In Confidence

Office of the Minister of Finance

The Chair
CABINET ECONOMIC GROWTH AND INFRASTRUCTURE COMMITTEE

REGULATIONS EXCLUDING CERTAIN ENTITIES FROM THE SCOPE OF THE PRUDENTIAL REGIME FOR NON-BANK DEPOSIT TAKERS

Proposal

1. This paper proposes that regulations be made under the Non-bank Deposit Takers Act 2013 (NBDT Act) to exclude certain entities from the prudential regime for non-bank deposit takers (NBDTs).

Executive Summary

2. An NBDT is an entity that issues debt securities to the public in New Zealand and carries on the business of borrowing and lending, or providing financial services, or both. Typical NBDTs are credit unions, building societies or finance companies.

3. NBDTs are currently subject to a number of prudential requirements. These include requirements relating to capital, liquidity and related party exposures. By 1 May 2015, all NBDTs will also be required to be licensed by the Reserve Bank of New Zealand (the Bank) under the NBDT Act.

4. The definition of NBDT is focused on the business being carried on by an entity rather than its corporate form. However, this broad definition also has the result of catching a number of entities that are either not in substance carrying on the business of an NBDT, or that raise special policy considerations that justify their exclusion from the regime. Specifically:

   - funding conduits (i.e. subsidiaries that issue debt securities to the public and on-lend the funds raised to their parent);
   - reverse funding conduits (i.e. parent companies that issue debt securities to the public and on-lend the funds raised to their subsidiaries);
   - payment facility providers (e.g. entities that raise money from the public solely for the purpose of issuing pre-paid payment facilities);
   - small registered charities (e.g. subsidiaries of churches that raise money from their congregations to fund charitable activities); and
   - certain special purpose vehicles established by registered banks (specifically, those used to raise regulatory capital on behalf of a registered bank).

5. It is difficult to justify applying prudential regulations that are designed for finance companies, building societies and credit unions to these kinds of entities. Accordingly, this paper proposes that regulations be made under the NBDT Act to declare these types of entities not to be NBDTs in specified circumstances. Amongst other things, this will result in a material reduction of compliance costs for these entities, who would otherwise be required to be licenced by the Bank.

Background

The prudential regime for NBDTs

6. NBDTs are subject to a number of prudential requirements under the NBDT Act. These include requirements relating to capital, liquidity, credit ratings, related party transactions, risk management and governance. These requirements are either imposed directly via legislation, or by requiring NBDTs to include certain obligations within their trust deeds. The Bank has the power to exempt individual NBDTs or classes of NBDTs from the obligation to comply with any of these prudential requirements.

7. In addition, under the NBDT Act all NBDTs are now required to be licensed by the Bank by 1 May 2015. The Bank has the power to impose conditions on NBDTs' licences (which amongst other things, may relate to prudential matters such as risk concentration, capital and related party exposures).

8. The NBDT Act also provides suitability requirements for directors and senior officers of NBDTs, places restrictions on changes of ownership involving an NBDT, and grants powers to the Bank to help it manage situations involving distressed or failed NBDTs (these include additional information-gathering and investigation powers, and the power to issue directions to an NBDT).

Treatment of boundary issues raised by the definition of NBDT

9. An NBDT is defined as an entity that issues debt securities to the public and carries on the business of borrowing and lending, or providing financial services, or both.[1] A typical NBDT will carry on the business of borrowing (through repeated or continuous issue of debt securities to the public) and lending (through the offer of loans to the public or a wide group of persons).

10. The definition of NBDT is focused on the business being carried on by an entity rather than its corporate form. However, this broad definition also has the result of catching a number of entities:

    - that may in substance not be carrying on the business of a typical NBDT (i.e. the kind of borrowing and lending activity noted in paragraph 9); or

    - that may raise special policy considerations justifying their exclusion from the regime.

11. It may be difficult to justify imposing prudential requirements designed for finance companies, building societies and credit unions on these types of entities.

[1] The concept of "offer to the public" in this definition has the same meaning as in the Securities Act 1978, which will shortly be replaced by the Financial Markets Conduct Act 2013 (FMC Act). The FMC Act replaces the concept of "offer to the public" with the broadly analogous concept of making a "regulated offer", and the definition of NBDT will be amended to reflect this change. References to "offer to the public" in the rest of this paper should accordingly also be read to include references to making a "regulated offer".

12. For this reason, the Bank has exempted a number of entities from all of the prudential requirements applying to NBDTs. Most significantly, funding conduits, payment facility providers and smaller charitable or religious organisations.

13. However, under the NBDT Act it is not possible to exempt an entity from the requirement to be licensed. The need for these entities to apply for a licence, despite their being exempt from all of the prudential requirements of the regime, suggests that there may be more appropriate ways of dealing with these entities under the NBDT Act.

14. The principal alternative to the status quo would be to make regulations declaring these entities not to be NBDTs for the purposes of the NBDT Act. This would have the effect of removing the need for them to apply for a licence.

15. Under section 73 of the NBDT Act, regulations declaring an entity not to be an NBDT can be made by an Order in Council made on the advice of the Minister of Finance, given in accordance with the recommendation of the Bank. However, when considering whether to advise and recommend the making of these regulations, the Minister and the Bank are required to have regard to:

- The nature of the business activities carried on by the person or class of persons and the extent to which those activities
  - (i) are similar in substance to the activities of an NBDT; or
  - (ii) involve activities as an NBDT; and
- The public interest; and
- Any other matters the Minister or the Bank considers relevant.

16. These matters are discussed below in relation to each of the entities that I recommend be declared not to be an NBDT for the purposes of the NBDT Act.

Comment

Intergroup funding vehicles (funding conduits and reverse funding conduits)

17. A "funding conduit" is a wholly owned subsidiary that issues debt securities to the public solely for the purpose of on-lending to, or investing funds in, its parent company (or the group of companies to which it belongs). Likewise, a "reverse funding conduit" is a parent entity that issues debt securities to the public solely for the purpose of lending to, or investing in, members of its corporate group.

18. Entities that act as funding conduits or reverse funding conduits prima facie come within the definition of NBDT by carrying on the business of borrowing (through the issue of debt securities to the public) and lending (by lending to other members of their corporate group).

19. Funding conduits are currently exempted from the prudential requirements applying to NBDTs by the Deposit Takers (Funding Conduits) Exemption Notice 2010. Likewise, Insurance Group Australia Ltd (the only currently exempt reverse funding

conduit) was exempted from these requirements by the Deposit Takers (Insurance Group Australia Ltd) Exemption Notice 2012.

20. I consider it is appropriate to declare funding conduits and reverse funding conduits (hereafter referred to as intergroup funding vehicles) to not be NBDTs for the purposes of the NBDT Act for the following reasons:

- An intergroup funding vehicle is raising funds that it then on-lends to other members of its corporate group, who use the funds for purposes other than carrying on the business of an NBDT. In these circumstances, the intergroup funding vehicle is not carrying on activities that are similar in substance to those of a typical NBDT, or which involve the activities of an NBDT. Instead they are merely part of an arrangement being used by a corporate group to raise funds for other business purposes;

- An intergroup funding vehicle is unlikely to raise systemic risks because it lends wholly to other members of its corporate group. Therefore, although its depositors would suffer a loss, the failure of a funding conduit is unlikely to have a material effect on confidence in the NBDT sector. In addition, the financial strength of an intergroup funding vehicle is likely to be a reflection of the broader final strength of the corporate group of which it is a part (especially given that it will often be guaranteed by other members of the corporate group). In these circumstances, I do not consider that there is a public interest in these entities remaining within the NBDT regime.

21. I propose that this declaration would generally apply in circumstances where:

- The entity uses 100% of the subscriptions raised from its issue of debt securities to the public to on-lend money to, or subscribe for or purchase securities in, another member of its group; and

- Neither the entity, or any other group member, carries on the business of lending money to any person outside the group.

22. For these purposes “lending” would mean providing “credit”, and credit would mean a right granted to a person by another person to:

- defer payment of a debt; or

- incur a debt and defer its payment; or

- purchase property or services and defer payment for that purchase (in whole or in part).

23. However, to ensure that this broad definition of lending does not create any unintended consequences, it may be necessary to provide further clarity on exactly when an entity would be treated as carrying on the business of lending. For example, I do not consider that an entity should be treated as carrying on the business of lending if it grants the right to purchase property or services and defer payment for that purchase purely as an incidental result of carrying on other business.

24. I consider that the specified circumstances I am proposing will ensure that the declaration is appropriately targeted, and could not be used to circumvent the NBDT regime (for example, by carrying on the business of borrowing in one company and lending through another company in the corporate structure).

Payment facility providers

25. Payment facility providers take in and hold funds from the public that they make available on demand either directly or in a specified form (such as equivalent foreign currency). They do not provide interest on such deposits. However, payment facility providers prima facie meet the definition of NBDT by offering debt securities to the public and carrying on the business of providing certain kinds of financial services.

26. Payment facility providers are currently exempted from all of the prudential requirements applying to NBDTs by the Deposit Takers (Payment Facility Providers) Exemption Notice 2009.

27. I consider it is appropriate to declare payment facility providers not be NBDTs for the purposes of the NBDT Act for the following reasons:

- Pure payment facility providers merely hold funds on behalf of persons, which can then be made available either directly or in a specified form. They do not aim to provide a financial or other return on the amounts they borrow. As a result, they are not carrying on activities that are similar in substance to those of an ordinary NBDT, or which involve the activities of an NBDT.

- Payment facility providers are unlikely to raise any systemic risks or the same level of risks to depositors where they hold an amount equal to the outstanding value of the call debt securities they issue in a trust account maintained with a bank. As a result, I do not consider that there is a public interest in these entities remaining within the regime.

28. I propose that this declaration would generally apply in circumstances where:

- The entity does not provide any financial services in New Zealand except issuing call debt securities which:

    - Take the form of pre-paid instruments issued by the company in New Zealand in favour of security holders; and

    - Under which the entity will not pay to security holders any interest, or any consideration in the nature of interest; and

- The entity holds an amount equal to the outstanding value of the call debt securities on issue in a trust account maintained with a registered bank in New Zealand, or an overseas bank which is subject to at least an equivalent amount of supervision.

29. I consider that these requirements will ensure that the declaration is appropriately targeted and cannot be used to circumvent the NBDT regime.

Small registered charities

30. Entities may register as charities under the Charities Act 2005 where they are established and operated for a charitable purpose, including relief of poverty, the advancement of education or religion, or any other matter beneficial to the community.

31. There are a number of registered charities that carry on the business of borrowing or lending, or providing financial services, or both, and therefore come within the definition of NBDT.

32. The treatment of registered charities under the NBDT regime is currently determined by the Deposit Takers (Charities) Exemption Notice 2014. Under this notice, registered charities are exempt from all of the requirements of the NBDT regime where they:

- Have outstanding debt securities offered to the public of under $15 million; or
- Have outstanding loans (excluding loans to certain associated persons) of under $5 million.

33. By contrast, registered charities over these thresholds are temporarily exempt from some requirements of the NBDT regime under transitional arrangements which are designed to give them time to shift to full compliance with the rest of the regime.

34. The thresholds of $15 million in outstanding debt securities or $5 million in outstanding loans reflect a natural break point between large and small charities that are acting as NBDTs. Entities over these thresholds are also of a size where they can no longer reasonably be classed as small when compared to the average size of many ordinary NBDTs.

35. In considering whether it would be appropriate to declare small registered charities not to be NBDTs for the purposes of the NBDT Act, I note that:

- Broadly speaking, these registered charities carry on business which is similar in substance to that of an ordinary NBDT, or which involve the activities of an NBDT, although there are certain differences. Most significantly, these organisations are not driven to make a profit for their shareholders or members like typical NBDTs. Instead they exist to support certain charitable objectives, and investors are often motivated to lend money to these organisations as a result of a desire to support these charitable objectives (rather than solely to obtain a financial return);
- There is a public interest in ensuring that these types of entity can continue to fulfil their charitable purposes. However, when operating on a larger scale these kinds of entities could potentially raise similar risks to other NBDTs (i.e.

their failure could materially affect a significant number of depositors and borrowers).

36. In light of these factors, I propose that smaller registered charities be declared out of the definition of NBDT. I consider that this strikes an appropriate balance between the competing public interest objectives of:

- ensuring that these entities are not subject to excessive compliance costs which could impact on their ability to fulfil their charitable purpose; and
- minimising the damage that could result from the failure of one of these types of entity.

37. I propose that this declaration would generally apply in circumstances where the registered charity:

- has total outstanding debt securities offered to the public of under $15 million; or
- has total outstanding loans to persons (other than certain related parties) of under $5 million; and
- has notified the Bank on an annual basis that it is meeting the specified circumstances listed above.

38. I consider that these thresholds (which reflect those in the current exemption applying to registered charities) provide an appropriate measure of the point at which these entities could no longer be classed as small when compared with other NBDTs. Restricting the scope of this declaration to registered charities also ensures that it only applies to entities that are genuinely established for a charitable purpose.

Certain special purpose vehicles established by registered banks

39. A special purpose vehicle (SPV) is a legal entity that is created to fulfil a specific objective. Such entities may be established and operated for the purpose of raising regulatory capital for a registered bank (whether by purchasing regulatory capital instruments from the registered bank and issuing matching instruments to investors, or vice versa).

40. In these circumstances the SPV carries on the business of borrowing (by offering regulatory capital instruments, or matching instruments, to investors in the form of debt securities) and lending (by lending the funds raised through this borrowing to the registered bank). As a result, these SPVs come within the definition of NBDT.

41. These types of SPV are currently exempted from all of the requirements of the NBDT regime by the Deposit Takers (Banks' Regulatory Capital) Exemption Notice 2014.

42. I consider that it is appropriate to declare these kinds of SPV not to be NBDTs for the purposes of the NBDT Act for the following reasons:

- These SPVs are wholly owned by a registered bank or a parent entity of the registered bank and only lend to the registered bank they are related to. In substance, this kind of SPV acts as a special form of funding conduit for a prudentially regulated entity that carries on the business of borrowing and lending (i.e. a registered bank). As such, they are not carrying on activities that are similar in substance to those of an ordinary NBDT, or which involve the activities of an NBDT;

- Because these kinds of SPV are not in substance carrying on the business of an NBDT, and are instead effectively acting as an extension of a registered bank, their operation is likely to raise few, if any, of the potential risks that may be raised by an ordinary NBDT. In addition, for every claim that investors have against one of these kinds of SPV, the SPV will generally have a matching claim against the registered bank, so the additional risk to investors from these entities being excluded from the NBDT regime is minimal. For these reasons, I do not consider that there is a public interest in these entities remaining within the NBDT regime.

43. I propose that this declaration would generally apply in circumstances where:

- The SPV is established and operated for the purpose of raising regulatory capital for a registered bank;

- The SPV raises regulatory capital for the registered bank, through either or both of the following arrangements:

    - By purchasing regulatory capital instruments from the bank and issuing equivalent debt securities to the public; or

    - By purchasing securities from the bank and issuing equivalent regulatory capital instruments in the form of debt securities;

- The SPV complies with any requirements that apply to the SPV under a condition of registration imposed on the registered bank under section 74 of the Reserve Bank of New Zealand Act 1989;

- The SPV lends at least 95% of the subscriptions received from its issue of securities to the public to the registered bank it is related to;[2] and

- The SPV does not carry on the business of lending to any entity apart from the registered bank it is related to.

44. I consider that these requirements will ensure that the declaration is only available to SPVs used by registered banks for the purposes of raising regulatory capital, and also

[2] SPVs would be allowed to retain up to 5% of the funds raised through these types of offers so that they could use these funds for other purposes (for example, strengthening their own capital position). The fact that these funds could not be used for carrying on the business of lending to third parties would ensure that the SPV could not use these funds to carry on the business of an NBDT.

ensure that these SPVs cannot be used for carrying on business analogous to that of an ordinary NBDT.

Consultation

45. Targeted consultation has been carried out with many of the entities that would be excluded from the definition of NBDT by the proposals in this paper. Where other affected entities have not been consulted, this is because the proposed declarations are either largely consistent with their treatment under existing exemptions, or because the proposed declarations only have the effect of reducing the costs they would otherwise be subject to.

46. Registered charities were consulted late in 2013 on the proposed thresholds for small charities to be exempted from all of the prudential requirements of the regime under the Deposit Takers (Charities) Exemption Notice 2014, and these thresholds are also reflected in the proposed declaration excluding them from the regime. During that consultation, some charities felt that the thresholds should be higher or exclude charities from the regime altogether. However, I consider that these thresholds strike an appropriate balance between reducing the risks that could be created by the failure of a large charity that was acting as an NBDT, and avoiding imposing disproportionate compliance costs on charitable entities.

47. The Treasury, the Ministry of Business, Innovation and Employment, and the Financial Markets Authority have also been consulted.

48. The Department of Prime Minister and Cabinet has been informed.

Financial Implications

49. There are no financial implications arising out of the proposals in this paper.

Human Rights

50. There are no human rights implications arising out of the proposals in this paper.

Legislative Implications

51. Regulations made under section 73 of the Non-bank Deposit Takers Act 2013 are required to implement the proposals in this paper.

Regulatory Impact Analysis

52. The Regulatory Impact Analysis requirements apply to the proposals set out in this paper. A Regulatory Impact Statement (RIS) has been supplied with this Cabinet paper.

53. An Adviser in the Operational Policy Team at the Reserve Bank has reviewed the RIS prepared by the Reserve Bank and considers that the analysis summarised in the RIS meets the quality assurance criteria.

Publicity

54. A copy of this paper will be posted on the Reserve Bank's website, and affected entities will be informed of Cabinet decisions excluding them from the NBDT regime.

Recommendations:

55. The Minister of Finance recommends that the Committee:

1. **Note** that NBDTs are subject to a series of prudential requirements in legislation, and under the Non-bank Deposit Takers Act 2013 are required to be licensed by the Reserve Bank;

2. **Note** that the definition of NBDT captures a number of entities whose activities are not in substance similar to that of a typical NBDT, or which raise special policy considerations that may justify their exclusion from the NBDT regime;

3. **Note** that the entities referred to in recommendation 2 have to date been exempted from most or all of the requirements of the NBDT regime;

4. **Note** that under the Non-bank Deposit Takers Act 2013 an NBDT cannot be exempted from the new requirement to be licensed, but an entity can be excluded from the regime altogether by being declared by regulations not to be an NBDT;

5. **Agree** that entities acting as funding conduits or reverse funding conduits be declared not to be NBDTs in specified circumstances;

6. **Note** that the specified circumstances referred to in recommendation 5 will generally be where:

    6.1 The entity uses 100% of the subscriptions raised from the issue of debt securities to on-lend money to, or to subscribe for or purchase securities in, another member of its group; and

    6.2 Neither the entity, or any other group member, carries on the business of lending money to any person outside the group;

7. **Agree** that entities acting as payment facility providers be declared not to be NBDTs in specified circumstances;

8. **Agree** that the specified circumstances referred to in recommendation 7 will generally be where:

    8.1 The entity does not provide any financial services in New Zealand except issuing call debt securities which:

        8.1.1 Take the form of pre-paid instruments issued by the company in New Zealand in favour of security holders;

8.1.2 Under which the entity will not pay to security holders any interest, or any consideration in the nature of interest;

8.2 The entity holds an amount equal to the outstanding value of the call debt securities on issue in a trust account maintained with a registered bank, or an overseas bank which is subject to at least an equivalent amount of supervision;

9. **Agree** that registered charities that come within the definition of NBDT be declared not to be NBDTs in specified circumstances;

10. **Agree** that the specified circumstances referred to in recommendation 9 will generally be where:

10.1 The charity has total outstanding debt securities offered to the public of under $15 million, or outstanding loans to persons (other than certain related parties) of under $5 million; and

10.2 The charity has notified the Bank on an annual basis that it is meeting the specified circumstances listed above;

11. **Agree** that certain special purpose vehicles (SPVs) established by registered banks be declared to not be NBDTs in specified circumstances;

12. **Agree** that the specified circumstances referred to in recommendation 11 will generally be where:

12.1 The SPV is established and operated for the purpose of raising regulatory capital for the registered bank;

12.2 The SPV raises regulatory capital for the bank through either or both of the following arrangements:

12.2.1 By purchasing regulatory capital instruments from the bank and issuing equivalent debt securities to the public; or

12.2.2 By purchasing securities from the bank and issuing regulatory capital instruments to the public in the form of debt securities;

12.3 The SPV complies with any requirements that apply to the SPV under a condition of registration imposed on the bank under section 74 of the Reserve Bank of New Zealand Act 1989;

12.4 The SPV lends at least 95% of the subscriptions received from its issue of securities to the public to the registered bank it is related to; and

12.5 The SPV does not carry on the business of lending to any entity apart from the registered bank it is related to;

13. **Invite** the Minister of Finance to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above recommendations.

14. **Authorise** the Minister of Finance to approve changes, consistent with the policy framework in this paper, relating to any minor or technical issues that may arise during the drafting process.

Hon Bill English

Minister of Finance

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