

The Chair

CABINET ECONOMIC GROWTH AND INFRASTRUCTURE COMMITTEE

REGULATIONS FOR NON-BANK DEPOSIT TAKERS - DEBT SECURITIES AND SUITABILITY CONCERNS

PROPOSAL

- 1 This paper seeks the Committee's agreement to the making of two sets of regulations under the Non-bank Deposit Takers Bill ('the Bill') concerning the prudential regulation of non-bank deposit takers ('NBDTs'). One set of regulations will declare building society shares to be debt securities for the purposes of the regime. The other set will prescribe the specific matters that are suitability concerns in relation to NBDT directors and senior officers.

BACKGROUND

- 2 The Bill represents a stand-alone framework for the prudential regulation of NBDTs (finance companies, building societies and credit unions being the usual entities). It brings across the existing prudential requirements that were in Part 5D of the Reserve Bank of New Zealand Act 1989 ('Part 5D') and it introduces some new requirements.
- 3 The powers and requirements that have been brought over from Part 5D relate to capital, related party exposures, credit ratings, corporate governance, liquidity and risk management. These requirements have been in place since 1 December 2010. The new requirements under the Bill are the final elements of the NBDT regime to be put in place, namely, licensing (entailing the suitability of directors and senior officers), change of ownership requirements, and enhanced investigation and enforcement powers for the Reserve Bank.
- 4 The proposed regulations are authorised under clause 72 of the Bill. Cabinet agreed to the introduction of the Bill in June 2011.

PROPOSED REGULATIONS DECLARING BUILDING SOCIETY SHARES TO BE DEBT SECURITIES

- 5 The core definition of NBDT in clause 5 of the Bill (and the definition of ‘deposit taker’ under the former Part 5D) is a person who:
- a) offers debt securities to the public in New Zealand; and
 - b) carries on the business of borrowing and lending, or providing financial services, or both.
- 6 A difference however arises between Part 5D and the Bill in relation to the treatment of building societies. Part 5D explicitly included building societies in the definition of deposit taker if they were incorporated under the Building Societies Act 1965.¹ This is not the case under the Bill, as there is no longer any explicit inclusion of building societies in the definition.
- 7 The change of approach was to stop so-called building societies taking advantage of New Zealand’s good name as a well regulated jurisdiction. In particular, the Reserve Bank has seen a number of these entities incorporating themselves under the Building Societies Act and then promoting themselves as being regulated by the Reserve Bank. The reality is however that they do not actually conduct any business here, it all being done offshore. In short, they have been using New Zealand like a “flag of convenience”.
- 8 Consequently, a building society will no longer be automatically treated as an NBDT under the Bill unless it satisfies the core definition. An issue arises in that the shares offered by building societies will often not meet the definition of debt security in clause 4 of the Bill, which is based on the corresponding definition in the Securities Act 1978.
- 9 The definition of debt security under the Bill may be extended by regulations made under clause 72 of the Bill. Clause 72(1)(d) authorises the making of regulations for the purposes of declaring certain securities to be debt securities for the purposes of this Bill.
- 10 The Reserve Bank recommends that regulations now be made to declare certain shares of building societies to be debt securities for the purposes of the Bill, in particular, those shares of building societies that are debt-like participatory securities. This reflects the approach that has been taken under the Securities Act (Building Societies) Exemption Notice 2002.
- 11 That exemption was granted because most building society shares have the characteristics of debt securities even though they are technically participatory securities for the

¹ Certain building societies that did not issue debt securities to the public in New Zealand were subsequently declared not to be deposit takers under Part 5D, per the Deposit Takers (Persons Declared Not to be Deposit Takers) Regulations 2011.

purposes of securities law. The exemption effectively substitutes the participatory securities regime with a debt securities regime based on an in-substance view of the securities involved. In short, the normal requirements of a statutory supervisor and deed of participation (as pertaining to participatory securities) are replaced by a trustee and trust deed (as pertaining to debt securities).

- 12 The proposed regulations essentially maintain the *status quo* in terms of the prudential regulation of building societies. They were subject to Part 5D and the proposed regulations will ensure they will continue to be subject to the same prudential regulation under the Bill.
- 13 Under clause 72(3) of the Bill, the Reserve Bank must be satisfied that the securities declared to be debt securities are similar in substance to debt securities. Therefore, only those shares of building societies that are debt-like in nature will be declared to be debt securities under the Bill.
- 14 Clause 8 of the Bill also requires the Reserve Bank to take account certain principles when carrying out its functions under the Bill. The Reserve Bank has taken these principles into account when developing these proposals, and considers that declaring building society shares to be debt securities for the purposes of the Bill furthers the principle of consistency in the treatment of similar institutions, regardless of matters such as their corporate form (clause 8(a)).

PROPOSED REGULATIONS PRESCRIBING SUITABILITY CONCERNS

- 15 Determining the suitability of directors and senior officers of NBDTs is an important part of the law under the Bill. Clause 4 of the Bill defines suitability concerns as matters, circumstances or conditions that must be drawn to the attention of the Reserve Bank if they apply to a director or senior officer of an NBDT, or a person that is proposed for such positions. An NBDT's governing body will have to certify whether any senior officer raises any suitability concerns and directors will have to self-certify if they do the same.
- 16 The Reserve Bank has to be notified of the outcome in either case, per a suitability notice. If a suitability notice states that a person does not raise any suitability concerns, the Reserve Bank is entitled to rely on that and may grant a licence to the NBDT. If the notice discloses that a suitability concern arises in relation to that person, the Reserve Bank can (after inquiry) either issue a notice of non-objection or refuse to issue such a notice where it is satisfied that the person is unsuitable. The Reserve Bank may withhold the grant of a licence to an NBDT in the latter situation.

- 17 The Reserve Bank can act to remove a director if a suitability notice was false or misleading in a material respect. It can also do this in relation to suitability concerns that have arisen since the grant of an NBDT licence or since the appointment of a director.
- 18 Clause 72(1)(e) of the Bill authorises the making of regulations prescribing the matters, circumstances, or conditions that are suitability concerns. The Reserve Bank now recommends the making of regulations prescribing suitability concerns, as follows:
- (i) the person is, or has been, subject to a bankruptcy proceeding or a proceeding for a judgment debt, or otherwise entered into a procedure under Part 5 of the Insolvency Act 2006;
 - (ii) the person has been a director or senior officer of an entity, or otherwise exercised significant influence over an entity, anytime within 7 years of that entity entering into moratorium, receivership, liquidation, voluntary administration, judicial management or statutory management;
 - (iii) the person has been convicted for an offence, or criminal charges have been laid against the person and the person has not been acquitted or discharged and the charges have not been dropped;
 - (iv) the person is, or has been, subject to any investigation, disciplinary action, or adverse findings by a professional or regulatory body for persons engaged in a particular profession or activity;
 - (v) the person is, or has been, subject to any investigation, 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);
 - (vi) the person has any conflict or potential conflict of interest that affects, or may affect, the person's proper performance of the duties of the position.
- 19 These suitability concerns would require notification whether the matters giving rise to the concerns took place in New Zealand or overseas. Current (i.e. unresolved) action will also require notification as a suitability concern. The Criminal Records (Clean Slate) Act 2004 will apply.
- 20 It should be noted that, although these suitability concerns create bright lines, the triggering of these concerns does not mean that the Reserve Bank will not ultimately give a notice of non-objection in respect of the person concerned. Each case will be considered by the Reserve Bank on its own facts and circumstances and whether, in the Reserve Bank's judgement, the suitability concern(s) raised render the person unsuitable to be a director or senior officer of the NBDT. Factors the Reserve Bank are likely to

take into account are the nature of the involvement of the person in the matter giving rise to concern, the nature of the concern itself and its gravity, and any extenuating circumstances.

- 21 The Bill provides a right of appeal to the High Court against any decision of the Reserve Bank concerning a person's suitability to be a director or senior officer. This appeal is by way of re-hearing, so the Bank's approach to suitability assessments will be shaped by any court decisions in this area. There is a further right of appeal to the Court of Appeal on a question of law (with leave).
- 22 A key objective of these regulations is to ensure that acceptable people are involved in the business of raising money from the public. The need for this is reinforced by the vast amount of money that has been lost to investors over the past few years, and what has been seen in the cases that are being brought to the courts in relation to the various finance company failures. Given what has occurred in the sector, the Reserve Bank considers it is essential to have the ability to evaluate a wide range of matters when it comes to determining the suitability of the people involved in retail fund raising activities, especially if investor confidence is to be restored. This will also serve to benefit those that rely on raising money from the public, i.e. the issuers and the businesses that look to them for funding. The Reserve Bank considers the range of matters to be identified as suitability concerns is appropriate in the circumstances.
- 23 As stated, the Reserve Bank is required to take into account certain principles when recommending regulations under the Bill. The Reserve Bank considers that these proposed regulations prescribing suitability concerns meet the principle of the desirability of sound governance of NBDTs, as set out in clause 8(d).

CONSULTATION

- 24 Clause 75 of the Bill requires the Reserve Bank to consult with the Financial Markets Authority before recommending the making of any regulations under the Bill. The Reserve Bank is also required to consult with any other persons the Reserve Bank considers will be substantially affected by the regulations.
- 25 The Reserve Bank has consulted with the Financial Markets Authority, the Ministry of Economic Development, the Treasury, the Ministry of Justice, Officials Committee for EGI, the Department of Prime Minister and Cabinet, and the Parliamentary Counsel Office in relation to this Cabinet paper. They all support the making of the two sets of regulations.

- 26 A public consultation paper was released by the Reserve Bank in April 2012. It was sent to the Financial Services Federation, the New Zealand Association of Credit Unions and the Trustee Corporations Association of New Zealand. It also went to all known individual NBDTs plus a number of law and accounting firms. The proposals in this paper closely reflect the proposals set out in the consultation paper.

Declaring building society shares to be debt securities

- 27 All respondents who commented on the proposed regulations declaring building society shares to be debt securities supported the making of the regulations.

Prescribing suitability concerns

- 28 There was broad support for the prescription of suitability concerns by regulations and with the ones that had been identified (save for two industry respondents who opposed the inclusion of the one concerning conflicts of interest). The thrust of the remainder of the industry comments commented on the scope of the concerns e.g. whether they should be time-limited, whether misconduct should be limited to dishonesty or transgressions related to the financial markets, whether any involvement with a failed entity would count. It has always been the Reserve Bank's intention to issue guidance on how the suitability concerns will be applied in practice and to give the NBDT sector as much assistance as possible when it came to this. That remains the intention.
- 29 Bearing in mind that the regulations set out triggers for the Reserve Bank's consideration of a person, it is the Reserve Bank's strong preference not to build in unnecessary constraints, such as time limits. In our view, inappropriate activities or behaviours that took place in, say the failures of the 1980s, are factors that should be taken into account. It is important that the Reserve Bank should have the ability to look at a broad range of factors that may be relevant to a person's suitability to be a director or senior officer of an NBDT. A person's attitude to compliance with the law generally is also considered relevant.
- 30 The Reserve Bank has adjusted the suitability concern about involvement with a failed entity to limit this to an involvement in the period of 7 years before the failure (paragraph 19 (ii) above refers). This cut-off is analogous with the Criminal Records (Clean Slate) Act 2004. The degree of involvement must also be at a level where the person had a significant influence, either directly or indirectly.
- 31 The Reserve Bank has also adjusted the suitability concern regarding conflicts of interest. Any conflict of interest must now be assessed by reference to the impact it may have on a person's ability to perform their duties, not by how it might affect the proper performance of the business. It is not intended to remove the conflict of interest concern, despite the fact that there are provisions in other enactments (such as the Companies Act 1993 and the Building Societies Act 1965) that relate to managing conflicts of interest. Including

conflicts of interest as a separate suitability concern means that a consistent approach is taken, regardless of the NBDT's corporate form, or whether the conflict could result in a personal benefit, or benefit a third party. It also means that the directors have at least turned their minds to both actual and potential conflicts of interest.

FINANCIAL IMPLICATIONS

32 [Redacted]

HUMAN RIGHTS

33 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.

LEGISLATIVE IMPLICATIONS

34 The proposals in the paper will require the drafting of regulations under the Non-bank Deposit Takers Bill.

REGULATORY IMPACT ANALYSIS

35 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.

36 A Senior Analyst in the Deposit-takers and AML 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.

37 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

38 The Reserve Bank will inform NBDTs and trustees when the regulations are made. It will put a statement on Reserve Bank's website.

RECOMMENDATIONS

39 The Minister of Finance recommends that the Committee:

- (i) **notes** that the Non-bank Deposit Takers Bill is expected to come into force on 1 October 2012;
- (ii) **notes** that when performing its functions and exercising its powers under the Non-bank Deposit Takers Bill, the Reserve Bank must take into account the principles in clause 8 of the Bill;
- (iii) **notes** that clause 72(1)(d) and (e) provide that the Governor-General may, by Order in Council, on the advice of the Minister given in accordance with a recommendation of the Reserve Bank, make regulations:
 - (a) declaring certain securities to be debt securities for the purposes of the Bill; subject to the Reserve Bank being satisfied that the securities are similar in substance to debt securities;
 - (b) prescribing the matters, circumstances, or conditions that are suitability concerns;
- (iv) **agrees** that regulations be made declaring the debt-like participatory securities of building societies to be debt securities for the purposes of the Bill;
- (v) **agrees** that regulations be made prescribing the following matters as suitability concerns for the purposes of the Bill:
 - (a) the person is, or has been, subject to a bankruptcy proceeding or a proceeding for a judgment debt, or otherwise entered into a procedure under Part 5 of the Insolvency Act 2006;
 - (b) the person has been a director or senior officer of an entity, or otherwise exercised significant influence over an entity, anytime within 7 years of that entity entering into moratorium, receivership, liquidation, voluntary administration, judicial management or statutory management;
 - (c) the person has been convicted for an offence, or criminal charges have been laid against the person and the person has not been acquitted or discharged and the charges have not been dropped;
 - (d) the person is, or has been, subject to any investigation, disciplinary action, or adverse findings by a professional or regulatory body for persons engaged in a particular profession or activity;
 - (e) the person is, or has been, subject to any investigation, 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);

- (f) the person has any conflict or potential conflict of interest that affects, or may affect, the person's proper performance of the duties of the position;
- (vi) **agrees** that the suitability concerns require notification whether the matters giving rise to the concerns took place in New Zealand or overseas;
- (vii) **authorises** the Minister of Finance to make changes, consistent with the policy framework in this paper, on any issues that may arise during the drafting process;
- (viii) **agrees** that the Minister of Finance directs officials to provide drafting instructions to the Parliamentary Counsel Office to give effect to the decisions above.

Hon Bill English

Minister of Finance

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