

The Chair

CABINET ECONOMIC GROWTH AND INFRASTRUCTURE COMMITTEE

REGULATION OF NON-BANK DEPOSIT TAKERS

PROPOSAL

1. In June 2007, Cabinet agreed to proposals for changes to the prudential regulation of non-bank deposit takers (CAB Min (07) 21/10 refers). This paper seeks approval for the introduction of a Non-Bank Deposit Takers Bill (“the Bill”), to complete the implementation of the regulatory regime.

EXECUTIVE SUMMARY

2. In June 2007, Cabinet approved the basic framework for the regulation of non-bank deposit takers (“NBDTs”), with the Reserve Bank as the prudential regulator.
3. I am now recommending that the Committee agree to the remaining details of the NBDT regulatory regime, as set out in the recommendations section of this paper, with the following main features:
 - a. Licensing of NBDTs: to ensure that NBDTs meet certain basic minimum requirements to operate as a retail deposit taker, in addition to the requirements applicable to debt issuers under securities law. This will take into account the ownership of the applicant, its ability to meet prudential standards, as well as compliance with securities law and the Anti-Money Laundering and Countering Financing of Terrorism Act 2009.
 - b. The directors and senior officers of NBDTs must not have a track record that indicates they are not suitable for their position. A number of “suitability criteria” will be prescribed by regulation, and there must be certification from the directors or the governing body that those concerns do not apply to appointees. Where the concerns do apply, the Reserve Bank will vet the applicants.
 - c. Transactions that would result in a person owning, or having the power to control, 20 percent or more of the NBDT’s voting securities, or 25 percent or more of the NBDT’s governing body, will need to be cleared by the Reserve Bank.
 - d. Powers for the Reserve Bank to detect and respond to the distress and failure of NBDTs, including general information-gathering and investigation powers, as well as powers to issue directions.
 - e. Part 5D of the Reserve Bank of New Zealand Act 1989 (“the Act”), which deals with the prudential regulation of NBDTs, will be incorporated into the Bill, subject to minor amendments.

4. These proposals will require legislation. It was agreed by the Committee in 2007 that the Act would be further amended to make these changes (EDC Min (07) 19/1 refers). However, the Act has become lengthy and quite cumbersome, and I am proposing a separate Act for the regulation of NBDTs. This will encompass the new proposals set out in this paper, as well as the existing provisions in Part 5D of the Act, with some minor remedial amendments.

BACKGROUND AND OVERVIEW

5. On 18 June 2007 Cabinet agreed that as prudential regulator of NBDTs, the Reserve Bank will be the agency that:
 - licenses and de-licenses NBDTs, in consultation with the Securities Commission (now the Financial Markets Authority);
 - administers fit and proper requirements for NBDT directors, senior managers and other persons with the ability to exercise control or significant influence over the NBDT; and
 - has powers to intervene to assume control of the process for managing acute distress or failure of an NBDT in situations where the Reserve Bank is satisfied that this is necessary to avoid significant damage to the financial system.

[CAB Min (07) 21/10]

6. Prudential regulation was to be implemented in two pieces of legislation. The first was the Reserve Bank of New Zealand Amendment Act 2008 (now Part 5D of the Act), implementing credit rating, capital, liquidity, and other prudential requirements, as well as associated offences, penalties, and enforcement powers for the Reserve Bank. The second piece of legislation was to implement the remaining elements of the regime, including licensing requirements, fit and proper requirements, and distress and failure management.
7. This paper relates to the second piece of legislation. While Cabinet approved the features of the full regime in 2007, it is important to consult Cabinet again for several reasons:
 - a. a reasonably long time has passed since the original decision;
 - b. there is no Cabinet approval for the Reserve Bank to have change of ownership powers;
 - c. there have been changes in policy in some areas, albeit these are relatively minor; and,
 - d. I intend to recommend a number of minor or technical changes to Part 5D of the Act.
8. Before the decision was taken by Cabinet in 2007, consultation was undertaken regarding the main elements of licensing, fitness and properness requirements, and distress and failure management. Further consultation was undertaken in 2010 on the detail of these elements, as well as on the new change of ownership proposals.
9. My recommendations in this paper are based on the Reserve Bank's further analysis of the need to control changes in ownership of NBDTs, and of options for best implementing fit and proper (or "suitability") requirements. This analysis has had regard to developments such as events in the NBDT sector, the enactment of the Financial

Service Providers (Registration and Dispute Resolution) Act 2008 and the Anti-Money Laundering and Financing of Terrorism Act 2009, the Reserve Bank's experience under Part 5D thus far, and the results of public consultation.

PROPOSALS

Definition of NBDT

10. Given the Reserve Bank's experience of Part 5D so far, I am of the view that the current definition of "deposit taker" in section 157C is too broad. In particular, the definition encompasses building societies and credit unions that are registered in New Zealand, but do not necessarily undertake any business in New Zealand. The objective of introducing NBDT regulation was to promote a sound and efficient financial system (CAB Min (07) 21/10 refers), and the prudential regulation of entities that do not take deposits in New Zealand does not fulfil that objective.
11. It is therefore proposed to amend the definition of "deposit taker" so that only those entities that meet the core aspects of the definition will be licensed as NBDTs, i.e. those that offer debt securities to the public in New Zealand and also carry on the business of borrowing and lending money, or providing financial services. A person will remain an NBDT until all debt securities have been repaid (subject to any issues of practical implementation). The Bank will have the ability to deem certain securities to be debt securities under the regime, and it will retain the ability to deem persons in or out of the definition of NBDT (both to be done by regulation). Submissions received during the consultation process agreed that entities that do not meet the core requirements should not be eligible to hold a licence.
12. I further propose that deposit takers be referred to in the Bill as "non-bank deposit takers", or "NBDTs". Entities regulated under Part 5D are generally described as "non-bank deposit takers" to distinguish them from registered banks, which are also deposit takers. This change would more clearly delineate between the two types of financial institution.

Licensing and De-licensing

13. All persons that satisfy the definition of NBDT will be required to hold a licence.
14. In September 2007, the Committee agreed to prohibit a person from conducting the business of a deposit taker, or holding itself out to be an NBDT, unless licensed by the Reserve Bank (EDC Min (07) 19/1 refers). Licensing is intended to ensure that NBDTs meet certain basic minimum requirements to operate as retail deposit takers. It will be an offence for a person to be an NBDT, or to hold itself out as a licensed NBDT, without holding a licence.
15. I am proposing that the Committee reconfirm the September 2007 decision that the Bank grant an applicant a licence if it can, *inter alia*, demonstrate its ability to meet prudential and other requirements, and compliance with fit and proper or suitability requirements on the part of its directors and senior officers. In addition, I am proposing that the applicant also be required to meet requirements relating to ownership.
16. The Reserve Bank will be required to maintain a publicly accessible register of licensed NBDTs.

Prudential requirements

17. From the outset, an applicant should demonstrate it has the ability to comply with the applicable prudential requirements. This will include compliance with the prudential requirements in Part 5D of the Act (and associated regulations), relating to credit ratings, governance, risk management, capital, related party exposures, and liquidity.
18. Where applicable, an applicant for a licence must also demonstrate that it:
- has, or will have, a trust deed registered or eligible to be registered by the Companies Office;
 - has, or will have, a trustee chosen from a list of trustees licensed by the Financial Markets Authority for the purpose of supervising their deposit taking activities; and,
 - has, or will have, an investment statement, and a prospectus that is registered or eligible to be registered by the Companies Office.
19. An applicant may also have to demonstrate its compliance, or ability to comply, with other requirements of securities law, and the requirements of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009.

Suitability requirements

20. In June 2007, Cabinet agreed to the introduction of fit and proper checks for directors and senior managers, to assess their suitability and integrity (CAB Min (07) 21/10 refers). This evaluation would form part of the licensing framework and would extend beyond the limited criminal and bankruptcy checks required for registration under the Financial Service Providers (Registration and Dispute Resolution) Act 2008.
21. The primary responsibility for ensuring that directors and senior management have suitable skills, experience, and integrity should lie with the NBDT's owners and its governing body. In line with this, an NBDT's governing body will have to certify that the suitability concerns do not apply to senior officers, and directors will be required to self-certify their own suitability.
22. If a suitability concern should arise in relation to a director or senior officer (whether at the time of an application for licence or subsequently), then the NBDT must refer the matter to the Reserve Bank for consideration. In that event, the Reserve Bank would indicate it has no objection to the person's appointment, or respond by not issuing the licence or by objecting to the appointment. These suitability concerns, which will be prescribed by regulation, are likely to include such things as:
- bankruptcy;
 - involvement in an entity that has gone into receivership, liquidation, voluntary administration, or been the subject of statutory or judicial management;
 - criminal offending;
 - disciplinary action or adverse findings by a professional or regulatory body for persons engaged in that profession;
 - adverse findings or action taken by any other regulatory authority, market operator, or government agency (whether taken directly or indirectly through a court or tribunal); and,

- conflicts of interest that could impact on the proper performance of the business.
23. The Reserve Bank may take into account the age of the matter, the nature of the involvement of the person, the nature of the concern itself, and its gravity when deciding what action it should take. It would be an offence for a person to falsely certify that the suitability concerns did not apply. It would also be an offence for the NBDT to appoint a senior officer, or allow a director to act, without providing the appropriate certification to the Reserve Bank.
24. A director or senior officer, or proposed director or senior officer, who is not deemed suitable by the Reserve Bank will have a right of appeal to the courts. This right of appeal will also be available where the Reserve Bank removes a person from his or her position on the basis of a misrepresentation about a suitability concern, or where the person subsequently raises a suitability concern.

Ownership requirements

25. I am proposing that ownership be a relevant consideration for the Reserve Bank at the time of licensing, and on an ongoing basis. At the time of licensing, the Reserve Bank should be able to identify those who exert influence or control over the applicant, including where an applicant is incorporated overseas. An applicant that is a branch may be licensed if the home jurisdiction has a regulatory regime that is comparable to that of New Zealand. If this is not the case, the applicant may be required to incorporate locally as part of the licensing process.
26. Once an NBDT is licensed, changes in its ownership should be subject to the Reserve Bank's supervision so as to avoid changes that are undesirable for financial stability. I am proposing the Reserve Bank's consent be required for transactions that would result in a person acquiring, or increasing, significant influence over an NBDT. This will be the ability to control 20% or more of the NBDT's voting securities, or to appoint 25% or more of the NBDT's governing body. This is similar to, but less restrictive than, the threshold in the banking regime, because ownership changes tend to occur more frequently in the NBDT sector.
27. The Reserve Bank could be expected to give its consent if it was satisfied that the new owners had incentives to monitor the activities, and influence the behaviour, of the NBDT in a way that would maintain or improve its soundness. In giving its consent, the Reserve Bank could specify the level of influence the person is permitted to have or acquire over the NBDT without having to obtain further consent. Terms and conditions could be imposed on consent.

Conditions of licence

28. The Reserve Bank will be empowered to impose specific conditions on a licence (at the time of licensing, and subsequently). For example:
- setting the commencement date for operations in New Zealand;
 - imposing requirements on the appointment of directors and senior officers;
 - setting limits on the NBDT's credit exposure to one particular party or to groups of related parties;
 - setting limits on the NBDTs' significant acquisitions; and,
 - restricting further deposit taking at the point of, or near, de-licensing.

De-licensing

29. The Bill will provide for both voluntary and mandatory de-licensing of NBDTs. The Reserve Bank will be able to de-license an NBDT in certain situations, including:
- a. failure to comply with relevant legal requirements;
 - b. a breach of licence conditions;
 - c. failure to comply with directions issued by the Reserve Bank; and
 - d. the NBDT is no longer operating as an NBDT and all debt securities issued to the public in New Zealand have been repaid.

Charging of fees

30. The benefits of prudential regulation of NBDTs by the Reserve Bank accrue to the NBDT and its depositors, as well as to the general public, via a more stable financial system. It is therefore arguable that NBDTs should bear at least some of the cost of prudential regulation. However, as NBDTs also have to pay trustees for ongoing supervision, it may not be appropriate to charge a licensing fee as well. Therefore, the current intention is not to charge fees. However, in line with the proposed regime for insurers, I recommend that there be authorisation for the Reserve Bank to charge licensing application fees should that be considered desirable in the future.

Existing NBDTs

31. The Bill will provide for a transition period for licensing of 12 months, giving existing NBDTs time to secure a licence, or make arrangements to repay debt securities issued to the public in New Zealand.

Distress and failure management

32. On 5 September 2007 the Committee agreed that:
- the Reserve Bank may recommend to the Minister of Finance that an [NBDT] (including its subsidiaries or associated persons) be given directions (with the consent of the Minister of Finance), under section 113 of the Reserve Bank of New Zealand Act, or to recommend to the Minister of Finance that the [NBDT] be placed into statutory management, under section 117 of that Act, where an [NBDT]:
 - is insolvent or about to become insolvent; or
 - has failed to comply with [NBDT] regulatory requirements; and
 - the failure of the [NBDT] could impede the maintenance of a sound and efficient financial system or cause significant damage to the finance system;
 - the Reserve Bank be required to consult the Securities Commission, Companies Office and trustee before exercising the powers in [the above paragraph];
 - the Reserve Bank be empowered to suspend all or some of the powers of a trustee in situations where an [NBDT] has been brought under the Reserve Bank of New Zealand Act;
 - the legislation make provision for trustees to be relieved of liability resulting from the suspension of their powers or from any actions taken by the Reserve Bank in a

situation where an [NBDT] has been given directions or placed into statutory management under the Reserve Bank of New Zealand Act.

[EDC Min (07) 19/1]

33. The developments in the NBDT sector since September 2007 indicate that the Reserve Bank should have appropriate powers to detect and respond to early signs of distress. However, rather than confirming this earlier decision to simply extend the approach for registered banks to NBDTs, I am proposing that the Committee agree to the following proposals relating to information gathering, direction powers, and statutory management.

Information gathering

34. I am proposing the Reserve Bank's information gathering powers be extended to assist it with detecting and responding to distress and failure, as well as with the routine monitoring of the sector. This would include powers to:
- require information from NBDTs for prudential purposes, not just for the purpose of investigating strict compliance with the Act and regulations (as is currently the case under the Act);
 - require information from associated persons of NBDTs, and to directly investigate an associated person, where necessary. This is on the basis that the Reserve Bank has seen many NBDTs with associated persons whose conduct and activities have had the potential to have a material effect on the NBDT and its creditors;
 - obtain additional information from the trustee for prudential purposes. In particular, if a trustee did not have the information in its possession, it would be required to obtain that information from the NBDT; and,
 - allow the Reserve Bank to require information provided to it to be audited.

Directions

35. The Reserve Bank has direction powers in relation to registered banks and insurers. This is a standard prudential tool, and I am proposing that the Reserve Bank also be empowered to issue directions to NBDTs. The grounds for giving directions will be similar to the grounds under the banking and insurance regimes, including where the NBDT is failing to comply with prudential requirements. Directions will extend from consulting with the Reserve Bank, to taking such actions as specified by the Reserve Bank to remedy the non-compliance. The Reserve Bank should also have the power to issue directions to an NBDT's associated persons, and to an NBDT's trustee.
36. The Reserve Bank will also be empowered to remove a director of an NBDT. Consistent with the approach for registered banks and insurers, there will generally be no right of appeal to the courts in such an eventuality. This is because such powers will only be available where the grounds for directions exist, and where it is necessary to remove or replace the director for the purposes of the Bill. However, a right of appeal is available if a director is removed on suitability considerations.

Statutory management

37. It is no longer proposed to establish a special statutory management regime for NBDTs, as exists for registered banks. Instead, statutory management would be available under the Corporations (Investigation and Management) Act 1989 ("CIMA").
38. A statutory management regime based on the registered bank model would give the Reserve Bank the ability to exercise control over the conduct of a statutory management,

which it would not have under CIMA. Notwithstanding this, I am proposing that a statutory management regime similar to that which applies to registered banks is not needed for NBDTs. Registered banks are generally regarded as having more systemic implications for the operation and soundness of the financial system, when compared with NBDTs. Therefore, a more “hands-on” approach by the regulator can be justified in the case of registered banks, but not for NBDTs.

39. The distress and failure of an NBDT will therefore be dealt with under general insolvency law, with the Financial Markets Authority able to recommend statutory management under CIMA. However, I propose that the Financial Markets Authority be required to consult with the Reserve Bank before such a recommendation is made. If the Reserve Bank itself believes that statutory management of an NBDT would be appropriate, it can always recommend this to the Financial Markets Authority.
40. I note that this decision not to introduce a special statutory management regime for NBDTs will be reviewed as part of the general review provided for in Part 5D of the Act (currently scheduled to take place in 2013).

Offences and penalties for non-compliance with regulatory requirements

41. The existing offences in Part 5D of the Act will be carried over to the Bill, with the same penalties. The Bill will also provide for offences and penalties to encourage compliance with the new NBDT regulatory requirements. These will be consistent with the current offences and penalties in Part 5D, with generally the same regulatory offence structure. I am proposing that the Bill will provide for additional offences, as set out in the recommendations.
42. The defence of absence of fault currently provided for in Part 5D will be incorporated in the Bill.
43. I am proposing that the legislation will prescribe penalties for these new offences. These will be consistent with the sanctions in Part 5D. Where Part 5D does not provide for a similar offence, the penalties will be consistent with those provided for in Part 5 of the Act, which relates to registered banks. The new offences will be assigned a specific “grade” depending on severity, and each grade will attract a corresponding penalty. At the high end, grade A offences will attract fines of up to \$2,000,000 for bodies corporate, and fines of up to \$200,000 and/or terms of imprisonment of up to 18 months for individuals, consistent with the current approach in Part 5D of the Act.
44. In general, grade A offences relate to the key requirements of the regime, for example, failing to hold a licence. Grade B offences generally relate to the bulk of the prudential requirements. The lower grades apply to those on the periphery of the NBDT regime. In this regard, grade C offences apply more generally, for example to persons who acquire a significant interest in an NBDT without first obtaining the Reserve Bank’s consent, and grade D offences apply to trustees, who are not directly regulated or supervised by the Reserve Bank.

Refinement and incorporation of Part 5D

45. The current Part 5D of the Act is to be incorporated into the Bill, along with the provisions of Part 7 of the Act which relate to NBDTs. This will include the review provision in section 157ZZ of the Act, with the review encompassing the ‘new’ provisions introduced by the Bill, including licensing and the bolstering of distress and failure management.

46. I intend to take this opportunity to refine certain aspects of the existing Part 5D. These are generally changes of a minor or technical nature. The material changes proposed were the subject of public consultation. Illustrative (rather than exhaustive) examples of the proposed changes to Part 5D are as follows:

- align the definition of “guaranteeing subsidiary” in section 157B(1) with the definition of “guaranteeing subsidiary” in regulation 4(1) of the Securities Regulations 2009;
- amend the definition of “subsidiary” in section 157B(1) to include entities that are in-substance subsidiaries;
- remove the reference to “collective investment schemes” in section 157C(1)(c)(i), as entities that issue debt securities as well as collective investment schemes should not be excluded;
- amend section 157L(1) so it is clear that the governance requirements are applicable to overseas entities as well as New Zealand entities;
- allow regulations to be made under section 157P for the purpose of prescribing minimum capital requirements when an NBDT is part of a borrowing group;
- amend section 157ZT(2) so that the act or omission of an NBDT’s shareholders cannot provide a defence to a prosecution for an offence against the Bill;
- repeal section 157ZU, as the discharge of a defendant is addressed in the Sentencing Act 2002; and,
- include a provision in section 157ZV that a person may be convicted of an offence even though the body corporate has not been charged with that offence.

Other technical amendments to the Act

47. I also recommend that the Bill include some technical amendments to the Act. These amendments are needed to enable the current versions of documents incorporated by reference (including accounting standards, banks’ conditions of registration) to be automatically legally valid. Currently, Orders in Council must be made to validate each change in these underlying requirements. This risks mismatches between the underlying requirements and banks’ disclosure requirements. The consequence is that registered banks would have to operate dual reporting systems where such mismatches occur, which would impose unnecessary costs. In addition, the incorporation by reference provisions of the Legislation Bill are not effective in some cases under the Act. The proposed technical amendments to the Act will be co-ordinated with amendments to the Legislation Bill.

48. Incorporation by reference provisions also appear in Part 5D. The same approach is proposed for NBDTs under the Bill as for registered banks.

49. I also intend to take this opportunity to amend section 78 of the Act. This section lists the matters to be considered in determining the ability of a registered bank to carry on its business in a prudent manner. Section 78 also provides for additions to the list of matters to be made by way of regulation. This has been done by virtue of the Reserve Bank of New Zealand (Registration and Supervision of Banks) Regulations 2008 (“the regulations”), which adds “policies, systems and procedures to detect and deter money laundering and the financing of terrorism” to the list of matters capable of being considered under section 78. I am proposing that this matter be added to the list in

section 78, and that the regulations be revoked. This would mean all the matters would be set out in a single piece of legislation, making it easier for registered banks and other interested parties to obtain information about the matters covered by Reserve Bank prudential supervision.

CONSULTATION

50. The Treasury, the Financial Markets Authority, the Ministry of Economic Development, the Ministry of Justice, and the Parliamentary Counsel Office have been consulted. Their comments have been taken into account in the course of preparing this paper. The Department of Prime Minister and Cabinet was informed. A concern was raised during consultation that the proposals do not include direct statutory management powers for the Reserve Bank in respect of NBDTs. This issue is being addressed in a separate process running alongside the progression of the Bill.

51. A consultation paper was issued to industry during October 2010, regarding the appropriate approach to licensing, suitability requirements, change of ownership requirements, and the detection and management of distress and failure. The proposals in this paper closely reflect the proposals set out in that consultation paper. The only significant differences relate to:

- the proposal that all entities meeting the “NBDT” definition must have a licence unless exempted. It is now considered that having a power of exemption in relation to the licensing requirement itself is not needed and could complicate the licensing regime;
- the proposal that existing NBDTs be given a provisional licence to allow them to come to compliance and secure a licence. Since December 2010, NBDTs have been required to comply with the full array of prudential requirements in Part 5D. In these circumstances, a provisional licence is no longer considered appropriate. Instead, NBDTs will have 12 months to come into compliance.

52. Overall, the submissions that were received were supportive of the proposals.

FINANCIAL IMPLICATIONS

53. The Reserve Bank will fund its costs associated with NBDT regulation through its Funding Agreement, rather than through charging fees in respect of applications for licence. However, provision will be made in the Bill for the Bank to charge a cost-recovery fee for licensing applications should that be considered necessary in the future.

HUMAN RIGHTS

54. It is not considered that the proposals in the paper would be inconsistent with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993. Officials from the Ministry of Justice should be able to provide a final view on this once they have considered the LEG draft of the Bill.

LEGISLATIVE IMPLICATIONS

55. The proposals in this paper will require the drafting of new legislation. The proposals will contain references and/or amendments to the Reserve Bank of New Zealand Act 1989, the Securities Act 1978, the Anti-Money Laundering and Countering the Financing of Terrorism Act 2009, the Financial Service Providers (Registration and Dispute Resolution) Act 2008, and the Corporations (Investigation and Management) Act 1989.
56. The Bill holds a priority 3 categorisation on the 2011 Legislation Programme (to be passed if possible in 2011).

REGULATORY IMPACT ANALYSIS

57. The Regulatory Impact Analysis requirements apply to the proposals set out in this paper. A Regulatory Impact Statement (RIS) has been prepared, and is attached to this paper.
58. An Adviser in the Deposit-Takers and Anti-Money Laundering Team at the Reserve Bank has reviewed the RIS prepared by the Reserve Bank and the associated supporting material, and considers that the analysis summarised in the RIS meets the quality assurance criteria.
59. I have considered the analysis and advice of my officials, as summarised in the attached RIS, and I am satisfied that, aside from the risks, uncertainties, and caveats already noted in this Cabinet paper, the regulatory proposals recommended in this paper:
- are required in the public interest;
 - will deliver the highest net benefits of the practical options available; and
 - are consistent with our commitments in the Government Statement on “Better Regulation, Less Regulation”.

PUBLICITY

60. The Reserve Bank will keep NBDTs and trustees informed as to progress with the passage of the legislation. It will put a statement on the Reserve Bank’s website, accompanied by a press release when the Bill is enacted.

RECOMMENDATIONS

61. It is recommended that the Committee:

Background

1. **note** that in September 2007 the Cabinet Economic Development Committee agreed to a number of proposals for the prudential regulation of NBDTs, including licensing and distress and failure management of NBDTs (EDC Min (07) 19/1 refers);
2. **note** that the Cabinet Economic Development Committee further agreed that these proposals be enacted in two separate bills (EDC Min (07) 19/1 refers);
3. **note** that the proposals relating to prudential requirements were enacted in the Reserve Bank of New Zealand Amendment Act 2008, covering credit ratings, risk management, governance, capital, related party exposures, and liquidity;
4. **note** that the proposals relating to licensing and to detection and management of NBDT distress and failure remain to be enacted;
5. **note** that submissions on the consultation paper issued in October 2010 broadly supported the introduction of licensing requirements for NBDTs, including suitability checks on directors and senior officers and change of ownership constraints, as well as distress and failure detection and management powers for the Reserve Bank;

Summary of main features

6. **note** that
 - 6.1. all NBDTs will be required to be licensed by the Reserve Bank;
 - 6.2. NBDTs will be required to comply with minimum prudential requirements, unless exempt;
 - 6.3. the appointment of NBDTs' directors and senior officers will be vetted by the Reserve Bank where specified suitability concerns apply;
 - 6.4. all transactions that result in a person acquiring or increasing their significant influence over an NBDT will need the Reserve Bank's consent. This is where the person has the ability, directly or indirectly, to appoint 25% or more of the NBDT's governing body, or a direct or indirect qualifying interest in 20% or more of the voting securities issued or allotted by the NBDT;
 - 6.5. the Reserve Bank will have extended information gathering powers as well as powers to direct NBDTs, associated persons, and trustees in certain situations;
 - 6.6. the Reserve Bank will have a power to remove directors and senior officers of NBDTs and associated persons; and,
 - 6.7. the Reserve Bank will have the power to de-license NBDTs;

Legislative structure

7. **note** that the Non-Bank Deposit Takers Bill will provide for a separate Act regulating NBDTs, and will incorporate (with minor amendments) the provisions of Part 5D of the Reserve Bank of New Zealand Act 1989;

8. **note** that the Non-Bank Deposit Takers Bill will also introduce new provisions relating to licensing, suitability requirements, ownership, and the detection and management of NBDT distress and failure;
9. **note** that the Non-Bank Deposit Takers Bill has been added to the 2011 Legislation Programme with a category 3 priority (to be passed if possible during 2011) (CAB Min (11) 4/6 refers);
10. **note** that the Minister of Finance intends to introduce the Non-Bank Deposit Takers Bill by August 2011;

Non-Bank Deposit Takers Bill

11. **agree** that the following decisions be included in the Non-Bank Deposit Takers Bill:

Definition of NBDT

12. the definition of “non-bank deposit taker” be amended to only cover persons that offer debt securities to the public in New Zealand (including securities that are deemed to be debt securities) and who carry on the business of borrowing and lending money, or providing financial services;
13. the legislation provide for the making of regulations deeming certain types of securities to be debt securities for the purpose of the Bill;
14. NBDTs will remain NBDTs until all debt securities issued to the public in New Zealand are repaid (subject to any issues of practical implementation);
15. “deposit takers” be referred to as “non-bank deposit takers” to distinguish them from registered banks;

Licensing of NBDTs

16. the legislation require a person wishing to be an NBDT to obtain a licence from the Reserve Bank;
17. the Reserve Bank be empowered to license applicants as NBDTs (subject to conditions as the Reserve Bank sees fit, to be prescribed by legislation or regulations) where the Reserve Bank is satisfied that, as applicable:
 - 17.1. the applicant is able to comply on an ongoing basis with the requirements relating to NBDTs, including the prudential and other requirements prescribed in the Securities Act 1978, the Anti-Money Laundering and Countering Financing of Terrorism Act 2009, and regulations made under those Acts;
 - 17.2. the applicant has a trust deed registered or eligible to be registered by the Companies Office;
 - 17.3. the applicant has a trustee that is licensed by the Financial Markets Authority; and,
 - 17.4. the applicant has, or will have, an investment statement and prospectus that comply with securities law as it relates to NBDTs;
18. the legislation provide for the making of regulations prescribing additional requirements for the Reserve Bank to consider when determining an application for a licence;
19. the legislation require the Reserve Bank to maintain a publicly accessible register of licensed NBDTs;

20. the legislation provide for the making of regulations prescribing fees payable in respect of licences, or the manner in which they may be calculated;

Suitability requirements

21. the legislation provide for the making of regulations prescribing the matters, circumstances, or conditions that are suitability concerns;
22. the legislation require attestations or certifications from directors or from an NBDT's governing body as to whether the prescribed suitability criteria apply to those appointed, or to be appointed, as directors or senior officers of an NBDT;
23. the legislation require the Reserve Bank's vetting of a director or senior officer where the prescribed suitability concerns arise;
24. the Reserve Bank be empowered to disallow, or object to, the appointment of a director or senior officer, or to require the removal of such a person, where the Bank is satisfied that the suitability concerns apply to that person, subject to a right of appeal to the courts;

Ownership requirements

25. the legislation require entities applying to the Reserve Bank for a licence to provide the Bank with information on the ownership and organisational structure of the applicant;
26. the legislation require prospective acquirers to obtain the Reserve Bank's approval for changes in ownership resulting in a person acquiring, or increasing, significant influence over an NBDT, specifically, the ability, directly or indirectly, to appoint 25% or more of the NBDT's governing body, or a direct or indirect qualifying interest in 20% or more of the voting securities issued or allotted by the NBDT, with related powers on the part of the Reserve Bank;

De-licensing of NBDTs

27. the Reserve Bank be empowered to de-license an NBDT at the NBDT's request, where the Reserve Bank considers de-licensing to be appropriate;
28. the Reserve Bank be empowered, after appropriate consultation, to de-license an NBDT on grounds set out in the legislation, including:
 - 28.1. failing to comply with relevant legal requirements;
 - 28.2. breaching licence conditions;
 - 28.3. failing to comply with directions issued by the Reserve Bank; and
 - 28.4. where the licensed person is no longer meeting the definition of an NBDT;
29. the legislation provide for the making of regulations prescribing additional grounds on which the Reserve Bank may cancel a licence;

NBDT distress and failure

30. the legislation empower the Reserve Bank to:
 - 30.1. require the supply of information from NBDTs for prudential purposes;
 - 30.2. require the supply of information from an associated person of an NBDT;
 - 30.3. investigate an associated person of an NBDT to ascertain whether the NBDT is in compliance with regulatory requirements;
 - 30.4. require a trustee to obtain information from the NBDT for prudential purposes, and to supply that information to the Reserve Bank;

- 30.5. require any information provided to the Reserve Bank to be audited;
 - 30.6. issue directions to NBDTs, an associated person of an NBDT, and an NBDT's trustee; and,
 - 30.7. remove a director of an NBDT or an associated person of an NBDT;
31. the Corporations (Investigation and Management) Act 1989 require the Financial Markets Authority to consult with the Reserve Bank before making a recommendation that an NBDT be placed into statutory management;

Offences

32. **agree** that the legislation set out offences that may be committed in respect of the new regulatory requirements, including:
- 32.1. being an NBDT, or holding out to be a licensed NBDT, if not licensed as an NBDT;
 - 32.2. certifying suitability when suitability concerns arise (whether knowingly or where it ought to have been known);
 - 32.3. an NBDT failing to comply with any conditions of its licence;
 - 32.4. an NBDT allowing a director to act, or appointing a senior officer, without first certifying whether or not the suitability concerns arose;
 - 32.5. an NBDT allowing a director to act, or appointing a senior officer, where suitability concerns arose, without first obtaining the Reserve Bank's non-objection;
 - 32.6. an NBDT failing to notify the Reserve Bank when it knew, or ought to have known, that suitability concerns arose in relation to a director or senior officer;
 - 32.7. failing to obtain the Reserve Bank's consent for a transaction that results in a person acquiring, or increasing, significant influence over an NBDT;
 - 32.8. an NBDT or an associated person failing to provide information requested by the Reserve Bank;
 - 32.9. an associated person failing to provide information or access to information to the Reserve Bank if required by the Reserve Bank to do so;
 - 32.10. an NBDT, associated person, or trustee failing to comply with directions issued by the Reserve Bank;
 - 32.11. an officer or employee of an NBDT, associated person, or trustee hindering compliance with directions issued by the Reserve Bank; and,
 - 32.12. unauthorised disclosure of the giving of directions or a notice of removal of a director.

Penalties

33. **agree** that the legislation prescribe penalties for offences that align with the penalties currently provided for in Part 5D and Part 5 of the Reserve Bank of New Zealand Act 1989;

Incorporation of Part 5D of the Reserve Bank of New Zealand Act 1989

34. **agree** that the legislation incorporate Part 5D of the Reserve Bank of New Zealand Act 1989, and the provisions in Part 7 of the Reserve Bank of New Zealand Act 1989 which relate to NBDTs;
35. **agree** that Part 5D of the Reserve Bank of New Zealand Act 1989 be incorporated with such minor or technical changes that may arise during the drafting of the legislation, or as may be authorised by the Minister of Finance;
36. **note** that Part 5D of the Reserve Bank of New Zealand Act 1989 provides for a review of the provisions of Part 5D by 2013;

Other technical amendments

37. **agree** that the Reserve Bank of New Zealand Act 1989 be excluded from the application of the incorporation by reference provisions of the Legislation Bill;
38. **agree** that the incorporation by reference provisions in the Reserve Bank of New Zealand Act 1989 be amended to provide:
- 38.1. that the most recent version of a document which is incorporated by reference is automatically the legally valid version except where a particular version of the document is specified; and,
- 38.2. if a particular version of a document is not specified where incorporated by reference and the document is revoked and not replaced, that the last version of the document before its revocation continues to be the legally valid version;
39. **agree** that the NBDT legislation include provisions for incorporation by reference equivalent to those in the Reserve Bank of New Zealand Act 1989 taking into account recommendations 37 and 38, with all necessary adjustments;
40. **agree** that section 78 of the Reserve Bank of New Zealand Act 1989 include the matters provided for in the Reserve Bank of New Zealand (Registration and Supervision of Banks) Regulations 2008 and that the Reserve Bank of New Zealand (Registration and Supervision of Banks) Regulations 2008 be revoked;

Authorisation of Minister

41. **authorise** the Minister of Finance to make changes, consistent with the policy framework in this paper, on any issues that arise during the drafting process;

Commencement date for legislation

42. **agree** that the legislation commences on 1 June 2012, with the licensing requirement commencing on 1 June 2013; and,

Next steps

43. **invite** the Minister of Finance to formally authorise drafting instructions to the Parliamentary Counsel Office to give effect to the decisions above.

Hon Bill English
Minister of Finance

_____/_____/_____

REGULATORY IMPACT STATEMENT

REGULATION OF NON-BANK DEPOSIT TAKERS

EXECUTIVE SUMMARY

- 1 In 2007, Cabinet agreed to a new framework for the regulation of non-bank deposit takers (“NBDTs”) (CAB Min (07) 21/10 and CAB Min (07)33/4 refer). This framework was to be implemented in two pieces of legislation. The first, the Reserve Bank of New Zealand Amendment Act 2008, provided legislative support for much of the new regulatory framework, including capital adequacy, related party lending, governance, credit ratings, liquidity, and risk management.
- 2 The proposals addressed in this paper relate to the second piece of legislation, which implements the remaining elements of the regime, including licensing and de-licensing, fit and proper, or “suitability”, requirements, change of ownership requirements, and distress and failure detection and management.
- 3 This paper sets out the Regulatory Impact Statement (“RIS”) for the proposed regulation of NBDTs. It should be read in conjunction with the associated Cabinet paper to the Cabinet Economic Growth and Infrastructure Committee.

AGENCY DISCLOSURE STATEMENT

- 4 This RIS has been prepared by the Reserve Bank of New Zealand. It provides an analysis of options to complete the regulatory framework for NBDTs.
- 5 The analysis builds on work undertaken by the Reserve Bank identifying problems in the industry and possible solutions to those problems.
- 6 That work, and various other changes that are currently underway in the NBDT regulatory environment, provides the framework for problem definition and the development of options in this RIS. For example, in the development of these proposals, it was assumed that the Financial Markets Authority Bill effectively determined the ambit of the Financial Markets Authority (“FMA”). It was similarly assumed that the Securities Trustees and Statutory Supervisors Bill represented the new regime for trustee supervision.
- 7 The proposals in this RIS have been subject to public consultation. No quantitative estimates of costs of compliance were provided by submitters.
- 8 The scope of this RIS is restricted to the main policy decisions with respect to each of the topics of regulation.

Toby Fiennes

Head of Prudential Supervision Department

Reserve Bank of New Zealand

07/06/2011

STATUS QUO AND PROBLEM DEFINITION

- 9 Prior to the enactment of the Reserve Bank of New Zealand Amendment Act 2008, now Part 5D of the Reserve Bank of New Zealand Act 1989 (“the Act”), there was a piecemeal approach to NBDT regulation, with different types of NBDTs subject to different requirements.
- 10 The regulatory framework for NBDTs was developed to overcome deficiencies in NBDT regulation, including inconsistency in prudential requirements across the sector, the absence of minimum entry requirements, and insufficient means for investors to assess and compare NBDT risk profiles. These deficiencies were identified as undermining competitive neutrality, and potentially impeding the maintenance of a sound and efficient financial system, and contributing to a misallocation of resources and instability in the sector.
- 11 In 2007, Cabinet agreed to a specific framework for NBDT regulation (CAB Min (07) 21/10 refers). Part 5D introduced the bulk of the prudential requirements, including governance, risk management, and capital and liquidity requirements. The Non-Bank Deposit Takers Bill (“the Bill”) provides for the implementation of the remaining elements, including licensing, suitability requirements for directors and senior officers, and detection and management of NBDT distress and failure.
- 12 The Bill proposes a licensing requirement that is intended to ensure that all NBDTs meet minimum basic standards, both at the time of licensing and on an ongoing basis.
- 13 The suitability requirements are designed to reduce the risk of NBDTs being imprudently managed or used for purposes that benefit related parties at the expense of depositors. Failures in the past few years have revealed significant managerial weaknesses in the sector. Investor confidence will be enhanced if investors know the organisations they are dealing with are not controlled by persons with a questionable track record. This in turn should promote confidence in the soundness of the financial system, and increase participation in the system.
- 14 The distress and failure management proposals provide the Reserve Bank with powers to intervene to detect and manage NBDT distress or failure, including enhanced information-gathering powers, and powers to issue directions and remove directors. They will bolster the Reserve Bank’s existing limited intervention powers.
- 15 The Reserve Bank is also proposing new change of ownership powers. These would allow the Bank to assess significant changes in NBDT ownership in much the same way as it can under the banking regime. The Reserve Bank’s main prudential concern is the suitability of ownership in the NBDT sector, both at the time of an application for licence and on an ongoing basis.
- 16 Changes in ownership are of particular concern to holders of debt securities who would have invested on the basis of the risk profile associated with the original ownership structure. Unrestricted changes in ownership could have a negative impact on the stability of the sector and may undermine investor confidence. Controls over changes of ownership would also have an important ancillary benefit to New Zealand in terms of improving its compliance with the Financial Action Task Force’s international anti-money laundering recommendations. These recommendations highlight the importance from an anti-money laundering perspective of having requirements for licensing and ongoing supervision.

OBJECTIVES

- 17 The Bill seeks to promote a sound and efficient financial system, and avoid significant damage to the financial system that could result from the failure of an NBDT.

REGULATORY IMPACT ANALYSIS

- 18 As noted above, the Bill will include new regulatory requirements in four distinct areas. The options considered by the Reserve Bank on each of these issues are outlined below. The first section discusses licensing requirements. The second section identifies options for implementing suitability requirements, and the third section deals with change of ownership requirements. The fourth section will address options regarding distress and failure of NBDTs.

Section 1: Licensing

- 19 The Bill will introduce a requirement for all NBDTs to be licensed by the Reserve Bank. In 2007, Cabinet agreed to a framework for the licensing of NBDTs. Under this framework, all persons that meet the definition of NBDT must be licensed (CAB Min (07) 21/10 refers). Cabinet agreed that an applicant would be granted a licence if it was able to demonstrate (or would be able to demonstrate) its ability to meet prudential requirements; its compliance with the suitability requirements; and its compliance with company and securities law (EDC Min (07) 19/1, confirmed by CAB Min (07) 33/4, refers).
- 20 The Bill seeks to implement these decisions of Cabinet, with a few additional licensing considerations, including the appropriateness of the applicant's ownership; compliance with any conditions imposed on the licence; the suitability of its directors and senior officers; and, for overseas applicants, the regulatory requirements in its home jurisdiction.
- 21 The licensing requirement will impose costs on both NBDTs and the Reserve Bank. The self-certification approach for assessing the suitability of applicants' directors and senior officers (discussed in the next section) means that licensing costs will be kept to a minimum. Applicants will be required to provide information broadly analogous to the material required to be produced with an exemption application, and the Reserve Bank expects that the licensing process will be similar to the exemption process, although less time-consuming. Therefore, the Reserve Bank expects that the administrative costs of licensing will be comparable to the costs of the exemption process, and that the cost of licensing all the expected applicants will be approximately \$160,000.
- 22 The cost of licensing can be met through:
- *Option 1:* Industry, i.e. charge a licensing fee; or
 - *Option 2:* Public funds, i.e. no licensing fee.

Option 1: Charge a licensing fee

- 23 Under this option, a licence applicant would be required to pay a fee to the Reserve Bank as part of its application. This would be a one-off fee, and an applicant would be unable to obtain a licence without paying the fee. The fee would be based on cost recovery, enabling the Reserve Bank to cover the administrative costs of licensing.

- 24 Prudential regulation by the Reserve Bank, including licensing, should reduce the risk of NBDT failure, which will benefit NBDTs and depositors. It could therefore be argued that it would be appropriate for NBDTs to bear some or all of the cost of such regulation (and to pass some or all of the cost of this on to depositors).
- 25 A specific licensing fee would add to the direct costs of the regulatory regime for NBDTs. Although it is unlikely that the imposition of a licensing fee would itself cause NBDTs to exit the sector, a licensing fee would increase NBDTs' costs to comply with the regime. Due to the nature of the information to be provided, it is likely that the cost to NBDTs of a licence application will be similar to the cost of an exemption application. The Reserve Bank estimates the cost to an NBDT of an exemption application to range from approximately \$5,000, to \$15,000. The actual cost depends on the complexity of the application, with most exemption applications falling at the lower end of that cost range. The Reserve Bank expects that most licence applications will also be less complex, and will also fall at the lower end of that cost range.

Option 2: No licensing fee

- 26 Under this option, the Reserve Bank would absorb the cost of licensing, in addition to the ongoing costs of regulation. The cost would be publicly funded through the Reserve Bank's Funding Agreement.
- 27 Public funding of licensing may be appropriate, as the Reserve Bank must exercise its regulatory powers to promote the maintenance of a sound and efficient financial system. It can be argued that the cost of licensing should therefore be met mainly by the public. While NBDTs and depositors also benefit from licensing, promotion of their interests is not the primary purpose of the regulatory regime.
- 28 The NBDT regulatory regime is also not a voluntary regime. Under other Reserve Bank-run regulatory regimes, namely the registering of banks and the designation of payment and settlement systems, entities opt in and therefore have a choice as to whether or not they pay a fee to the Reserve Bank. However, under the NBDT regime, a person that meets the definition is automatically required to be licensed and to meet the prudential requirements. The compulsory nature of this regime suggests that a licensing fee should not be imposed. This is also the case for insurers under the Insurance (Prudential Supervision) Act 2010 ("the Insurance Act").

Preferred option

- 29 NBDTs are already required to conform to the brunt of the regulatory regime, and licensing should be a relatively straightforward process relative to the adjustments already made. Currently, the preferred option is not to charge NBDTs a licensing fee. Although the benefits of licensing fall partly to the NBDTs themselves, NBDTs already incur the costs of supervision by trustees as part of the regulatory regime. A licensing fee would simply add to NBDTs' compliance costs, and as the regulatory regime is not a voluntary regime, it seems inappropriate at this stage to add a licensing fee to the costs NBDTs are already incurring as a result of regulation.

Section 2: Suitability requirements

- 30 Suitability assessments provide a background check on the suitability of those who run an NBDT. To establish a regulatory framework in this area, it must first be determined which individuals within an NBDT should be subject to suitability requirements, and then a process for making assessments needs to be identified.
- 31 In 2007, Cabinet agreed that directors, senior managers and persons with the ability to exercise control or significant influence over the NBDT should be subject to suitability assessments. Where a director or senior manager did not meet the requirements, Cabinet agreed that the Reserve bank should be able to disallow their appointment, or require their removal (EDC Min (07) 19/1, confirmed by CAB Min (07) 33/4, refers). The Reserve Bank sees no reason to depart from this position, and has identified directors and senior officers as those who should be subject to the requirements.
- 32 In terms of the process, the Reserve Bank has considered three options for carrying out suitability assessments, as follows:
- *Option 1:* The banking regime;
 - *Option 2:* The insurance regime under the Insurance Act; or
 - *Option 3:* A hybrid approach.

Option 1: The banking regime

- 33 All banks must be registered by the Reserve Bank. Section 73 of the Act requires the Reserve Bank to have regard to the suitability of the directors and senior managers of an applicant for registration. However, generally the primary responsibility for assessing suitability remains with the bank's shareholders (for director appointments) and with its board (for senior management appointments). The Reserve Bank's assessment takes the form of a negative assurance (i.e. not objecting to an appointment), rather than a positive affirmation of suitability.
- 34 A bank is required to supply curriculum vitae for all proposed directors, the chief executive officers, and the executives that report directly to the chief executive, before any appointment is made. Criminal records are also checked, and checks with other regulators in New Zealand and overseas may also be carried out.
- 35 Adopting such an approach for the NBDT sector would provide a robust framework, which could be expected to have a positive impact on the quality of management in the sector in the long run. This might be considered appropriate in light of the failures that have occurred in the sector that could, in part, be attributed to directors and senior managers with previous involvement in failed financial institutions.
- 36 However, this option may impose delays on the licensing of NBDTs and the appointment of new directors and senior officers, as the Reserve Bank would have to assess the suitability of each proposed appointment, and unsuitable candidates would have to be replaced. Under the banking regime, it can take up to 5 weeks to process a fit and proper application. As applications must be provided for each appointment, this would add to NBDTs' compliance costs. The number of NBDTs compared to the number of registered banks means that this option would impose extra administrative costs on the Reserve Bank.

Option 2: The insurance regime

- 37 Under the Insurance Act, all insurers must be licensed by the Reserve Bank. A licensed insurer must provide an appropriate fit and proper policy to the Reserve Bank, and take all practicable steps to comply with that policy.
- 38 The fit and proper policy must clearly specify the qualifications, experience, requirements, and other criteria for a particular position. The policy must also include a process for assessing the fitness and propriety of a person for a position. This policy must be approved by the Reserve Bank, and any material amendments must also have the Reserve Bank's approval.
- 39 The primary responsibility for assessing suitability remains with the insurer. The Reserve Bank has the power to remove individuals only where it has reasonable grounds to believe that person is not suitable to hold the particular position.
- 40 If this approach was adopted for the NBDT sector, it would avoid the potential for delay that may arise under option 1, as the time required for the Reserve Bank to review a policy would be less than that required to process a number of individual fit and proper applications. It represents a reasonably low-cost option for NBDTs, and would allow the Reserve Bank to retain the ultimate power to block appointments if necessary. However, it would mean that the onus is on the Reserve Bank to identify any potentially undesirable appointments. This would create a challenging and potentially costly monitoring role for the Reserve Bank, which is likely to be inefficient given the range of entities operating in the sector.

Option 3: Hybrid approach

- 41 The third option is a hybrid approach, which is to require potential appointees that trigger certain criteria to be referred to the Reserve Bank for its consideration. This retains the low cost, self-assessment dimension of the insurance regime, whilst providing some of the stronger protections in the banking regime. It seeks to create a risk-based approach to regulation, allowing the industry to self-certify where there is low risk, while bringing persons of potential risk to the attention of the Reserve Bank.
- 42 The responsibility for ensuring that directors and senior officers are fit to perform their duties would remain with the shareholders (for directors) and the NBDT (for senior officers) in the first instance. This would be buttressed by a scheme whereby the appointment of any person that triggers a pre-defined set of criteria would require vetting by the Reserve Bank.
- 43 These criteria are likely to include considerations such as:
- bankruptcy;
 - involvement in an entity that has gone into receivership, liquidation, voluntary administration, or been the subject of statutory or judicial management;
 - criminal offending;
 - disciplinary action or adverse findings by a professional or regulatory body for persons engaged in that profession;
 - adverse findings or action taken by any other regulatory authority, market operator, or government agency (whether taken directly or indirectly through a court or tribunal); and

- conflicts of interest that could impact on the proper performance of the business.
- 44 This co-regulatory approach would require the Reserve Bank to make fewer assessments than under option 1, which would reduce costs for NBDTs, as well as administrative costs for the Reserve Bank.
- 45 The costs of co-regulation will fall to both NBDTs and the Reserve Bank. That said, NBDTs are likely to, or should, already have an internal policy for appointments that canvasses similar ground to the proposed criteria. Therefore, in practical terms, the new suitability requirements are likely to simply amount to a notification requirement, minimising the costs to the NBDT of replacing an appointee, and the costs to the Reserve Bank of assessing appointments.

Preferred option

- 46 The preferred option is the hybrid approach of referral to the Reserve Bank of only those appointees that breach the trigger criteria. The suitability of those responsible for the management of the NBDT is still assessed, but co-regulation reduces costs by limiting the number of assessments that are made by the regulator. As NBDTs are likely to already be carrying out due diligence on appointments, the marginal cost of this new requirement for NBDTs is expected to be minimal.

Section 3: Change of ownership controls

- 47 The proposed controls on changes of ownership will allow the Reserve Bank to assess significant changes of ownership in much the same way as it can under the banking regime. The aim of these powers is not to prevent changes of ownership as a matter of course; rather it is to empower the Bank to disallow changes of ownership that are undesirable from a financial stability perspective.
- 48 In analysing the appropriate regulatory structure, the Reserve Bank has had regard to three options, namely:
- *Option 1*: No restrictions on change of ownership;
 - *Option 2*: The banking regime; and
 - *Option 3*: The banking regime recalibrated for the NBDT sector.

Option 1: No restrictions

- 49 This option represents the continuation of the *status quo*. Under this approach, the Reserve Bank would not have the ability to intervene in respect of changes of ownership within the NBDT sector, and licences would transfer with the entity. This approach would not impose compliance costs on the industry, nor any material monitoring or administrative costs on the Reserve Bank.
- 50 However, the Reserve Bank considers that open and unchecked changes of ownership could result in undesirable ownership structures that may present a significant risk to depositors of the NBDT, with possible spill over impacts to depositors in other NBDTs. It may also hinder effective supervision and monitoring. Similarly, unchecked changes in ownership may increase complexity for depositors seeking to assess the risk profile of individual NBDTs and the financial position and circumstances of NBDTs' ultimate shareholders.

Option 2: The banking regime

- 51 Following the approach adopted under the banking regime, all transactions that would result in a person acquiring a significant influence over an NBDT would require the consent of the Reserve Bank. A “significant influence” under the banking regime is the ability to appoint 25 per cent or more of the board of directors or to control 10 per cent or more of the entity’s voting securities.
- 52 Allowing the Reserve Bank to object to certain changes of ownership would help avoid ownership arrangements that are likely to increase the risks of a major shareholder’s problems adversely affecting an NBDT. Such a power may also contribute to overall confidence in the wider deposit taking sector. For example, term depositors would be particularly concerned that a change in ownership should not dramatically alter the risk profile of the NBDT during the term of their deposit.
- 53 The problem with simply adopting the banking regime approach for the NBDT sector is that the calibration may not be appropriate for the NBDT sector. The greater number, and smaller scale, of organisations in the NBDT sector, makes significant changes of ownership more likely than in the banking sector. Therefore, the Reserve Bank’s consent might be required for a large number of transactions. This could mean higher costs for the sector, in terms of the actual cost of notification and providing information to the Reserve Bank, and potential delays in having transactions approved. It would also have greater resource implications for the Reserve Bank.

Option 3: The banking regime recalibrated

- 54 This option recalibrates the banking regime to provide a less restrictive hurdle to changes in ownership. The Reserve Bank’s consent would be required where a transaction would result in a person acquiring the ability to appoint 25 per cent or more of an NBDT’s board of directors, or to control 20 per cent or more of an NBDT’s voting securities (compared to 10 per cent under the banking regime).
- 55 The 20 per cent threshold mirrors a control threshold under the Takeovers Code. This higher threshold will impose a less onerous regulatory requirement on NBDTs. The threshold also reflects the reduced risks to system-wide financial stability posed by NBDTs, while still addressing the potential for mischief in the NBDT sector. A higher threshold can also be expected to reduce the compliance costs, as fewer transactions will be caught, resulting in fewer notifications to the Reserve Bank and fewer delays.

Preferred option

- 56 The preferred option is to restrict certain changes in ownership, but at a higher threshold than under the banking regime, i.e. option 3. Restricting changes in ownership will prevent unsuitable changes, while still allowing changes in ownership to occur at a level that will allow consolidation and strengthening of the NBDT sector. By setting an appropriate threshold for restrictions, the change of ownership requirements should not impose material costs on NBDTs.

Section 4: Distress and failure detection and management

- 57 In 2007, Cabinet also agreed that the Reserve Bank have powers to respond to NBDT distress and failure in situations where the Reserve Bank is satisfied that intervention is required to maintain the soundness and efficiency of the financial system or to avoid significant damage to the financial system that could result from the distress or failure of an NBDT (CAB Min (07) 21/10 refers).
- 58 In September 2007, Cabinet agreed that the powers available to the Reserve Bank to manage the distress and failure of a registered bank should be extended to NBDTs (EDC Min (07) 19/1, confirmed by CAB Min (07) 33/4, refers). In light of the Reserve Bank's experience of the NBDT sector, the Reserve Bank has revisited this decision on the appropriate level of intervention into the NBDT sector. The Reserve Bank considered three options:
- *Option 1:* Limited distress and failure management powers for the Reserve Bank;
 - *Option 2:* Distress and failure management powers based on the banking regime; or
 - *Option 3:* Distress and failure management powers based on the banking regime but recalibrated to reflect the nature of the NBDT sector.

Option 1: Limited distress and failure management powers for the Reserve Bank

- 59 This option represents the continuation of the *status quo*. Under the *status quo*, the distress or failure of an NBDT is primarily the trustee's responsibility. General insolvency law provides a number of options at the later stages of distress, including liquidation, receivership, and statutory management. The Reserve Bank's ability to intervene is limited to investigations to check compliance with prudential requirements.
- 60 This option reduces the potential moral hazard created by the Reserve Bank's involvement in the NBDT sector. It diminishes any expectations that the Reserve Bank will intervene, and perhaps even bail out NBDTs. Monitoring and administrative costs for the Reserve Bank are also reduced.
- 61 However, the status quo leaves the Reserve Bank unable to act if the distress or failure of an NBDT may threaten the soundness and efficiency of the financial system. General insolvency law does not take systemic concerns into account. The *status quo* also results in a piecemeal approach to distress and failure management, as the different insolvency mechanisms available under general insolvency law may have potentially different effects on different types of NBDTs.

Option 2: The banking regime

- 62 Cabinet agreed to this option in 2007. Extending the banking regime to NBDTs would give the Reserve Bank a full range of powers to intervene where financial system stability is at risk, in accordance with the purposes in Part 5D of the Act. This would involve the Reserve Bank having the power to make a recommendation to the Minister that an NBDT be placed in statutory management.
- 63 Adopting the banking regime could be seen to be a relatively heavy-handed intervention, given the differences between the sectors. NBDTs do not present the same financial stability and systemic concerns as registered banks, and simply

adopting the banking regime does not recognise the disparity between the risks posed by the failure of a registered bank and the failure of an NBDT. Such intervention is not in accord with the Reserve Bank's role as the regulator of the sector, as opposed to the supervisor (a role that is carried out by trustees). It would also be the most costly option for the Reserve Bank, and increase the risk of moral hazard that comes from intervention.

Option 3: The banking regime recalibrated

- 64 The third option represents a middle ground between the status quo of limited intervention and extending the intrusive provisions of the banking regime. As the supervisors of NBDTs, trustees should have the primary responsibility for managing the distress or failure of individual NBDTs. However, the Reserve Bank should have the ability to intervene for wider financial stability purposes.
- 65 This option involves the Reserve Bank having the power to require information from, and to investigate, NBDTs for prudential purposes, and also to issue directions to NBDTs, their associated persons, and their trustees. The most intrusive power available, statutory management, will remain with the FMA under the Corporations (Investigation and Management) Act 1989. This reduces the moral hazard arising from intervention by the Reserve Bank, as well as the cost of intervention for the Reserve Bank.

Preferred option

- 66 Each of these options has minimal cost implications, as the purpose of the legislation would put significant constraints on the Reserve Bank's use of distress and failure management powers. However, each of these options is also affected by the split between supervision and regulation in the NBDT sector, in that the Reserve Bank regulates NBDTs, while the trustees are responsible for their supervision.
- 67 Option 3 is the preferred option. This option gives the Reserve Bank a number of tools to intervene in the distress or failure of an NBDT. Moral hazard is minimised as the Reserve Bank can only intervene to the extent necessary to achieve its statutory purposes which reflect systemic considerations. Any risk of uncoordinated regulatory action due to the involvement of the Reserve Bank, the trustees, and the FMA can be minimised by information sharing and collaboration.

CONSULTATION

- 68 The Reserve Bank undertook a broad consultation with industry regarding the appropriate approach to licensing and suitability requirements prior to submitting the initial proposals to Cabinet in 2007. A reasonable period of time has passed since then, and the NBDT sector has changed considerably, so the Reserve Bank has undertaken further consultation. A consultation paper was publicly released in October 2010, outlining the Reserve Bank's proposals.
- 69 The submissions received in response to the consultation paper were considered when developing the proposals set out in this paper. Approximately fifteen responses were received, from the public, individual NBDTs, the Financial Services Federation, the Trustee Corporations Association, and the New Zealand Association of Credit Unions. The overall response to the consultation paper was supportive in principle.
- 70 Respondents were supportive of the proposed licensing requirements, and for the Reserve Bank to be able to impose conditions on licences. Respondents supported de-

licensing for persistent/serious non-compliance with requirements, as long as the threshold for de-licensing was sufficiently high to reflect the consequences of this for the NBDT.

- 71 The majority of respondents also supported, in principle, suitability checks for directors and senior officers of NBDTs. However, a number of respondents perceived the proposed suitability concerns as hard-line tests rather than triggers for discussion with the Reserve Bank. This caused some respondents to be concerned about the width of the suitability concerns.
- 72 Respondents also supported introducing restrictions on changes in NBDT ownership, which was a new proposal in the 2010 consultation.
- 73 Respondents supported the gathering of information for prudential purposes, in relation to associated persons of the NBDT as well as the NBDT itself. There was a variety of opinions regarding the Reserve Bank's proposed power to request the auditing of any information supplied.
- 74 In relation to distress and failure management, support for the Reserve Bank's proposed direction powers was only on the basis that these powers be used restrictively. Respondents agreed that a distressed NBDT should be managed according to general insolvency law, rather than through a Reserve Bank-run statutory management regime.
- 75 Following release of the Consultation Paper, the Reserve Bank met with, or obtained feedback from, the Treasury, the Ministry of Economic Development, the FMA, the Ministry of Justice, Parliamentary Counsel Office, and the Department of the Prime Minister and Cabinet.

CONCLUSIONS AND RECOMMENDATIONS

- 76 The Reserve Bank's analysis of the options outlined above has resulted in the following conclusions:
- Licensing: Applicants for an NBDT licence will not be charged a license fee at this stage.
 - Suitability requirements: All directors and senior officers should be subject to suitability checks. The Reserve Bank considers that this test should be a self-certification exercise in the first instance, to minimise the regulatory burden and compliance costs. The self-certification process will be supported by an additional requirement to refer any appointments that trigger a pre-defined set of criteria to the Reserve Bank.
 - Change of ownership: The Reserve Bank's prior consent should be required for any transaction that results in a person holding, or increasing, a significant influence over an NBDT. This is the ability to appoint 25 per cent or more of the board of directors or to control 20 per cent or more of an NBDT's voting securities.
 - Distress and failure management: The distress and failure management framework must be calibrated to reflect the risk posed by NBDTs, and the role of trustees as the supervisors of NBDTs. The Reserve Bank will have the ability to gather information regarding NBDTs, their associated persons, and

their trustees, as well as investigation and direction powers. The power to place an NBDT into statutory management will remain with the FMA.

IMPLEMENTATION

- 77 It is expected that the licensing requirement will come into force 12 months from the date the legislation is enacted. All NBDTs will then be required to comply with the licensing requirements. The Reserve Bank considers that, as all the other prudential requirements are already in force, a 12 month transition period will provide sufficient time for NBDTs to obtain a licence.
- 78 At the time the licence is granted, and for any future appointments, the directors of the NBDT will have to self-certify their suitability, and certify the suitability of senior officers. The Reserve Bank will vet the appointment of a person who raises a suitability concern. The Reserve Bank must be notified if a person raises a suitability concern after their appointment.
- 79 One of the issues that the Reserve Bank will consider as part of any licence application is the ownership of the applicant. The requirement to obtain the Reserve Bank's consent for certain transactions will apply on an ongoing basis.
- 80 Trustees will continue to be responsible for enforcing compliance with those requirements that must be included in trust deeds. The Reserve Bank will take direct enforcement action in respect of matters that are not part of trust deed arrangements. New enforcement action will include issuing directions to the NBDT, the NBDT's trustee, and any associated persons of the NBDT; prosecuting offences; and de-licensing NBDTs.
- 81 The Reserve Bank's costs in performing its functions in relation to NBDTs will be funded through its Funding Agreement under the Act.

MONITORING, EVALUATION AND REVIEW

- 82 The Reserve Bank will monitor the operation of these provisions, and their impact on the NBDT sector, on an ongoing basis.
- 83 Under section 157ZZ of the Act, the Reserve Bank is required to review and report on the operation of Part 5D no later than 5 years after commencement. This review will continue notwithstanding the incorporation of Part 5D into the Bill. The review is intended to be a fundamental review of all aspects of the regime, and will include the new aspects introduced by the Bill, i.e. licensing, change of ownership, etc. Upon completion of the review, the Reserve Bank will prepare a report for the Minister of Finance, who will table the report in the House of Representatives.