



Consultation Document: Review of the Credit Rating Exemption Threshold for Non-bank Deposit Takers

The Reserve Bank invites submissions on this consultation document by 5pm on Monday 20 October 2014

Submissions and enquiries should be addressed to:

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Please note that a summary of the submissions may be published. If you consider that any part of your submissions should properly be withheld on the grounds of commercial sensitivity or for any other reason, you should indicate this clearly.

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Introduction

1. Non-bank Deposit Takers (NBDTs) are entities that offer debt securities to the public in New Zealand and carry on the business of borrowing and lending, or providing financial services, or both.
2. NBDTs are prudentially regulated by the Reserve Bank of New Zealand (the Bank) under the Non-bank Deposit Takers Act 2013 (the NBDT Act). The prudential regime for NBDTs requires them to meet certain requirements relating to capital, liquidity, related party exposures, and a range of other matters. The Bank is responsible for licensing NBDTs, although the day-to-day supervision of NBDTs is carried out by trustees.
3. Under the prudential regime, NBDTs are also required to have a local currency (New Zealand dollar), long term, issuer rating.¹ This rating must be from a rating agency approved by the Bank.²

Rationale for the credit rating requirement

4. The Bank's philosophical approach to prudential regulation is based on the three pillars. Specifically:
 - Regulatory-discipline (i.e. the requirements imposed on a regulated firm by the prudential regime);
 - Self-discipline (i.e. a firm's internal risk management and governance systems); and
 - Market-discipline (i.e. the incentives placed on firms by the fact that investors and other market participants are monitoring their risk profile, and financial performance and position).³
5. Consistent with the importance of self and market discipline under this framework, prudentially regulated entities (banks, insurers, and NBDTs) are required to have a credit rating or financial strength rating, unless they are covered by an exemption.
6. In the context of NBDTs, credit ratings are intended to provide a simple way to inform depositors of an NBDT's risk profile, as well as facilitating the comparison of risks across the sector. In this way, they contribute to the market disciplines that apply to NBDTs and incentivise them to run their businesses in a prudent and sound manner.
7. The third party scrutiny provided by a credit rating assessment also provides a valuable internal discipline for NBDTs, enhancing the self-discipline pillar of our supervisory approach. In addition, the requirement to have a credit rating allows the Bank to have a less intrusive supervisory approach than would otherwise be the case, as rating agencies provide an additional level of oversight, providing the market with an independent evaluation of an entity's financial condition.

¹ Section 23(1)(a), Non-bank Deposit Takers Act 2013 and Regulation 6, Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposure) Regulations 2010.

² Section 23(1)(b), Non-bank Deposit Takers Act 2013. The rating agencies that have been approved by the Bank for the purposes of this section are Standard and Poor's Rating Service, Fitch Ratings, and Moody's Investor Services.

³ *The Evolution of Prudential Supervision in New Zealand*, p.5, Reserve Bank of New Zealand: *Bulletin*, Vol. 75, No. 1, March 2012.

Rationale for the exemption from the credit rating requirement for small NBDTs

8. While the Bank places significant weight on the importance of credit ratings, we also recognise that the benefits of requiring entities to obtain a credit rating can be outweighed by the costs this imposes on smaller entities. More broadly, the Bank is concerned to ensure that the prudential regimes it administers operate efficiently and do not impose unnecessary costs.
9. In light of these considerations, the Deposit Takers (Credit Ratings Minimum Threshold) Exemption Notice 2009 provides that NBDTs are exemption from the requirement to have a credit rating where:
 - they are part of a borrowing group with consolidated liabilities of less than \$20 million; or
 - they are not part of a borrowing group and have liabilities of under \$20 million themselves.⁴
10. As a consequence of not being subject to a rating assessment, exempt entities are also required to maintain a minimum capital ratio of at least 10% (rather than the minimum 8% capital ratio required for other NBDTs).
11. In order to grant an exemption under the NBDT regime the Bank must be satisfied that, amongst other things, compliance would be unduly onerous or burdensome for the entity concerned. At the time the exemption was drafted, the direct and indirect costs to an entity of obtaining a credit rating amounted to an average of 20% or more of after-tax profits for entities with consolidated liabilities of under \$20 million. In the Bank's view, at that time this made compliance with the rating requirement unduly onerous or burdensome for these entities.

Why review the exemption threshold at this time?

12. The Bank remains of the view that credit ratings provide an important independent assessment of an entity's creditworthiness, and continue to be a key part of the prudential regime. However, there are two reasons why the Bank also considers that it is appropriate to review the credit rating exemption threshold at this time.
13. Firstly, the current exemption threshold was set approximately five years ago,⁵ and the Bank considers that it is prudent to periodically review these kinds of thresholds in order to ensure that they remain appropriate and fit-for-purpose. The significant changes to the size and nature of the NBDT sector over the last five years also strengthen the case for carrying out this kind of review.
14. Secondly, the regulatory framework has changed with the introduction of licensing under the NBDT Act, which may influence the overall calibration of the other regulatory requirements under the regime. In particular, the link between the requirement to have a credit rating and the level of supervision imposed by the Bank was recognised in the

⁴ The liabilities of the borrowing group or individual NBDT must be measured as a monthly average over an historical 12 month period to determine whether they come below the \$20 million threshold.

⁵ The Deposit Takers (Credit Rating Minimum Threshold) Exemption Notice 2009 came into force on 7 August 2009.

Cabinet paper that proposed the first tranche of prudential requirements for NBDTs.⁶ It follows that the establishment of the licensing regime for NBDTs might, in combination with other factors, justify changing the exemption threshold.

The framework for considering the appropriate exemption threshold

15. The current credit rating exemption is established under the generic exemption making powers in the NBDT Act, which require the Bank to not issue or amend an exemption unless it is satisfied that:
- The exemption will be consistent with the maintenance of a sound and efficient financial system;
 - Compliance with the relevant provision or provisions would, in the circumstances, require the licensed NBDT, class of licensed NBDTs, or trustee to comply with requirements that are unduly onerous or burdensome; and
 - The extent of the exemption is no broader than reasonably necessary to address the matters that gave rise to the exemption.⁷
16. These statutory requirements establish the basic framework for assessing what the threshold should be to qualify for the credit rating exemption. However, there are also a number of more specific matters that may influence our analysis within this framework. These are discussed in turn below.

The benefits of the credit rating requirement

17. Credit ratings provide a simple, clear indication of risks to investors. They also provide a valuable internal discipline for NBDTs (i.e. the process of obtaining and maintaining a rating helps to incentivise good governance and risk management).
18. The importance of credit ratings in the NBDT regime is indicated by (amongst other things) the matters that the Bank is required to have regard to when exercising its powers under the NBDT Act (which include the desirability of providing depositors with the information to assess risk in relation to potential investments and distinguish between high-risk and low-risk NBDTs).
19. The important role of credit ratings in the scheme of the NBDT regime (and the other prudential regimes administered by the Bank) means that there is likely to be an upper limit to how high the exemption threshold could go while still being consistent with the maintenance of a sound and efficient financial system.

Consistency with other regulatory regimes

20. All registered banks are required to have a credit rating, and only very small licensed insurers are exempt from the requirement to have a financial strength rating. As a general rule, the Bank prefers to align the approach taken under the prudential regimes it administers where possible, unless there is good reason to take a sector specific approach.

Impact of credit rating costs on NBDTs' net profit before tax and income

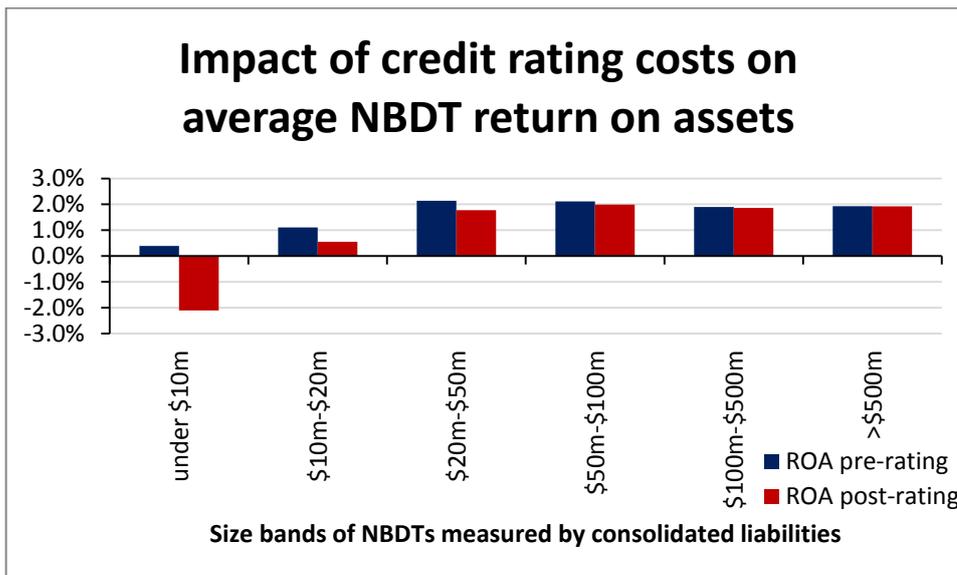
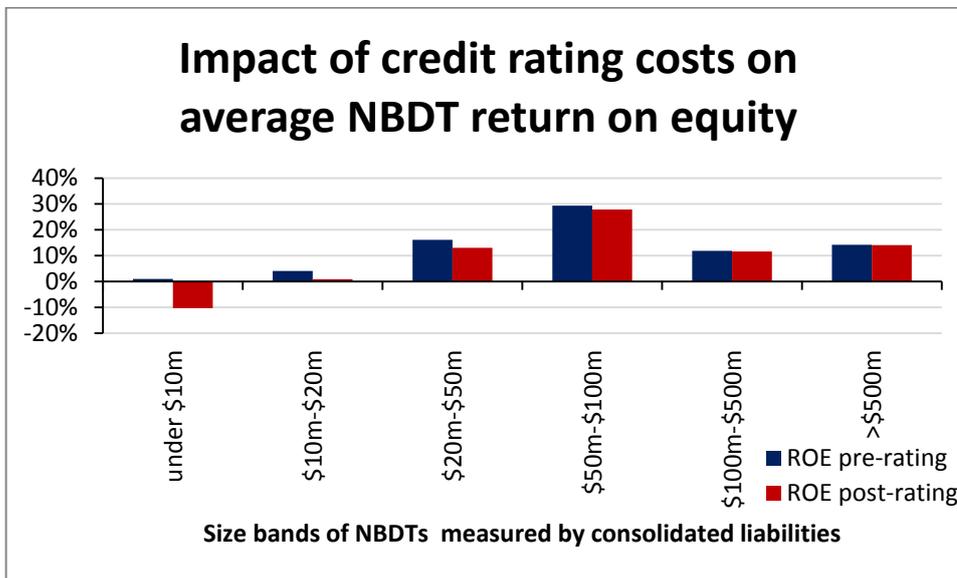
⁶ Paragraph 29 of the 2007 Cabinet paper *Review of Financial Products and Providers : Regulations of Non-bank Deposit Takers* available at: <http://www.med.govt.nz/business/business-law/pdf-docs-library/past-work-and-older-topics-pdfs/review-of-financial-products/cabinet-paper-non-bank-deposit-takers.pdf>

⁷ Section 70(2), Non-bank Deposit Takers Act 2013.

21. The cost of obtaining a credit rating is the principle reason why the credit rating requirement could be argued to be unduly onerous or burdensome. We understand that maintaining a credit rating might cost a typical NBDT around \$100,000 per year in direct and indirect costs, although this cost can vary significantly depending upon the size of the NBDT.

Q.1 Do you agree that the direct and indirect costs to an NBDT of obtaining a credit rating are typically around \$100,000 per year?

22. To provide an indication of how this cost impacts current NBDTs, the tables below highlight the average impact of credit rating costs on NBDTs return on assets and return on equity.

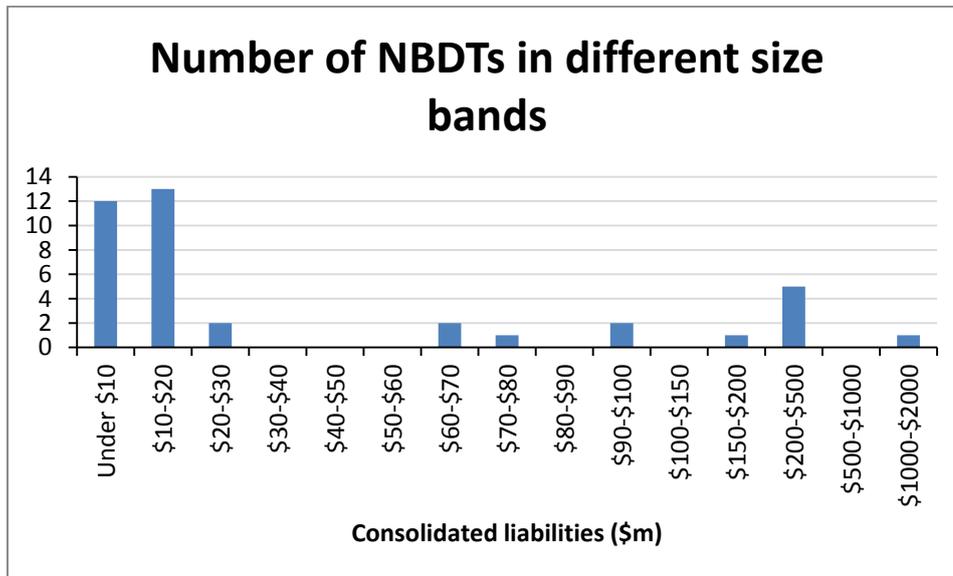


23. These tables highlight the significant impact of rating costs on smaller NBDTs. However, there are just two current NBDTs with assets in the in the \$20 million to \$50

million range. This makes it difficult to tell just how representative these costs impacts would be for any new NBDTs that moved into that size range in future.

Distribution of NBDTs by size

24. The table below sets out the distribution of NBDTs by size. It highlights a clustering of NBDTs below the \$20 million threshold and the very small number of NBDTs with consolidated liabilities between \$20 million and \$60 million.



25. We have received some anecdotal evidence suggesting that the cost of obtaining a credit rating may be impeding the growth of small NBDTs, and this table may provide some circumstantial support for this argument (although we think it is likely that a variety of other factors may also be contributing to this distribution).

Q.2 Do you consider that the costs of obtaining a credit rating creates a material disincentive for smaller NBDTs to grow their business?

The value of credit ratings for smaller NBDTs

26. We have received anecdotal evidence suggesting that the size of an entity creates a de facto ceiling around the level of the rating that could generally be provided to the entity by the rating agency.
27. The size of an entity is one of many factors that may influence its financial resilience. We would be interested in views on whether the small size of some NBDTs does create a de facto limit to the level of credit rating they can obtain, and if so, whether this is simply a reasonable reflection of the impact that the size of an entity may have on its financial resilience.

Q.3 Do you consider that the size of an entity creates a ceiling around the maximum level of credit rating an NBDT is able to obtain? If so, do you consider that this is a reasonable reflection of the impact that the size of an entity may have on its financial resilience?

Q.4 Are there other matters that you consider we should be taking into account when considering whether the exemption threshold is set at a level that is consistent with the maintenance of a sound and efficient financial system and covers entities for whom compliance would be unduly onerous or burdensome? If so, what are these matters?

Options for the exemption threshold

28. We see three broad options for the exemption threshold. These are:

- Option 1: The status quo;
- Option 2: A small increase in the exemption threshold to take into account inflation and test whether the rating requirement impedes the growth of small NBDTs; and
- Option 3: A larger increase in the threshold with a corresponding requirement to hold more capital.

Option 1: The status quo

29. The current exemption for entities with consolidated liabilities of under \$20 million is contingent on exempt entities having to maintain a capital ratio of at least 10%. We continue to see the status quo as being consistent with the maintenance of a sound and efficient financial system, given the small size of exempt entities and the fact that they are required to hold more capital.
30. The issue with the status quo is therefore whether it is unduly onerous or burdensome to expect entities slightly over the \$20 million threshold to comply with the credit rating requirement. Given that there are only two NBDTs with liabilities between \$20 million and \$50 million, this is not so much a question of whether compliance would be unduly onerous or burdensome for specific entities at the moment, and more a question around the point at which compliance is likely to become unduly onerous or burdensome for a hypothetical “average” NBDT with liabilities in the \$20 million to \$50 million range.

Q.5 Do you agree with our analysis of the status quo? Are there any additional costs or benefits of the status that we should be considering?

Option 2: A small increase in the exemption threshold to take into account inflation and test whether the current threshold a genuine impediment to growth

31. The second option is to provide for a small increase in the exemption threshold (perhaps up to \$25 million). In part this would reflect inflation, and in part it would provide an opportunity to test what kind of a barrier, if any, the existing threshold is to the growth of smaller NBDTs (i.e. it would provide slightly more headroom for NBDTs under the existing threshold to grow without having to obtain a credit rating, and an opportunity to see if they make use of this headroom).
32. We believe that this option would continue to be consistent with the maintenance of a sound and efficient financial system in that the change to the threshold would be too small to have a material effect on the total liabilities of all of the NBDTs that were exempt from the rating requirement. It is also unlikely to materially affect the analysis

of when compliance with the credit rating requirement may be unduly onerous or burdensome.

Q.6 Do you agree with our analysis of this option? Are there other costs or benefits of this option we should be considering?

Option 3: A larger increase in the threshold with a corresponding requirement to hold more capital

33. The third option would be to provide for a larger increase in the exemption threshold (perhaps to \$30 million or \$40 million), coupled with a corresponding increase in the level of capital that exempt entities must be required to hold (perhaps 12% rather than the current 10%).
34. There are few NBDTs with between \$20 million and \$50 million in liabilities at present, which makes it difficult to assess what the impact of credit rating costs would be on a "typical" NBDT in this size range. In turn, this makes it hard to identify the point at which compliance might become unduly onerous and burdensome for NBDTs in this size range.
35. To carry out this analysis, it may be necessary for the Bank to establish the profile of a hypothetical NBDT in this size range with an "average" business and level of profitability. This could provide a benchmark which the impacts of credit rating costs could be tested against, and a basis for applying the unduly onerous or burdensome test.
36. We note that the increased level of capital that exempt entities must hold under this option has the advantage of reducing the risk associated with a relaxation of the credit rating requirement, and would help to satisfy the Bank that this option is consistent with the maintenance of a sound and efficient financial system.
37. However, if the level of capital these entities are required to hold is not calibrated correctly, this could either create new risks in the sector as a result of the net level of regulation being reduced, or require entities to hold so much additional capital that it is not really practical to qualify for the exemption.

Q.7 Do you agree with our analysis of this option? Are there other costs or benefits of this option we should be considering?

Q.8 Which of the four options for the credit rating exemption threshold do you prefer? Are there other options you think we should consider?

Next steps

38. The Bank would welcome the views of submitters on which of the three options canvassed above should be adopted.

39. Following an analysis of submissions received, the Bank anticipates making a decision before the end of the year on which of these options it will proceed with.