected to enforce compliance with the provisions of the trust deed and to take appropriate action during times of financial stress and difficulty.

In the light of the trustees' role as supervisors of NBDTs, they are obliged to report instances of material non-compliance or likely non-compliance with regulations to the Reserve Bank.

10 Role of trustees

Under the NBDT regime, the Reserve Bank is the prudential regulator while trustee corporations are the supervisors of deposit takers. The Reserve Bank formulates prudential regulations through the issuance of rules that will affect the

11 Conclusion

The Reserve Bank of New Zealand Amendment Act 2008 established a prudential regime for the non-bank deposit taking sector. Consultation for rating agency approval

criteria has already been completed. The Reserve Bank expects to begin the consultation process for capital and related party exposures towards the end of 2008, and to have all regulations in place over 2009. The Reserve Bank expects that the new legislation will see improvements in the capacity of the New Zealand financial system to manage and cope with stresses and difficulties in the NBDT sector as they arise.

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