ARTICLES

Regulating non-bank deposit takers

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The non-bank deposit taking (NBDT) sector comprises building societies, credit unions and finance companies. NBDTs can play an important role in the economy, providing services complementary to those provided by banks. In recent years, many finance companies have failed, resulting in a significant loss of value in the sector. These failures have revealed weaknesses in the operating models of several finance companies, such as high levels of related party exposures and inadequate capitalisation relative to the risks taken.

On 1 December 2010, NBDTs became subject to new regulatory requirements relating to capital adequacy, related party exposures, liquidity and governance. This represents a further step in the implementation of a new prudential regulatory regime administered by the Reserve Bank. Regulations setting out credit rating requirements came into force on 1 March 2010 and NBDTs have been required to have a risk management programme since September 2009.

The new regulatory regime is aimed at promoting the soundness and efficiency of the financial system by setting minimum prudential standards that NBDTs must meet. The requirements have been modelled on the banking regime, but have been tailored so that they are fit for purpose for the NBDT sector.

This article explains the requirements in force on 1 December 2010 and discusses the motivation for these requirements.

Introduction

1 The Role of the Reserve Bank

On 1 December 2010, NBDTs became subject to new regulatory requirements relating to capital adequacy, related party exposures, liquidity and governance. These requirements represent a major step in the implementation of a new prudential regulatory regime for NBDTs administered by the Reserve Bank. Other existing requirements under the prudential regime are the requirement for NBDTs to have a credit rating and the requirement for NBDTs to have a risk management programme. These requirements came into force in March 2010 and September 2009 respectively.

The Reserve Bank's new regulatory powers over NBDTs derive from the addition of a new Part 5D in the Reserve Bank Act (the Act) in September 2008.[1] The Reserve Bank's powers in the NBDT sector are expected to be expanded next year. The Reserve Bank is consulting on a second Bill that would grant it powers in relation to licensing, fit and proper person requirements, changes of ownership and powers of intervention, such as the power to obtain information or give directions in certain circumstances.

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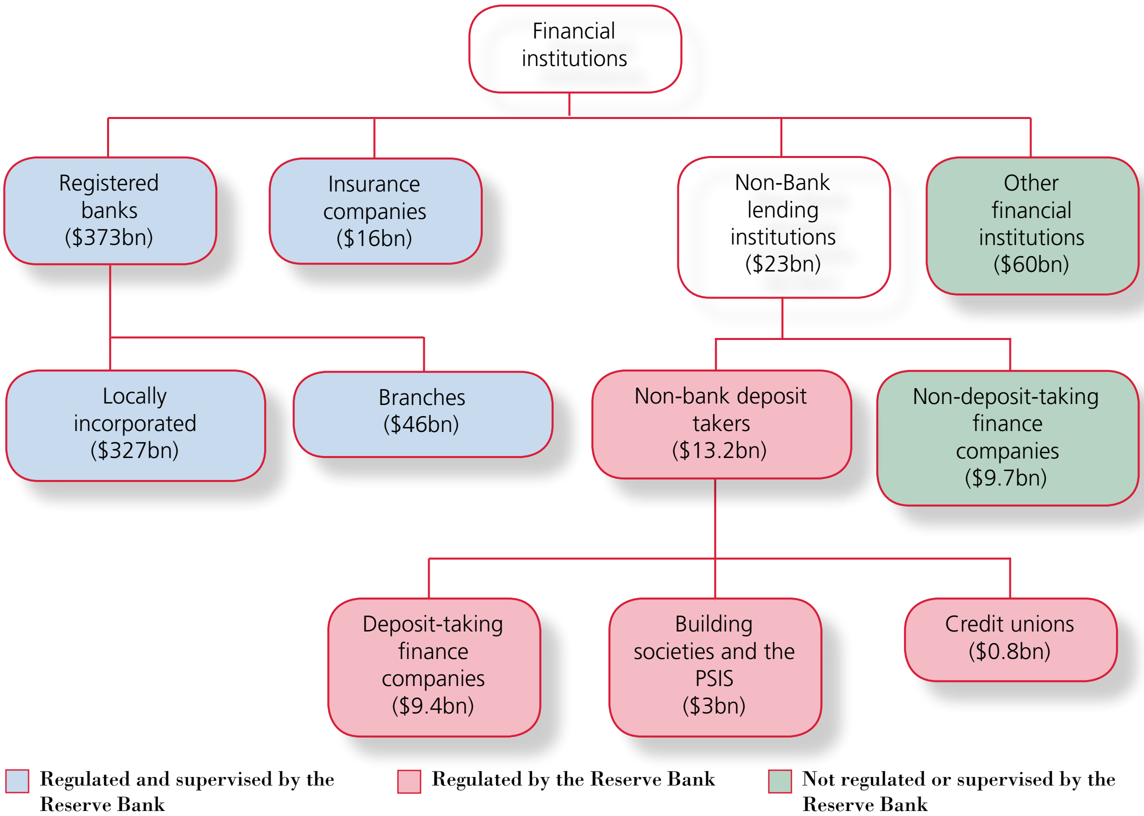
The new prudential powers complement the Reserve Bank's existing powers as the regulator and supervisor of the banking sector. In addition, in September 2010, the Insurance (Prudential Supervision) Bill was passed making the Reserve Bank the prudential regulator and supervisor of the insurance sector. These changes have created a single prudential regulatory agency for financial institutions in New Zealand and bring a common purpose to the regulation of these entities; namely, the promotion of a sound and efficient financial system. However, in the case of the NBDT sector, trustees act as the supervisors, unlike for banks and insurance companies where the Reserve Bank is both regulator and supervisor (see box 1).

[1] See http://www.rbnz.govt.nz/about/ourlegislation/index.html to access the legislation.

Figure 1

Institutional structure of the New Zealand financial sector



Note: Source RBNZ. Numbers in brackets refer to the total assets of the sector. Bank and non-bank lending institution data as at 30 June 2010 and insurance data as at 31 December 2008. The number for deposit-taking finance companies includes firms in receivership, moratorium or liquidation. UDC is included in the figure for registered banks and not in the deposit-taking finance company sector.

In recommending regulations for the NBDT sector, the Reserve Bank has used the banking regime as a point of reference. However, the Reserve Bank has also been conscious to ensure that regulatory costs are not unduly onerous for small entities and that regulation appropriately recognises that NBDTs operate under different business models to banks. Hence, requirements have been tailored to be fit for purpose for the NBDT sector.

The new prudential powers complement the Reserve Bank's existing powers as the regulator and supervisor of the banking sector. In addition, in September 2010 the Insurance (Prudential Supervision) Bill was passed making the Reserve Bank the prudential regulator and supervisor of the insurance sector.

2 The NBDT sector and the rationale for regulation

The NBDT sector comprises two main types of entity: deposit-taking finance companies and savings and lending institutions such as building societies, credit unions and the PSIS Ltd (a co-operative company). The essential characteristic for an institution to be subject to the NBDT prudential regime is that it offers debt securities to the public and then lends the money out or otherwise provides financial services.[2]

The NBDT sector represents less than 5 percent of the financial assets held by financial institutions in New Zealand.

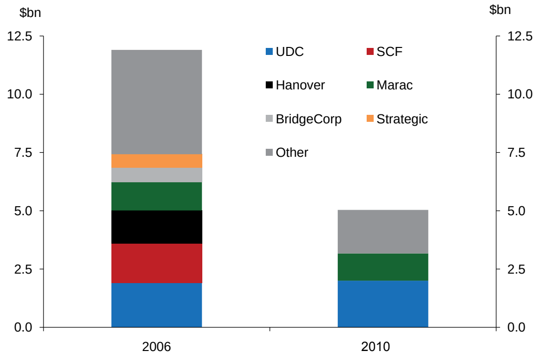
[2] Section 157 of the Act defines a deposit taker as "a person who offers debt securities to the public in New Zealand and carries on the business of borrowing and lending money, or providing financial services, or both." Banks, collective investment schemes, local authorities and the Crown are specifically excluded. In this paper, we use the term NBDT to mean deposit taker as defined by the Act.

The failure of many finance companies over recent years has highlighted a number of areas where regulation and supervision of the NBDT sector has been inadequate.

Other financial institutions include registered banks, insurance companies, non-deposit-taking lending institutions and other financial institutions, such as superannuation and managed funds (figure 1). Although NBDTs only comprise a small proportion of the financial system, the sector can play an important role in the economy, often financing activities with which banks have not traditionally been involved.

Since 2006 a number of finance companies have filed for receivership or liquidation, gone into moratorium or otherwise exited the market. This has seen a significant reduction in the assets held by finance companies and a significant reduction in lending from the NBDT sector. In 2006, deposit-taking finance companies accounted for approximately $12 billion in assets. The Reserve Bank estimates that the remaining active deposit-taking finance companies (that is finance companies not in moratorium, receivership or liquidation) now account for approximately $5 billion in assets. Finance companies engaged in property development lending have had a particularly high rate of failure and lending to this sector has been greatly reduced. It is likely that the NBDT sector's exposure to the property development sector will remain reduced as the model of retail funding for high risk exposures has been proven unsustainable.

Figure 2
Assets of active deposit-taking finance companies in 2006 and 2010



Source: RBNZ
Note: Excludes finance companies operating under a moratorium arrangement or that are in receivership. The chart identifies specific finance companies with assets over $500 million only.

In comparison, savings institutions have generally operated under more conservative business models than finance companies. Savings institutions have performed relatively well over the recent period and have not suffered similar failures.

The Reserve Bank has had concerns about the level of risk taken in the NBDT sector, particularly by finance companies, for a number of years.[3] The failure of many finance companies has highlighted a number of areas where the regulation and supervision of the NBDT sector has been inadequate.

In particular, many finance companies held low levels of capital for the level of risk they took and lacked diversification in their loan portfolios. This left them vulnerable to adverse changes in economic conditions. Further, many finance companies had high levels of related party exposures in their loan books. In addition, the absence of uniform measurement standards and limited transparency in financial information made it difficult for the market to assess and compare risks across the sector. These issues have contributed to declining confidence and consequent funding and liquidity problems.

In October 2008, the government implemented the Crown's Retail Deposit Guarantee Scheme, which covered qualifying NBDTs. The original scheme expired in October 2010. An extended version of the scheme, with more stringent qualification requirements, is in operation until December 2011. Only a small number of entities are participating in this scheme.

The following sections of this paper discuss the requirements for NBDTs in force as at 1 December 2010.

[3] See for example the 2004 *Financial Stability Report* p21 which commented, in relation to the rapid growth of non-bank financial institutions, that "if the economy slows next year, as is projected, that could provide a litmus test of the extent to which the growth recorded by this sector reflects sustainable expansion in its role…and the extent to which growth has been achieved by taking on additional risk".

Box 1
Trustees' powers and duties

In the case of banks and insurance companies, the Reserve Bank is both regulator and supervisor. But for NBDTs, the Bank is the prudential regulator, while trustees act as front-line supervisors. This arrangement is unique to the NBDT sector.

NBDTs are required, under The Securities Act 1978, to appoint a trustee to represent the interests of security holders. In this capacity, trustees supervise and monitor the performance of NBDTs and take actions in the event of breaches of trust deeds. Minimum prudential standards, set by way of regulations made under the Act, are imposed on NBDTs through trust deeds executed between the NBDT and the trustee. Trustees may negotiate for more stringent prudential requirements if they consider it justified for a particular institution and in the best interest of security holders.

In line with the regulatory framework for NBDTs, the Act has given trustees additional powers and duties. For example, a trustee can amend a trust deed where said trust deed does not comply with prudential requirements and the trustee is unable to agree to a change with the NBDT. Trustees are required to report certain matters to the Reserve Bank, such as if an NBDT is not complying with regulations or if an NBDT is unable to pay debts as they become due.

In order to enhance cooperation between trustees as front-line supervisors and the Reserve Bank as prudential regulator, the Reserve Bank entered into a Memorandum of Understanding (MOU) with the Trustees Corporations Association of New Zealand (TCA) and its members and associate members. The focus of the MOU is to facilitate an ongoing working relationship between trustees and the Bank, with the intent to promote open communication and active exchange of information.

For its part, the Reserve Bank endeavours to provide guidance and assistance to TCA and its members in implementing regulations made under Part 5D. The MOU will be reviewed on a regular basis to ensure that it remains relevant and effective in promoting cooperation and coordination among the parties concerned.

Prudential Requirements

3 Risk-management programme

Many of the finance companies that failed over recent years had poor risk management practices. For example, some finance companies had poorly diversified loan portfolios, or loans held with inadequate security, e.g. subordinated mortgages coupled with schemes which allowed interest to be added to principal rather than being paid.

The first new requirement under the NBDT prudential regime came into force in September 2009. This required that NBDTs have, and take steps to comply with, a risk management programme setting out procedures for the identification and management of credit, liquidity, market and operational risk.[4]

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The Reserve Bank has issued guidelines to help NBDTs comply with the requirement to have a risk management programme. Some of the matters covered by the guidelines are:

- the programme should cover all activities affecting the NBDT's risk profile and cover all material risks;
- where possible, the NBDT should quantify its exposure to risk;
- contingency plans for managing stress events should be included; and

[4] Section 157M of the Act requires that every deposit taker must have a risk management programme and take all practicable steps to comply with that programme.

- the programme should be regularly reviewed.

Guidance is also provided on best practices to be followed for operational considerations, such as the role of the governing body and senior management, and definitions for credit, liquidity, market and operational risks are given.

4 Credit ratings

Credit ratings assist investors in making investment decisions by providing a simple way to compare the financial strength of different institutions. A poor credit rating indicates that there is a higher risk that an institution will default on payments to investors. For example, a triple A-rated institution's probability of default is approximately 1 in 600 over 5 years, whereas a double B-rated institution's probability of default is approximately 1 in 10 over 5 years.[5]

As of 1 March 2010, NBDTs have been required to have a credit rating from an approved rating agency, unless an exemption applies.[6] NBDTs for which the consolidated liabilities of the borrowing group are less than $20 million are exempted from this provision until 1 March 2013.[7] The $20 million threshold was set in recognition that the cost of obtaining a credit rating would be disproportionately high for small institutions.

Ratings may apply to a particular issue of securities or to the issuer itself. An issuer rating evaluates the creditworthiness of an entity, whereas an issue rating rates a particular issue of securities (which depends on where the debt ranks in order of preference in insolvency). Regulations require that NBDTs hold a long-term issuer rating.[8] In contrast registered banks are required to maintain an issue rating, applicable to their long-term senior unsecured New Zealand dollar obligations payable in New Zealand. For NBDTs an issuer rating was preferred as it provides a benchmark rating of NBDTs (which is not dependent on the priority of a particular issue of securities) and is also likely to be relatively easy for depositors to understand.

5 Capital requirements

Minimum capital requirements are a basic prudential requirement for banks and NBDTs. An entity's capital comprises shareholders' equity and accumulated earnings; it represents the owner's funds at risk. Hence, capital provides an incentive for owners to manage the business prudently and provides a cushion to protect depositors and other creditors against unexpected losses.

Many finance companies have been inadequately capitalised relative to the risks taken. This made them vulnerable to possible failure in the face of adverse economic conditions. The following table shows an estimate of the capital ratio for four failed finance companies, measured using the NBDT capital adequacy framework discussed below, compared to their reported equity-to-assets ratio prior to their failure.

Regulations stipulating a minimum capital ratio to be included in the trust deeds of NBDTs came into force on 1 December 2010.[9] The regulations require that NBDTs with

Table 1
Comparison of capital ratios for failed NBDTs

NBDT	Capital ratio NBDT framework % (estimate)	Equity/assets last accounts %
Bridgecorp	2-4	8
Dorchester	2 1/2- 4	11
Hanover	1-3	11
South Canterbury Finance	-5.7	9.5

Source: Figures for Bridgecorp, Dorchester and Hanover are an RBNZ estimate made in 2008 based on data available at the time. These figures may overstate the true capital position of the entities. Data for SCF is as at 31 December 2009.

5 The probability of default refers to the approximate median likelihood that an investor will not receive repayment on a five-year investment on time and in full, based upon historical default rates published by rating agencies. See http://www.rbnz.govt.nz/finstab/nbdt/requirements/3857981.html for more information on credit ratings and a list of NBDTs that have received credit ratings.

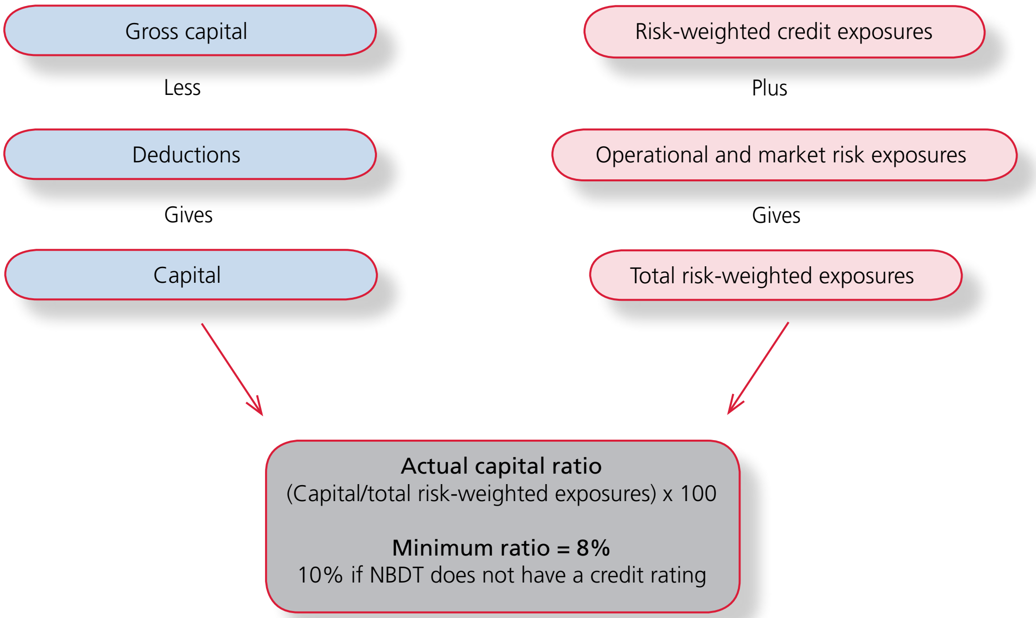
6 Section 157I of the Act requires that deposit takers have a credit rating provided by an approved rating agency.

7 Deposit Takers (Credit Ratings Minimum Threshold) Exemption Notice 2009.

8 Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010.

9 Deposit Takers (Credit Ratings, Capital Ratios and Related Party Exposures) Regulations 2010. Capital ratio regulations are promulgated under Section 157S of the Act. Section 157P allows for the setting of a minimum capital level. This is not a requirement at present.

Figure 3
Calculation of the capital ratio



a credit rating hold a minimum of 8 percent of capital to total risk-weighted exposures and an NBDT without a credit rating hold a minimum of 10 percent. Trustees may require that a higher capital ratio be set in the trust deed, should they judge the position of the NBDT to warrant additional capital. This requirement is similar to banks, which are required to hold a minimum of 8% total capital to total risk-weighted exposures.

Capital adequacy framework

The NBDT capital adequacy framework determines how to compute an NBDT's capital ratio. It is largely based on the banking regime's capital adequacy framework, which itself is based on "Basel II" requirements.[10] For the NBDT sector, adjustments were made where necessary to take account of different characteristics in the NBDT sector compared to the banking sector.

Many finance companies have been inadequately capitalised relative to the risks taken. This made them vulnerable to possible failure in the face of adverse economic conditions.

The essential elements of the capital adequacy framework are the calculation of:

- capital; and
- total risk-weighted exposures.

The framework defines what types of capital instruments can be included in gross capital. Capital is then calculated as the difference between gross capital and required deductions.

We use the term 'total risk-weighted' exposures to refer to the sum of the risk-weighted amount for credit risk and the aggregate amount for market risk and operational risk. Credit risk is the risk of loss to an NBDT arising from a counterparty defaulting on or being unable to meet its obligations. This is the main component of risk exposures. Market risk measures the level of risk an NBDT faces from changes in interest rates, exchange rates and equity prices. Operational risk refers to risks arising from the running of the business, such as fraud and legal risk.

The capital ratio is calculated as the percentage of the NBDT's capital to total risk-weighted exposures.

[10] The Basel Committee on banking supervision provides a forum for regular cooperation on supervisory matters. From time to time, the Committee issues non-binding guidelines and supervisory standards to inform national banking regulators.

If the NBDT is part of a borrowing group (comprising the deposit taker and all its guaranteeing subsidiaries), the capital ratio must be calculated on a consolidated basis. Below, we provide more detail on the calculation of the capital ratio.

Capital

The banking regime allows two types of capital for regulatory purposes: tier 1 and tier 2. Tier 1 capital represents a permanent and unrestricted commitment of funds with the ability to absorb losses without the need for the entity to cease trading. Tier 2 capital has some of the attributes of tier 1 capital but is restricted in its ability to absorb losses other than in a winding up. Tier 2 capital may, for example, have a stated maturity date that limits the life of the instrument.

In addition to being required to hold a minimum ratio of total capital to total risk-weighted exposures of 8 percent, banks are required to hold a minimum ratio of 4 percent of risk-weighted tier 1 capital to total risk exposures.

For the NBDT sector, only tier 1 capital is permitted for capital adequacy purposes. The main reasons for this are: very few NBDTs have tier 2 capital instruments; tier 1 capital is available to absorb losses without requiring the entity to cease trading; a single-tier regime is simpler to understand and administer than a multi-tier regime; and, significantly, the international regulatory community is moving towards greater emphasis on tier 1 capital in the banking regime.

Under the NBDT regime, gross capital consists of:

- issued and fully paid-up ordinary shares;
- fully paid-up perpetual non-cumulative preference shares;[11]
- retained earnings and reserves; and
- minority interests.

A number of deductions are then made from gross capital to arrive at the measure of capital used for the purposes of calculating the capital ratio. These deductions include items such as goodwill, intangible assets and deferred tax benefits.[12] The deductions ensure that what is counted as capital is truly available to absorb unanticipated losses in the event of financial distress.

Total risk exposures

NBDTs are required to hold capital against credit, market and operational risk.

Credit risk

As with banks, the amount of capital an NBDT is required to hold against credit risk depends on the riskiness of the NBDT's assets. To make capital requirements risk sensitive, credit risk is calculated by multiplying the value of assets in defined assets classes by risk weights. Risk-weighted assets are them summed up to calculate 'risk-weighted credit exposures'.

The NBDT capital adequacy framework recognises a number of asset classes including: cash; claims on the Crown or Reserve Bank; claims on other New Zealand-registered banks; residential mortgages; property development loans; loans secured over machinery; personal loans and equity investments. Several of these categories are further divided into sub-classes based on certain risk characteristics. For example, mortgages are further categorised in terms of the ranking of the security and the loan-to-value ratio (LVR).

The risk weight applying to a particular asset indicates the degree of risk associated with that asset. For example, cash carries a risk weight of 0 percent; first ranking residential mortgages with an LVR of between 80-90 percent carry a risk weight of 100 percent; second or subsequent ranking property development loans carry a risk weight of 300 percent.[13]

11 Non-cumulative preference shares can only be included in capital if they meet certain criteria prescribed in clause 10(4) of the regulations, such as that the payments of dividends must be able to be withheld and the shares are not redeemable at the option of the holder. Further, under clause 10(5) non-cumulative preference shares without full voting rights may not be more than 25 percent of capital if the NBDT is not a qualifying mutual, and 50 percent of capital, if it is a qualifying mutual.

12 Clause 10(3) of the Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010 sets out the full list of deductions that must be made.

13 The risk-weights are included in the Schedule to the Deposit Takers (Credit Ratios, Credit Rating and Related Party Exposures) Regulations 2010.

Box 2
Calculating risk weights for residential housing

The approach to the calculation of risks weights for the NBDT capital adequacy framework is based on the approach used for banks. For banks, however, risk weights are derived from the Basel II standardised model, or alternatively from the internal models approach, provided that the bank meets certain criteria and has secured the Reserve Bank's approval. Under the standardised model, risk weights for asset categories are prescribed. Under the internal models approach, banks may use their own models to generate input for calculating risk weights, subject to the approval of their models by the Reserve Bank.

Although a similar approach to calculation of risk weights as in the standardised approach for banks was applied in the NBDT framework, the resulting risk-weights are different for a number of asset classes. This is because the calculation of risk weights takes account of a number of differences between banks and NBDTs, such as the higher level of risk in NBDTs' portfolios due to a lower level of diversification. The NBDT risk weights were also calculated using more up-to-date data.

The risk weights for NBDT residential housing loans used the housing risk weights from the bank standardised approach as the starting point. These risk weights were then amended to reflect the characteristics of the NBDT sector by drawing on outputs generated by the Reserve Bank's housing lending risk model. This model simulates various scenarios and computes, in each of these scenarios, factors such as probabilities of losses and defaults for a mortgage portfolio. The inputs used to calibrate the NBDT framework were the same as for banks, with the exception of volatility in housing prices, which was increased to reflect that NBDTs are typically more exposed to regional housing lending portfolios and are hence more vulnerable to regional house price volatilities. These differences, and the updating of inputs used in the Bank's model, led to higher risk weights in the NBDT framework compared with the standardised banking framework for mortgages with an LVR of over 80 percent. The higher risk-weight also reflects that there are some circumstances where banks are required to hold capital for housing loans where NBDTs are not (e.g.housing loans in default).

Banks also calculate risk-weighted credit exposures by summing up risk-weighted assets. Where differences between the NBDT and banking sector are unimportant, the risk weights for NBDTs are the same as for banks (e.g., cash carries a weight of 0 percent in both regimes). However for a number of classes of exposures, different risk weights have been prescribed for NBDTs to better reflect particular characteristics in this sector. The calculation of risk weights is discussed in more detail in box 2 with regard to an example of calculating the risk weights for residential housing.

Market and operational risk

The amount of capital required to cover market and operational risks for NBDTs is calculated by multiplying the average of the book value of total assets and risk-weighted credit exposures by a scalar, is:

$$Required\ capital = \frac{total\ assets + credit\ exposures}{2} * 0.175$$

An average of total assets and risk-weighted credit exposures is used, as both these measures are likely to be correlated with particular measures of market or operational risk. The scalar is derived from registered banks' operational and market risk figures but adjusted upward to reflect the fact that operational risk is generally higher for smaller institutions.

In the banking regime, operational risk capital is either calculated as a scalar of a moving average of both balance sheet and income statement items, or may be based on a bank's internal model where Reserve Bank approval has been obtained. Market risk capital is calculated using the market risk exposures methodology. These methodologies are complex and were not considered appropriate for the NBDT sector.

6 Related party exposures

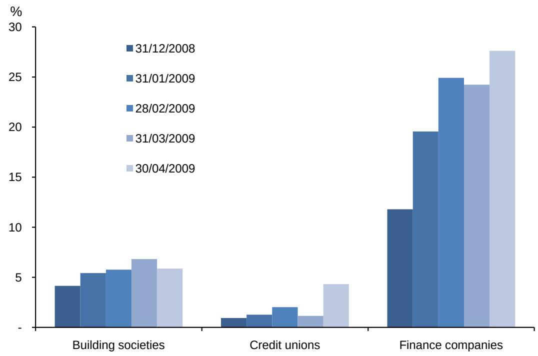
Related party exposures can be problematic because relationships with related parties can be abused. For example, related parties may be accorded preferential treatment or may not be subject to as rigorous credit checks as would be the case for non-related parties.

> A number of finance companies that failed over recent years had high levels of related party exposures.

A number of the finance companies that failed over recent years had high levels of related party exposures. For example, some finance companies extended loans to companies or projects promoted by a director of a company in the same borrowing group as the finance company. In other cases, loans were extended to a related party of the finance company's parent entity and may even have been guaranteed by the parent. Analysis of related party exposures was difficult due to the absence of uniform standards and definitions to measure related party exposures. Figure 4 shows the percentage of related party exposure to paid up capital for building societies, credit unions and finance companies.

Regulations on related party exposures came into force on 1 December 2010.[14] The regulations provide for a maximum limit on aggregate related party exposures of no more than 15% of the capital of the NBDT, or if it is part of a borrowing group, relative to the capital of that borrowing group.

Figure 4
Related party loans to paid up capital (%)



Source RBNZ 2009

Registered banks are also subject to limitations on related party exposures. Similar to NBDTs, credit exposures to a non-bank connected person are not to exceed 15 percent of the banking group's tier 1 capital. For aggregate credit exposures (non-bank and bank connected entities), banks are subject to a ratings-contingent framework that correlates the maximum level of connected exposures to the bank's credit rating.[15] For example a bank with a double A or above credit rating can have exposures of 75 percent of tier 1 capital, a bank with an A rating can have exposures of 40 percent of tier 1 capital.

The Act defines a related party, in relation to a NBDT. This definition has been extended by regulation.[16] The definition covers key office holders, those with a substantial interest in the entity and other entities with significant ownership or directorship crossover. The definition is similar to that applying to banks; the main difference is the inclusion of interlocking directorships and a lower threshold for substantial interest for NBDTs.[17]

7 Liquidity

Liquidity risk refers to the risk that either: (a) an entity cannot meet its financial obligations as they fall due; or (b) an entity can only meet its financial obligations at an elevated cost. The policy rationale for liquidity requirements is two-fold. First, an entity that cannot raise funds to meet its financial obligations at reasonable cost may become insolvent. This could result in a loss of confidence in the sector and lead to a further withdrawal of funding for the remaining entities. Second, it is important that investors have good information on entities' liquidity management so that they can make quality investment decisions.

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14 Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010. Related party regulations are promulgated under section 157V of the Act.

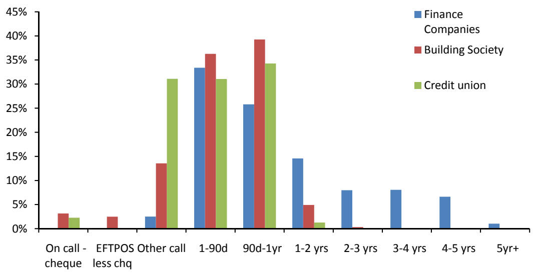
15 The policy for banks is contained in BS8 "Connected Exposures" in the Banking Supervision Handbook: http://www.rbnz.govt.nz/finstab/banking/regulation/0094291.html

16 Section 157B of the Act and Clause 4 of the Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010.

17 See the annex for more detail on the definition of 'related party'.

Within the NBDT sector, liquidity management practices are varied. Credit unions and building societies provide bank like transaction services to their clients and are hence funded mainly from on-call funds or funds at short-term maturities. These institutions generally hold high levels of liquid assets to manage the risk of excessive withdrawal of funds. Finance companies have been used as longer-term savings vehicles for depositors and hence tend to have a greater proportion of funding at maturities of greater than one year. Their liquidity management strategy is to try and match the maturities of funding to that of lending. It is important that any requirements relating to liquidity are sufficiently flexible to allow NBDTs to manage liquidity in a way appropriate to their business type.

Figure 5
Maturity profile of $NZ funding within the NBDT sector as at 31 October 2009



Source Reserve Bank SSR

From the onset of the recent finance company failures and subsequent diminishing investor confidence, the ability of finance companies to raise new funding was limited. Their ability to meet liquidity requirements was predominately dependent on the successful repayment of their loan book assets. During this period, finance companies within the consumer financing sector have shown some success in meeting their financial obligations. However, finance companies within the property financing sector have been particularly vulnerable to liquidity shortfalls as their loan book assets have proven to be highly illiquid in a stressed market. Savings institutions have continued to enjoy high levels of reinvestment and have hence been able to manage their liquidity positions.

Regulations that came into force on 1 December 2010 require that trustees and NBDTs agree appropriate quantitative liquidity requirements to be included in trust deeds.[18] In practice, this allows requirements to be tailored to the business model of the NBDT; provides the trustee with powers to monitor and enforce those requirements; and provides investors with information to assess different NBDTs. Many, but not all, trust deeds already contain some form of liquidity requirements. The Reserve Bank has also issued non-binding guidelines to assist the sector to develop appropriate requirements and therefore fulfill the obligations in the regulations. These guidelines set out matters such as the measurement of liquidity risk, assets that may be used in calculating quantitative requirements and a stress testing methodology. In addition, as discussed, NBDTS must address liquidity management in their risk management plans.

In contrast to the approach taken to NBDTs, liquidity requirements in the banking regime are more prescriptive, requiring that large locally incorporated banks meet a minimum standard. This regime has two main components. Large locally incorporated registered banks are required to maintain funding from stable sources, such as retail deposits or longer-term wholesale funding, at a minimum level (called the core funding ratio). The current requirement is that 65 percent of the bank's funding is from stable sources. It is intended that the core funding ratio be increased in steps to 75 percent over time. Locally incorporated registered banks must also hold sufficient levels of liquid assets against short-term liabilities, calculated on both a weekly and monthly basis (the one-week and one-month mismatch ratio).[19]

8 Governance

It is important that the directors of an NBDT act in the best interests of the NBDT. This provides a level of assurance to security holders that their interests will not be prejudiced in favour of a related entity or individual. Independent directors are considered the cornerstone of best practice

[18] Deposit Takers (Liquidity Requirements) Regulations 2010. These regulations are promulgated under section 157Z of the Act.

[19] See Hoskin K, I Nield and J Richardson (2009) "The Reserve Bank's new liquidity policy for banks", Reserve Bank *Bulletin*, 71(4)

corporate governance, as they are better able to provide impartial advice and direction to the company, particularly in dealings with related parties.

From 1 December 2010, NBDTs that are companies or building societies must have at least two independent directors and a chairperson who is not an employee of either the NBDT or a related party. In addition, NBDTs that are subsidiaries are prohibited from including in their constitutions provisions that would allow their directors to act other than in the interests of the NBDT.[20] Similar provisions apply to locally incorporated registered banks.

9 Conclusion

A strong non-bank sector is an important part of a sound and efficient financial system, particularly given the role the sector plays in financing activities that banks have not traditionally been involved with.

The NBDT sector has been through a period of major change over recent years. Many finance companies have failed or otherwise exited the market, with finance companies exposed to property development suffering a particularly high rate of failure. Whilst economic conditions have been difficult, many of the finance companies that failed had poor risk management and lending practices, inadequate capitalisation high levels of related party exposures. Savings institutions have generally had more conservative business models and have not suffered similar failures as in the finance company sector.

The NBDT sector's exposure to the property development sector is likely to remain greatly reduced, as the model of retail funding for high-risk exposures has proven to be unsustainable. The funding of viable projects in the property development sector will require new funding models better suited to the financing of higher-risk projects. For example, a number of private equity-based funding vehicles have been launched over recent months with the intention of financing both new and existing property development.

The new regulatory regime for NBDTs, administered by the Reserve Bank, addresses many of these weaknesses in the NBDT sector. The regime is aimed at promoting the maintenance of a sound and efficient financial system. The Reserve Bank has made substantial progress in implementing this new regime. The most significant requirements to date are the capital adequacy requirement, restrictions on related party exposures and the requirement for NBDTs to have a credit rating. NBDTs are also required to meet good practice corporate governance standards, explicitly agree to a quantitative liquidity target with their trustee and formulate and abide by a risk management plan. New legislation is expected to come into force in 2011 providing requirements for licensing and changes in ownership, fit and proper person standards and powers of intervention for the Reserve Bank.

The regime for NBDTs is similar to that for banks. However, the requirements have been tailored to be fit for purpose for the NBDT sector. This approach sets minimum prudential standards for NBDTs whilst recognising the importance of having a diverse NBDT sector that provides niche services to complement banks.

20 These provisions are provided in section 157L of the Act.

Annex

Comparison of requirement for banks and NBDTs

Policy	Banks		NBDTs
Credit ratings	Banks must maintain a rating for their long-term senior unsecured New Zealand dollar obligations payable in New Zealand		NBDTs must maintain a New Zealand dollar, long-term, issuer rating
Capital requirements	Total capital must not be less than 8% of total risk-weighted exposures Tier 1 capital must not be less than 4% of total risk-weighted exposures Total capital of the banking group must not be less than $30 million		Tier 1 capital must not be less than 8% of total risk-weighted exposures for NBDTs with credit rating or 10% of total risk-weighted exposures for NBDTs without credit rating
	Deductions	Deductions for assets of little value in distress of bank or for equity-like assets	Deductions similar to banking regime but tailored to NBDT business
	Exposure types	Credit, market and operational risk	Credit, market and operational risk
	Credit risk	Assets risk-weighted to calculate risk-weighted credit exposures Risk weights based on either Basel II standardised model or advanced bank internal model	Assets risk-weighted to calculate risk-weighted credit exposures Risk weights set by RBNZ based on characteristics of NBDT sector
	Market risk	RBNZ market risk model	Scalar applied to average of total assets and risk-weighted assets
	Operational risk	Scalar applied to total assets and income or banks may calculate based on internal models	Scalar applied to average of total assets and risk-weighted assets
Liquidity	Large locally incorporated banks must maintain, for the end of each business day: (a) A one-week mismatch ratio of ≥ 0%; (b) One-month mismatch ratio of ≥ 0%; (c) One-year core funding ratio of ≥ 65% (expected to be raised to 75% over time).		NBDTs and trustees are required to ensure that trust deeds include quantitative liquidity requirements Guidelines are provided on how to determine these requirements

Policy	Banks		NBDTs
Related party exposures	Credit exposures to non-bank connected persons shall not exceed of 15% of the banking group's tier 1 capital Aggregate allowable credit exposures of the banking group to all connected persons depends on the rating of the bank		Aggregate exposures to related parties must not exceed 15% of the capital of the borrowing group
	Definition of related party	Owners: a person holding a substantial direct or indirect interest in the registered bank	Owners: a person holding a substantial direct or indirect interest in a member of the NBDT group
		Sister entities: an entity in which the owner has a substantial interest;	Sister entities: an entity in which the owner has a substantial interest;
			Subsidiary/held entities: a (non-guaranteeing) subsidiary or an entity in which a NBDT has a substantial interest
		Directors of the registered bank	Directors and senior office holders of NBDT group members and their relatives Interlocking directorships: entities with 40% commonality in governing body
		Substantial interest means holding 20% or more of: • issued securities; • dividend entitlements; • voting rights; • control over composition of governing body	Substantial interest means holding 10% or more of: • ordinary shares; • control of the company; • voting rights; or • control >25% of composition of governing body.
	Credit exposure	Maximum loss incurred if the related party fails to meet its obligations	Maximum loss incurred if the related party fails to meet its obligations
Governance	Locally incorporated registered banks must meet the following requirements: • have at least 2 independent directors; • the chairperson of the board must not be an employee of the bank; • the bank's constitution must not allow a director to act other than in the interests of the bank		NBDTs must meet the following requirements: • have at least 2 independent directors; • the chairperson of the board must not be an employee of the bank; • subsidiary NBDT's constitution must not allow a director to act other than in the interests of the NBDT

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