Ministry of Economic Development
Manatū Ōhanga

Review of Financial Products and Providers - Stage One: Framework, Problem Identification and General Directions for Reform - Report to Minister of Commerce

Regulatory and Competition Policy Branch

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Executive Summary

Introduction

This report represents the outcomes of Stage One of the Review of Non-Bank Financial Products and Providers (RFPP). It outlines a framework for the review, an assessment of the current regulatory regime against the framework and some initial thinking on the problems and high level directions for reform.

Both the problems identified and the directions for reform represent the preliminary thinking of officials. A considerable amount of work and consultation with the industry still needs to be undertaken in order to develop policy proposals for government by mid to late 2006 on the RFPP.

Officials have assessed existing regulatory arrangements in the financial sector against the framework for the RFPP which sets out desired outcomes, objectives, tools and regulatory design criteria. In summary, officials believe that any regulatory regime for the financial sector should seek to promote a sound and efficient financial system in which the public have confidence. Within this overall objective, we also believe it is important that regulatory arrangements facilitate, and do not stifle, innovation and efficiency in the financial sector, and that compliance costs and administration costs are kept relatively low. An overview of how officials believe the framework should be applied to different parts of the financial sector is provided at the end of this executive summary.

After assessing the current regulatory regime against the framework for the RFPP, officials believe that the current regulation of the financial sector is not fundamentally flawed. However, some areas of improvement have been identified within the regulatory framework. These include areas where costs on business could be reduced, regulation made more effective and consumer protection enhanced. We see the scope to make a number of changes that will help strengthen the financial sector, improve the effectiveness of regulation, reduce compliance burdens in some areas, and provide a greater basis for public confidence in the financial system. These changes would also assist in bringing New Zealand closer into line with international best practice, into closer compliance with international standards and codes and provide a basis for closer coordination with Australia, where appropriate.

Generally officials believe that the current securities offering regime in the Securities Act, the regulation of collective investment schemes (CIS),[1] and the regulation of short term/general insurance are fundamentally sound. A number of improvements are suggested in the paper, however, which will provide more effective disclosure to consumers and investors, reduce some compliance costs for issuers, address issues with the application of the law, and enhance trust deeds for collective investment schemes and debt issues.

Some more substantive changes are being proposed in relation to non-bank deposit taking institutions, long term insurance, supervision of Trustee Corporations and Statutory Supervisors and in relation to registration and entry requirements for financial institutions, these are summarised below.

[1] These include unit trusts, participatory securities, contributory mortgages and group investment schemes.

Non-Bank Deposit Taking Institutions (NBDTI)

While we believe that the current regulatory regime for the issue of most non-deposit debts securities is generally sound (subject to some enhancements discussed below), we do think that there needs to be some additional prudential supervision of NBDTIs,[2] (i.e. those financial institutions that take deposits from, or issue deposit-like debt securities to, the public, or which provide some form of transaction-making capacity to the public). We think that the nature of deposit taking and transaction-providing facilities warrants a higher level of regulation and supervision than is the case for other forms of debt securities offerings. The reasons for this are the expectations of depositors, the consequences of a NBDTI failure for depositors and the wider financial system, and particular vulnerabilities of NBDTIs.

Depositors in NBDTI have an expectation that their deposits will be available upon demand or at maturity, and may rely on at least some of their deposits for day-to-day transactions purposes. In addition, NBDTIs face risks of runs and contagion given that a significant proportion of their assets are effectively on call. Given this, in most countries, financial institutions that provide deposits, particularly on-demand deposits and payment system facilities, are subject to a more formalised licensing and supervision framework than are other types of debt-issuing financial institutions. In New Zealand, this is not the case. NBDTIs, such as building societies, credit unions, the PSIS and finance companies that provide deposit and payment facilities are not subject to a consistent set of licensing and supervision arrangements. Although they are subject to prudential oversight by trustees under the Securities Act, the prudential requirements in trust deeds and the standards of supervisory practices of trustees vary considerably from institution to institution. Moreover, the current arrangements do not achieve the objectives that should be met for the NBDTI sector.

In order to maintain a sound and efficient financial system, in which depositors have confidence and which is more resilient in times of stress we believe that a more standardised, consistent and formalised licensing and prudential supervision regime for NBDTIs should be explored. However, any regime should not undermine competition, choice or diversity in this area. Therefore any regulatory regime would need to ensure that the level of regulation varies depending on the size and the risks posed by an institution’s business. As stated above any regulatory changes in this area will need to be carefully assessed and discussed with interested parties.

Further work still needs to be done in determining precisely where the line should be drawn between deposits and other debt securities and further consideration given as to whether increased prudential regulation and supervision should be conducted by an official regulator or contracted out to appointed agents, such as trustee corporations (where the prudential requirements are specified by a government regulatory authority and the trustees are overseen by that authority - i.e. a co-regulatory model).

In the case of those financial institutions that issue debt securities to the public but that do not fall into a “deposit-taking” category, including probably most finance companies, we do not see a need for such entities to be subject to licensing and supervision on the same basis as NBDTIs. Rather, these entities would continue to be subject to the trust deed requirements of the Securities Act, and therefore be supervised by trustees. However, we do see a need for some modifications to existing trustee arrangements in order to provide better protection to investors in finance companies and similar financial institutions, including minimum

[2] Such as building societies, credit unions, PSIS and some finance companies that offer demand deposits

requirements for trust deeds, closer oversight of trustees and more effective disclosure by finance companies and other issuers.

Insurance and Superannuation

We believe that there is insufficient prudential supervision of some categories of insurance – particularly where insurance policies are complex and long term in nature and difficult to transfer or to replace (for example life insurance, defined benefit superannuation schemes and health insurance). In such cases the complexity and long term nature of the product can lead to problems of monitoring that cannot be remedied merely by disclosure. Disclosure alone will not sufficiently minimise the risks of an institution failing and significant loss being suffered as the product cannot be easily transferred or replaced. Officials believe that in such areas there needs to be additional licensing and prudential supervision of insurance providers and our initial thinking is that the supervision be undertaken by a government regulator. In designing and consulting on additional prudential regulation in this area, as a number of insurers operating in New Zealand are overseas branches and subsidiaries of foreign insurers, we will need to ensure that any regulatory regime does not impose an unnecessary regulatory burden on overseas providers, while ensuring that there are adequate protections for New Zealand policy holders. Officials will consult with domestic and overseas insurers in developing any proposals.

Trustee Corporations

We believe that the trustee corporation and statutory supervisor model is fundamentally sound in most respects for those financial institutions that do not require a more formalised system of prudential supervision. The trustee corporations have generally undertaken their role well. However, a number of minor problems have been identified with the current model which require attention. These issues relate mainly to a lack of official oversight of trustees in the performance of their role, a lack of consistent or minimum requirements in trust deeds and a lack of consistency in regulatory practices by trustee corporations. These deficiencies make it difficult for government to maintain a comprehensive overview of the financial sector or to ensure that the objectives of regulation are being met. Officials believe that the government needs to consider whether trustee corporations and statutory supervisors should be subject to greater oversight by a regulatory body in the performance of their functions, that a more level playing field be established for people who wish to undertake the role currently performed by trustee corporations and that there be a more standardised approach to trust deeds and trustee practices, and that trustees and statutory supervisors are subject to greater transparency and accountability. Officials plan to work closely with the Trustee Corporations Association and trustee corporations in considering this co-regulatory model.

Registration and Entry Requirements

New Zealand has signed up to the Financial Action Task Force (FATF) 40 Recommendations on combating money laundering and the financing of terrorism. As part of compliance with these recommendations the government will need to consider the development of a more comprehensive registration framework for, and increased monitoring of, financial providers (including financial institutions and intermediaries) and the imposition of further “fit and proper” requirements on financial providers. The current gaps and deficiencies in the registration and monitoring arrangements for financial providers impedes government’s ability to monitor the financial sector, identify the nature of the risks within the sector, and prevent those with serious criminal backgrounds from controlling or influencing financial providers. This makes it difficult to get whole of sector data and identify risks and issues in the sector. Officials believe that in order for New Zealand to comply with the FATF requirements and to enable the government to comprehensively assess the financial sector, it will be necessary to introduce a basic

registration and monitoring framework across most of the financial sector. However, it is important that any registration regime, reporting and entry requirements should be simple, minimise as much as possible compliance costs and that the framework does not impede innovation and competition in the financial sector.

Financial Intermediaries Task Force

The Financial Intermediaries Task Force is reporting back to you at the end of July on issues and options relating to financial intermediaries. Officials have seen an earlier draft of the proposals for reform and are broadly comfortable with the directions proposed. While we appreciate that there is a desire in the sector to see the reforms progress as fast as possible, there are overlaps in relation to some of the issues raised and the regulation of the rest of the financial sector. Officials will provide to put up a more detailed paper advising the government on the process forward for the Task Force's recommendations following receipt of the final report. Essentially we will be proposing that the government make in principle decisions on the recommendations to give a level of certainty to the market about the general direction the government proposes to take in relation to the recommendations. This will enable the market to start to prepare for the reforms. However, more work still needs to be done on the recommendations and careful consideration of the links to this review considered.

Progress Forward

As stated above, this paper represents only the preliminary views of officials and more work and consultation needs to be undertaken before final views can be presented. If you agree to the recommendations in this report officials will move to stage two of the review which is the development of options for reform. These options for reform will be developed in conjunction with advisory groups, made up of industry and government agencies. Any options for reform will then be released in discussion papers and feedback sought on the papers and through focus groups at the beginning of 2006.

Securities Offerings/Collective Investment Schemes/Intermediaries

Outcomes

- Investment for innovation and growth
- Facilitation of wealth accumulation
- Confidence in the sector which encourages participation

Reasons for Intervention

- Information asymmetries;
- Unfair or fraudulent conduct;
- Lack of alignment of incentives

Objectives

- Promote well informed investors/consumers
- Promote effective intermediation
- Encourage soundly governed institutions

Tools

Deposit Taking Institutions

Outcomes

- Efficient functioning of day to day transactions and payment system
- Confidence in the sector which encourages participation

Reasons for Intervention

- Depositors expectations to be repaid
- Potential for runs
- Risk of contagion

Objectives

- To minimise risks of contagion and runs;
- To provide a well founded basis for consumers to rely on financial promises being kept
- Encourage soundly governed institutions

Tools

- Merit and Prudential supervision regulation (key focus)

Insurance

Outcomes

- Facilitation of effective risk management;
- Investment for growth and innovation

Reasons for Intervention

Short Term Insurance

- Information asymmetries
- Unfair or fraudulent conduct;
- Lack of alignment of incentives

Long Term Insurance and Superannuation = Short Term Issues Plus…

- Complexity and long term nature of financial products
- Issues of transferability and replacement of insurance cover

Objectives

Short Term

- Promote well informed investors/consumers

• Disclosure (key focus) • Conduct regulation • Occupational regulation • Corporate governance requirements • Minor prudential regulation in some areas **NB: all of the non-bank financial sector also has the following objectives:** • To facilitate contestability, competitiveness and innovation; and • To ensure timely and orderly resolution of distressed institutions • Deter, detect and minimise risk of unfair or fraudulent conduct (however, more of a focus in the securities area)	• Corporate governance requirements • Disclosure	• Encourage soundly governed institutions **Long Term Insurance and Superannuation = Short Term Plus …** • To provide a well founded basis for consumers to rely on financial promises being kept **Tools** **(Short Term Insurance)** • Disclosure (key focus) • Conduct regulation • Corporate governance requirements **(Long Term Insurance/Superannuation)** • Merit and Prudential Supervision (Key focus) • Corporate governance requirements Disclosure

Purpose of Report

1. The purpose of this report is to outline the framework for the Review of Non-Bank Financial Products and Providers, provide an assessment of the current regulatory regime against the framework and identify any issues, and to seek your agreement to proposed directions for reform. In addition, as the Minister of Finance has an interest in this area we recommend that you forward and discuss this paper with him.

Analysis

Background

2. The key objective for the RFPP is to develop an effective and consistent framework for the regulation of non-bank financial institutions, financial intermediaries and financial products that promotes confidence and participation in financial markets by investors and institutions, and results in a sound and efficient financial sector.

3. The RFPP considers the regulation of insurance (health, life and general), superannuation, CIS, non-bank financial institutions (friendly societies, credit unions, building societies, finance companies, industrial and provident societies), futures and derivatives and offerings of securities. This report will also touch on how the recommendations of the Financial Intermediaries Task Force can be progressed and considered along side the RFPP.

4. The RFPP does not cover registered banks, securities trading law (as this has been the subject of a number of previous reviews) and consumer credit law as the Credit Contracts and Consumer Finance Act 2003 has just recently been implemented.

5. The RFPP provides a response to the Law Commission review of the Life Insurance Act 1908, the Financial Intermediaries Task Force, the Ratings and Deposits Review and includes the Phase 2 changes to the Credit Unions and Friendly Societies Act and the fourth part of the securities law reform programme- a review of the Securities Act 1978.

6. MED is leading the RFPP, with the support of an inter-departmental working group made up of the Treasury, Securities Commission, Reserve Bank, and the Ministry of Consumer Affairs. The working group has been consulted in the preparation of this report.

Content of the Report

7. This report represents the findings of Stage One of the RFPP. Stage One includes:

- The development of a framework for the RFPP;
- An assessment of the current regulatory regime for the non-bank financial sector against the framework for the RFPP, including identifying any problems; and
- Some general directions for reform of the non-bank financial sector that will be used to inform the later stages of the RFPP and the work being led by Treasury on domestic institutional arrangements that is due to report back to Ministers in October 2005.

8. In reviewing the current regulatory regime for the non-bank financial sector against the framework for the RFPP officials have utilised: information that the government has gathered through previous consultation in the non-bank financial sector (e.g. the review of the Life Insurance Act 1908, the various securities law reform reviews, the ratings and deposits review etc); international assessments of New Zealand's regulatory regime (e.g. the Financial Sector Assessment Programme ("FSAP") and New Zealand's compliance with the FATF 40 recommendations); analysis undertaken by officials; and additional input from key stakeholders.

9. Consultation on the problem identification was undertaken with: the Insurance Ombudsman, the New Zealand Association of Credit Unions, Manchester Unity, Investment, Savings and Insurance Association of New Zealand, the Insurance Council, the Insurance Brokers Association of New Zealand, the Association of Superannuation Funds of New Zealand, the

Financial Services Federation, the New Zealand Society of Actuaries, NZX, the Trustee Companies Association (and individual Trustee Corporations), Institute of Finance Professionals of New Zealand, the Institute of Directors, the Bankers Association, the Retirement Commission, the Shareholders Association, Health Funds, the Consumers Institute, KPMG, various law firms, merchant banks, friendly societies and building societies.

10. The paper first outlines the overall framework for the RFPP, it then discusses how this framework applies to what are categorised as three different areas of the financial sector: securities offerings and CIS; NBDTIs and insurance and superannuation. The problems identified with the current regulatory arrangements and the recommended directions for reform for each of these areas are also discussed.

Framework for the Review of Financial Products and Providers

11. Outlined below is the framework that officials have adopted for the RFPP. It contains:

- The outcomes for financial markets that officials believe the government would like to achieve in order to stimulate sustainable economic development.
- The reasons for government intervention in financial markets, consistent with seeking to achieve the desired outcomes;
- The objectives of regulation to achieve these outcomes;
- The regulatory tools that are applicable; and
- The desired attributes of regulatory design.

Outcomes of Financial Markets

12. The financial system, which includes financial products and providers and financial markets, is central to a vibrant and resilient economy. Financial institutions, financial intermediaries and markets are at the centre of the processes that provide liquidity, credit and payments processes that allow firms and individuals to obtain finance, invest funds, meet their financial obligations, manage their risks and conduct business. A robust and efficient financial sector, where the financial system is resilient to economic shocks and the public have a strong basis for being confident in the sector, is an essential prerequisite for a strong and dynamic economy.

13. The outcomes that the government would like from a well functioning non-bank financial sector are:

- A financial system that is resilient in the face of economic and financial shocks;
- Investment which encourages growth and innovation;
- An environment that facilitates wealth accumulation;
- Facilitation of effective risk management (i.e. the ability to mitigate and pool risk);
- Confidence in the sector that encourages participation by consumers, firms and providers; and
- Efficient functioning of day to day transactions and payment system.

Reasons for Regulatory Intervention in the Financial Sector

14. Ideally financial markets through competition and the provision of good information would achieve the outcomes outlined above. Experience suggests, however, that there are often market failures that may warrant government intervention. The key reasons we believe that the government should intervene in the non-bank financial sector include:

- **Information asymmetries**: these occur as investors and consumers have much less information about the risk profile of a product or institution than those inside an institution. This is caused by the fact that investors do not often have sufficient expertise, time or

information to make choices unaided and that information is costly to gather and share. This can lead to an inefficient allocation of resources through adverse selection, and may also stifle innovation and efficient operation of business.

- **Unfair or fraudulent conduct**: Investors and consumers are reliant on providers acting with integrity. However, investors' lack of expertise and the fact that people operating within providers have more information than investors leaves investors/consumers vulnerable to opportunistic behaviour (e.g. unfair or fraudulent conduct).

- **Lack of alignment of incentives**: Incentives within financial institutions and intermediaries are not always well aligned to the needs of consumers or to the soundness of the financial system (e.g. directors and managers of financial institutions may be more motivated by a desire to maximise short-term profit rather than managing longer-term risks; or circumstances may occur where there are a number of people with interests in an entity or product and those interests differ);

- **The complexity and long term nature of financial products**: sometimes, the complexity or long term nature of an institution/product can lead to problems of monitoring, particularly for solvency that cannot be remedied merely by disclosure. In such cases, governments may require companies to have greater checks and balances on their assets and liabilities (e.g. enhanced monitoring and reporting by those with expertise to understand the information provided or capital adequacy standards).

- **Contagion**: There is a potential for a difficulty in one financial institution to spread to other financial institutions when investors and depositors are unable to differentiate between sound and unsound financial institutions (contagion risk). This can be a source of instability to the financial system as a whole or in parts.

- **Runs**: some non-bank financial institutions may be subject to runs by creditors, for example a deposit taking institution experiencing financial difficulties, where depositors (wholesale and retail) may run to get their money out first. These runs can make an otherwise solvent institution insolvent and impose unnecessary costs on the depositors, investors and economy more generally.

- **Issues of transferability**: Governments may also be willing to impose additional regulatory requirements when there are problems with transferability of accounts and policies or when the failure of an institution would have significant consequences for a particular sector or group sector of the community. For example, this approach might be taken in a situation when an institution fails and significant loss is suffered either as the financial product cannot be easily transferred or redeemed, or the product is needed to facilitate business or trade.

- **Expectations and Confidence**: There may be erosion of public confidence in the financial system if investors and consumers cannot have a reasonable expectation that financial products are what they are purported to be or that providers cannot be relied upon to adhere to their representations and contractual obligations. Ultimately, no financial system can be sound and efficient, and support a vibrant economy, without public confidence in the financial system.

Objectives for Financial Sector Regulation

15. When governments intervene in the financial sector we believe that the main objective for regulation is to promote a sound and efficient financial system in which consumers/investors

have confidence. To achieve this overarching objective, the following more specific objectives for the regulation of the non-bank financial sector have been identified:

- **To promote well informed investors/consumers** (on the basis of reliable, timely, relevant, accessible, relatively easily understood and quality information);
- To promote effective intermediation (through intermediaries that are accountable, manage appropriately conflicts of interest and have the experience and expertise to effectively match an investor with their product specification);
- **To deter, detect and minimise the risk of unfair or fraudulent conduct: including money laundering and other financial crimes** (through well defined and enforced prohibitions against market misconduct that do not deter legitimate or efficient market conduct);
- **To provide a well founded basis for consumers to rely on financial promises being kept** (primarily in circumstances when a failure to perform will result in costs that are widespread or severe or the institution's ability to perform is inherently difficult to evaluate);
- **To encourage soundly governed institutions** (through competent management that are held accountable and effectively manage risks and competing interests);
- **To minimise the risks of contagion and runs** (where this could pose a risk to the soundness and efficiency of the financial system);
- To ensure timely and orderly resolution of distressed institutions; and
- To facilitate contestability, competitiveness and innovation in the financial sector.

Regulatory Tools

16. There are a number of regulatory tools that are used to meet the desired regulatory objectives. The type of tools and the extent to which they are used will vary depending on the objectives that are seeking to be achieved. These include:

- **Disclosure requirements**: this can include disclosure in relation to financial products, providers, and intermediaries and can be supported by financial reporting standards and external audit requirements.
- **Conduct Regulation**: this regulation aims to prohibit certain types of inappropriate market conduct or financial crimes from occurring.
- **Corporate Governance requirements**: these can include specification of duties and liabilities of those taking part in the management of an entity, as well as rights and obligations of shareholders or members and board composition etc;
- **Merit Regulation/occupational regulation**: these requirements can include negative licensing/assurance (e.g. removing someone's ability to take part in a role because of a previous breach of the law) or the imposition of fit and proper person requirements (e.g. requirements that require someone to have certain experience/expertise before they can undertake a role). Occupational regulation is a subset of merit regulation but can include a range of requirements that need to be met before a person can undertake an occupation, including registration and self regulatory requirements.

- **Prudential Regulation and Supervision**: prudential regulation and supervision focuses mainly on risk management structures and the containment of risks within financial institutions. It can include forms of disclosure or merit regulation but also includes such things as capital ratio requirements, liquidity ratios, limits on exposure positions, regular monitoring of financial institutions and mechanisms for prompt intervention by a regulator for breach or stress etc by a regulator.

- **Investor/Consumer Compensation Schemes**: another tool used in other jurisdictions to protect the users of financial services is insurance or fidelity funds. This form of insurance covers consumers against loss as a result of default of a provider up to a defined level of cover.

- **Education**: is also an important tool for arming investors so that they can make informed choices about their investments and savings.

Desired Attributes of Financial Sector Regulation

17. In assessing the current design of regulation and also in designing regulation relating to the non-bank financial sector going forward we have and will take into account the following regulatory principles:

- **Reinforce market disciplines**: regulation must reinforce and not undermine market disciplines on financial institutions and inherent incentives for sound institutional governance and risk management practices.

- Cost effective: regulation should be well targeted to well defined objectives and go no further than meeting those objectives (i.e. it must be commensurate with the problem, impact and risks). In particular regulation should aim to minimise compliance or transaction costs and careful identification should be undertaken as to who bears the costs and the impact of those costs. All non-regulatory measures (market solutions and self regulation) and their effectiveness should be considered before any decision to regulate.

- **Transparency**: regulation should be clearly understood and any regulation, codes and standards readily available so that well-informed decisions can be made and risks understood. Transparent regulation also reduces uncertainty and costs for providers.

- **Reduce regulatory arbitrage**: any regulatory regime developed should not create incentives for providers to structure products or investments solely to take advantage of favourable regulatory treatment.

- **Flexibility**: the design of any regulatory regime should be sufficiently flexible to let firms markets and products innovate and move with technological change and should not put up excessive barriers to entry.

- **Enforcement and supervision**: any regulatory regime needs to have: appropriate and flexible redress mechanisms; use, where appropriate, of industry self-regulation or private supervisors; have regulators with the necessary functions and powers to effectively monitor and enforce the rules; and effective penalties that deter.

- **Compliance with International principles**: in order to have a financial sector that attracts investment and participation any regulation developed will aim to comply with international standards and codes, unless there is a good reason for New Zealand regulation to be different.

- **Enhance coordination with Australia**: any regulatory regime developed with be considered within the framework for the Memorandum of Understanding on Business Law Coordination between New Zealand and Australia. This means that there will be a presumption in favour of coordination (in order to reduce where possible transaction costs and so that firms ideally only have to comply with one set of laws), however, this presumption will be overturned where there are good reasons for the laws to be different between the two countries.

Application of Framework to the Financial Sector and Key Problems Identified

18. Officials have assessed the current regulatory regime against the framework outlined for the RFPP. Officials believe that the current regulation of the financial sector is not fundamentally flawed. However, some areas of improvement have been identified within the regulatory framework. These include areas where costs on business could be reduced, regulation made more effective and consumer protection enhanced.

19. Some of the areas where improvements could be made to the current regulation of the non-bank financial sector arise from a lack of clarity around regulatory objectives. This leads to problems in identifying what regulation is trying to achieve with respect to certain financial products and providers and results in an inconsistent use of regulatory tools in some cases. This lack of clarity risks undermining confidence in the system, through creating uncertainty for investors and reduces the effectiveness of regulation and the accountability of regulatory agencies. There is a concern that consumers/investors do not understand the purpose or limits of the current regulation and may have an expectation of greater government regulation then actually exists.

20. The detailed assessment against the framework, problem identification and directions for reform has been divided into three areas for the non-bank financial sector, each revolving around their particular set of regulatory objectives. These are: securities offerings and CIS; NBDTI; and insurance and superannuation. The reason for separating these into categories is because some of the outcomes, objectives and regulatory tools discussed in the framework above may vary across the non-bank financial sector, as they are more important or are specific to different areas of the non-bank financial sector and correspondingly the regulatory tools should also be applied in different ways

21. Essentially the following conclusions have been made in each part:

- **NBDTI**: officials think that the current regime for NBDTI while not fundamentally flawed, does have some areas where improvement could be made and suffers from a lack of clear regulatory objectives. We believe that a distinction needs to be drawn between institutions offering investment in non-deposit debt securities (which has different objectives and reasons for regulatory intervention) and money deposited with deposit taking institutions which deal with consumers' day to day transactions and may have links to the payment system. Because of the expectation that depositors have in relation to accessing their funds, and the risks of contagion and runs, we are recommending that NBDTIs be subject to a more formalised, standardised and consistent licensing and supervision framework. However, any framework developed will need to ensure that the level of regulation varies depending on the size and the risks posed by an institution's business, and therefore there needs to be considerable further consultation before proposals are developed;

- **Insurance and Superannuation**: officials believe that there is insufficient prudential supervision of some categories of insurance – particularly where insurance policies are complex and long term in nature and difficult to transfer or replace (for example life insurance, defined benefit superannuation schemes and health insurance). Officials believe that in such areas there needs to be additional prudential supervision and our initial recommendation is that this supervision be undertaken by a government regulator. In relation to short-term/general insurance officials believe that the objectives are clear and that it is fundamentally sound. Some minor improvements need to be made to the regime to address issues raised through consultation, these relate to such things as improving the

requirements to entry; minimising abuse by overseas companies of the New Zealand regime; and making consistent requirements across all entities offering insurance. In relation to all insurance officials also believe that options be explored for reducing costs for branches and subsidiaries of overseas insurers while protecting New Zealand policy holders; and that the problems with the Insurance Contracts Act be addressed.

- **Securities Offerings and Collective Investment Schemes**: offical believe that the regulatory regimes for securities offerings and CIS also based on sound objectives and do not raise significant issues. Some directions for reform are discussed in this paper which focus on addressing issues raised through consultation and analysis. These include re-visiting the effectiveness of the two-document disclosure system and the current disclosure requirements; re-consider the types of offers, investors and products covered by the legislation; consider whether the disclosure requirements for securities should be prescriptive or principle based; the role of credit ratings; disclosure over the life of a security; and what more can be done to educate consumers and investors.

- **Trustee Corporations:** the current trustee corporation and statutory supervisor model is working well and these bodies play an important part in ensuring efficient securities markets. Some minor issues have been identified with the regime which relate mainly to a lack of official oversight of trustees in the performance of their role, a lack of consistent or minimum requirements in trust deeds and a lack of consistency in regulatory practices. Officials are recommending that the model be maintained but that we explore options for greater oversight by a regulatory body of the performance of their functions and that there be a more standardised approach to trust deeds. Officials plan to work closely with the Trustee Corporations Association and Trustee Corporations in considering this co-regulatory model.

- **Registration, reporting and entry criteria**: New Zealand has signed up to the Financial Action Task Force (FATF) 40 Recommendations on combating money laundering and the financing of terrorism. As part of compliance with these recommendations the government will need to consider the development of a more comprehensive registration framework for, and increased monitoring of, financial providers (including financial institutions and intermediaries) and the imposition of further “fit and proper” requirements on financial providers. The current gaps and deficiencies in the registration and monitoring arrangements for financial providers impedes government’s ability to monitor the financial sector, identify the nature of the risks within the sector, and prevent those with serious criminal backgrounds from controlling or influencing financial providers. This makes it difficult to get whole of sector data and identify risks and issues in the sector. Officials believe that in order for New Zealand to comply with the FATF requirements and to enable the government to comprehensively assess the financial sector, it will be necessary to introduce a basic registration and monitoring framework across most of the financial sector. However, it is important that any registration regime, reporting and entry requirements should be simple, minimise as much as possible compliance costs and that the framework does not impede innovation and competition in the financial sector.

22. The following objectives for regulation which are applicable across all of the non-bank financial sector include:

- To ensure timely and orderly resolution of distressed institutions;

- To deter, detect and minimise the risk of unfair or fraudulent conduct, including money laundering and other financial crimes; and

- To facilitate contestability, competitiveness and innovation in the financial sector (however this objective has more of a focus in the securities and collective scheme area).

Problem Identification and Directions for Reform: Non-Bank Deposit-Taking Financial Institutions

23. For your information attached as Appendix 1 to this report is a brief outline of the current regulatory regime for NBDTIs in New Zealand.

Problems Identified

24. Debt securities currently include a range of debt instruments. Most of the problems with debt securities that are investment instruments can be addressed through enhanced disclosure and improvements to the trustee arrangements, aided by a clearer legislative indication of the regulatory objectives (and therefore the regulatory limitations) for these products. However, debt securities that take the form of deposits or are deposit-like, and especially those of a callable nature or those with payment facilities, present a different set of problems. NBDTIs such as building societies, credit unions, PSIS and certain finance companies offer retail banking products like demand deposit accounts and transaction services, and other deposit-like facilities. Clear regulatory objectives have never been articulated for government intervention in the NBDTI sector although the regulatory objectives for intervention are broadly similar.

25. Depositors have an expectation that they will have immediate access (or very easy) to their assets (including income) in deposit accounts held with NBDTIs and in many cases rely on those funds to meet their day-to-day transaction needs. Failure by NBDTIs to honour their promises in this respect may seriously erode public confidence and impose immediate hardship on these individuals. Current supervisory arrangements via trust deeds do not provide an adequate protection to depositors, mainly because there are currently no minimum prudential requirements for trust deeds, the content of trust deeds vary greatly across different NBDTIs, the supervisory practices of trustee corporations vary and do not anchor to minimum standards, and there is insufficient transparency and accountability in trustee arrangements. It is also difficult for individual depositor/investor to monitor the providers' behaviour through existing disclosure arrangements or to make well-informed decisions as to where to place their funds. In addition, NBDTIs are also susceptible to runs as depositors cannot easily distinguish between sound and unsound institutions. Finally, there is also a risk of contagion for NBDTIs, where one NBDTI's difficulties can cause runs on other NBDTIs, potentially leading to widespread distress within parts of the financial sector. For all these reasons, officials see a need to strengthen the prudential regulation and supervision of NBDTIs.

Directions for Reform

26. The current regulatory regime for NBDTIs is not fundamentally flawed. Rather, these problems represent areas of the current regulatory regime which can be improved. These problems also affect individual NBDTIs in different degrees. Consequently, NBDTIs will be consulted in the next phase of the review to ensure that the regulatory objectives are achieved in a way that does not impose disproportionate compliance costs.

27. We consider that the objectives for regulating NBDTIs should be: to promote a competitive, contestable and innovative market, to minimise the risks of contagion and runs, to provide a well founded basis for consumers to rely on financial promises being kept, and to encourage soundly governed institutions. The most appropriate tools to achieve these objectives are prudential regulation, merit regulation and corporate governance requirements, and institutional disclosure. We believe that different regulatory tools are necessary for deposits and debt issuers because the reasons for intervention and objectives for NBDTIs (i.e. those arising from the use of these institutions to facilitate transactions and provide access to the payment system rather than for

investment, and the consequent high expectation that promises will be met) and the objectives for debt issuers (i.e. information asymmetries relating to an investment and a focus on informed investors) are different.

Inconsistent Regulatory and Tax Treatment

Problems Identified

28. There is no level regulatory playing field because NBDTIs are regulated differently depending on their organisational form and trustee corporation.

29. It is fair to say that of all the NBDTIs, credit unions are subject to the most restrictions on their business. They cannot accept more than $250,000 from any member and also have restraints on their borrowing and investment powers. This creates an un-level playing field within which the credit unions can compete for business (although the tax advantages conferred on them compensate for this to a large extent).

The government has given in-principle agreement to lifting most of these restrictions that would allow them more freedom in the way they operate provided their membership agree to exercise such freedom and if their trust deeds are accordingly amended.

30. Concern has also been raised about the tax advantage that is currently enjoyed by credit unions. The tax differential results in businesses offering similar deposit-taking services being taxed differently and may reduce competition and distort decisions, especially if the other restrictions on credit union business activities are relaxed.

Directions for Reform

31. NBDTIs should be subject to the same types of regulation in respect of their deposit-taking activities but the level of regulation will vary depending on the size and complexity of an institution's business.

32. Officials think it would be desirable to remove many of the current restrictions on credit unions as part of a move towards a more consistent and more effective licensing and prudential supervisory regime for NBDTIs. On this basis, credit unions would be subject to closer supervisory oversight, as well as more robust governance arrangements, enabling some of the existing statutory-based restrictions on their business activity to be removed. The in-principle changes must be consistent with this change.

33. Officials will need to further consider whether the existing taxation differential is warranted.

Difficulties Defining a Deposit-Taking Institution

Problems Identified

34. There is a need to identify how and where to draw the boundary between a deposit taker and a debt issuer. While it is possible to identify some key features of deposits, it is not easy to draw a bright line between a deposit and an investment.

35. While some finance companies offer deposit accounts, most of their core business is not offering demand deposit accounts as the majority of their funding takes the form of other debt instruments. Hence, the treatment of finance companies that engage in deposit-taking requires further exploration.

Directions for Reform

36. Further work needs to be undertaken to define NBDTI to ensure that the boundary that is drawn meets the objectives that have been identified for the increased regulation of these institutions without imposing unnecessary costs.

37. For those finance companies that do offer deposit or deposit-like facilities, we believe they should be subject to the same regulation and supervision as we propose for other NBDTIs. However, these companies are also debt issuers. More information will have to be gathered about the number of finance companies that offer demand deposits and the total amount of such deposits to inform decisions in this area such as the need for any *de minimis* exemptions and appropriate supervisory arrangements.

38. For those finance companies that do not provide deposit or deposit-like facilities, we see the scope for a lower level of licensing and prudential supervision. In these cases, we think it would be appropriate to maintain the existing trustee-based supervision, but on the basis of improvements to the trustee arrangements discussed below, such as some minimum requirements for trust deeds, minimum standards for trustee supervisory practices, stronger oversight of trustees by a regulatory authority, more effective disclosure, general securities offerings provisions, and minimum registration and entry requirements.

Inadequate Prudential Regulation

Problems Identified

39. NBDTIs should be subject to similar regulatory controls that apply to banks because they offer retail banking services, but tailored to the particular nature of the NBDTI risks and their much smaller size and less complex business. While credit unions and building societies are subject to financial restrictions in their trust deeds, there are still concerns about the adequacy of their risk management processes and expertise. Government has agreed in principle to remove current constraints on credit unions which will allow credit unions to take on more risks if their trust deeds are appropriately amended to address such risks. A concern has been expressed about the adequacy of the trust deeds as a risk management tool to protect depositors with credit unions that decide to take on such risks.

Directions for Reform

40. There is insufficient prudential regulation of NBDTIs to achieve the regulatory objectives we have identified. NBDTIs should be subject to the same classes of controls for risks in deposit taking although the degree of such regulation must be adjusted for and reflect the risks posed. NBDTIs need time to build their capacity and capability for risk management to compete with the banks. We acknowledge that this is a significant departure from the way in which some of these institutions are currently regulated. This policy shift is not driven by any market failure but rather an identification of gaps in the industry, inconsistency of regulatory treatment and the objectives for reform.

Inadequate Supervision by a Regulator

Problems Identified

41. The FSAP has highlighted New Zealand's reliance on private sector monitors for non-Bank financial institutions. Currently, all NBDTIs are monitored by trustee corporations through their trust deeds. Issues with trustee corporations have are discussed below. Differences in the

content of trust deeds and the supervisory approach of the trustee corporations make it difficult for depositors to understand the extent of supervision being exercised in respect of each NBDTI and to compare one with another. Existing supervisory arrangements also do not provide a consistent basis for adequately protecting depositors or for responding to a multiple NBDTI failure or distress situation. The existing arrangements also fail to provide an adequate basis for licensing NBDTIs and ensuring that NBDTI shareholders/owners, directors and managers meet appropriate levels of integrity, expertise and experience.

42. Finally, there is no consistent obligation on NBDTIs to furnish timely qualitative and quantitative information to a regulator. The FSAP assessment highlighted that most non-bank financial institutions are only required to report their financial results on an annual basis and often with a substantial reporting lag. Concern has been expressed about reliability of such financial information as the majority of NBDTIs are audited by second and third tier auditors.

Directions for Reform

43. We believe that a strong case exists for increasing the level of prudential regulation and supervision of NBDTIs, bringing all such entities (appropriately defined) into a broadly standardised regulatory framework, but where the level and nature of supervision varies depending on the size and complexity of the business of each institution. It needs to be further considered whether such supervision should be conducted either by a government agency, or by private sector trustees (with oversight of trustees by a government agency).

44. All NBDTI could be required to make appropriate and consistent disclosure to either trustee companies and/or a regulator depending on which directions for reform in relation to supervision are taken. Such information is necessary for the regulator to monitor the soundness of the industry and therefore it is essential that there is an established mechanism for the information to be received by the regulator.

Variances in Governance Standards

Problems Identified

45. Comment was also received about the varying standards of governance for NBDTIs. Many thought the governance regime set out in the Companies Act provides a better system for ensuring accountability through prescribed mechanisms for shareholder remedies and processes for the appointment and removal of directors.

46. Entities organised around mutuality (such as credit unions and building societies) view accountability in a different way from a corporation. In a corporation, it is axiomatic that the shareholders, being the owners of the corporation, have certain rights to hold management to account. This ability by shareholders to exert some discipline on management is missing in a mutual organisation where there is no clear line between ownership and management. A distinguishing characteristic of a credit union is that it is owned by its members. Management is made up of members who are supposed to run the organisation for the benefit of the members.

This system might have worked well in a small mutual organisation where peer pressure exerted the necessary discipline on management. However, doubt has been expressed on the ability of a building society or credit union today to effectively rely on that discipline.

47. The FATF report also creates impetus for the introduction of “fit and proper” requirements for managers, directors and significant shareholders of NBDTIs.

Directions for Reform

48. There is a need to ensure effective governance across all NBDTIs as some currently fall below the basic governance requirements of the Companies Act. However, a one-size-fits-all approach must be avoided. The level of governance should not be so onerous as to paralyse the operation of the less well-resourced providers.

Deficiencies in Crisis Management

Problems Identified

49. Specialisation among trustee corporations raises concern about the capacity of the trustee corporations concerned to successfully manage a solvency or liquidity crisis in the NBDTI sector. For instance, 14 of the 15 building societies are supervised by one trustee, the majority of credit unions are monitored by two trustee corporations and the majority of the finance companies are supervised by two trustee corporations.

50. Also, should the problem be contagious, we need more assurance that the trustee corporations can work together with the Registrar, Reserve Bank and the Securities Commission to effectively manage the crisis.

Directions for Reform

51. To better ensure that objectives of regulating NBDTIs are met in ensuring institutional soundness, the regulator would need to be able to monitor the governance and risk profile of these institutions and intervene where breaches occur. In an extreme situation, the regulator needs to have well-tested crisis management skills to handle any distress at institutions in trouble as well as containing any risks of contagion to the financial system. Our preliminary thinking is that a more consistent and formalised framework of licensing and prudential supervision by a single regulatory authority, or within a co-regulatory model, would provide a much better basis for ensuring that distress and failure events within the NBDTI sector are managed effectively.

Problem Identification and Directions for Reform: Securities Offerings and Collective Investment Schemes

52. For your information attached as Appendix 2 to this report is a brief outline of the current regulatory regime for securities offerings and CIS in New Zealand.

Application of the Framework to Securities Offerings and Collective Investment Schemes

Problems Identified

53. The current regulatory regime for securities offerings and CIS is fundamentally sound. However we have identified, through consultation and analysis, a number of areas where the regulatory regime could be improved. These areas include: ensuring that the right type and degree of disclosure is given for the right type of products and regarding offers to people who need the protection of regulatory intervention; and ensuring that responsibility for securities offers attaches to the appropriate parties.

Directions for Reform

54. The directions for reform discussed below include: re-visiting the effectiveness of the two-document disclosure system and the current disclosure requirements; re-considering the types of offers, investors and products that should be covered by the legislation; considering whether the regulation of securities should be prescriptive or performance based; the role of credit ratings in disclosure; what is the appropriate disclosure over the life of a security; and what more can be done to educate consumers and investors.

55. The outcomes sought for the regulation of securities offerings and CIS are investment for innovation and growth and investment for wealth accumulation. Access to capital is a key factor in business growth and innovation. For many firms, capital is accessed through issuing securities to the public. Equity securities are important for businesses in higher risk sectors of the economy, where debt financing may not be a realistic option. Issuing debt securities can provide access to longer term debt than borrowing from a bank. Securities markets also provide opportunities for households to diversify their investments and risks in a cost efficient way, by investing in a range of businesses and sectors either directly or through a CIS. The reasons for intervention in this area include the need to address information asymmetries, unfair or fraudulent conduct and incompetent management.

56. The main objectives for the regulation of securities offerings and CIS are: to promote well informed investors; deter, detect and where possible eliminate unfair or fraudulent conduct;[3] encourage soundly governed institutions; and to promote effective intermediation.

57. The most appropriate tools for securities offerings and CIS, which fit with the regulatory objectives include: disclosure (this is the key tool and focuses on both the product and the provider), conduct regulation, occupational regulation (this may be utilised in relation to financial intermediaries to ensure they are suitably qualified), and corporate governance requirements.

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[3] While this is more relevant for secondary market dealings in securities it is also applicable to the primary market;

58. Currently merit regulation is not really used in relation to securities offerings. This may be due to the fact that in the past merit regulation was not considered as important for securities offerings as it was for other non-bank financial institutions whose stability, and therefore the competency of the management, was considered more important. Some prudential regulation may also be required for debt securities or in relation to brokers trust accounts. However, prudential regulation is less important in the securities offering area because securities are investment products, which carry a degree of risk to the investor. Therefore, there is less justification for government regulation to secure the performance of financial promises, and greater moral hazard risks arising from doing so.

Structure of Legislation

Problem Identified

59. The Securities Act 1978 has been amended many times and the current configuration of the Securities Act and the placement of provisions between the Securities Act, Securities Regulations 1983 and the Schedules to the Regulations are confusing to users of the legislation. In addition, since the Securities Act came into force, a number of other pieces of securities market legislation have been passed. There is considerable cross-referencing required between the Securities Act and this other legislation.

Direction for Reform

60. The RFPP should consider the appropriate structure of securities law and how this law best fits with other securities market legislation, so that securities law is coherently expressed and transparent. It should also consider of what should be covered in legislation, regulation and class exemption notices.

Application of the Securities Act 1978

Type of Products: Problems Identified

61. Since the Securities Act came into force in 1978 and the Regulations in 1983, the types of financial products available for investment have expanded in nature and changed dramatically. There have been some amendments to the Securities Act to reflect these changes; however because of its prescriptive nature, the Securities Act does not easily accommodate new and innovative products, for example derivatives.

Type of Offers: Problems Identified

62. Some concern was raised in consultation that the application of the Securities Act to some offers is unnecessary and that the compliance costs involved discourages issuers from making these offers to the public. An example given in consultation was investment grade debt offered by Local Authorities and State Owned Enterprises.

63. Concern was also raised in consultation about the limited application of the Securities Act to contributory mortgages. Given the number of inspections carried out and brokers prohibited by the Securities Commission and the number of cases taken by the National Enforcement Unit, it is clear that contributory mortgages pose a significant risk to the public.

Directions for Reform

64. The RFPP should consider the types of products that should be covered by the legislation and how different products should be regulated. This includes whether different products should be regulated specifically and the definitions of security revisited, or whether principled based regulation should apply. It also includes consideration of the scope of financial products that it is appropriate to cover, in particular the appropriate regulatory regime for derivative products.

65. The RFPP should also consider the types of offers and investors that should be covered by all or part of the legislation. Specifically, the RFPP should revisit how an offer to the public is defined and whether this remains an appropriate dividing point for the application of securities law. The RFPP should also consider the extent to which and the manner in which the law should extend to offers by state owned enterprises, local authorities, and to different classes of investor, including wholesale or professional investors.

The Appropriate Form and Extent of Disclosure

66. There has been some criticism that the current prescriptive regulations impose unnecessary compliance costs on issuers and do not provide investors with the information they need to make informed choices about which products or providers best suit their needs and risk levels.

Form - Problems Identified

67. The investment statement and prospectus are designed for particular audiences but it is questionable whether each document reaches those audiences and whether both documents are needed for all types of securities. Particular concerns raised in consultation were:

- Some retail investors do not use or understand the investment statement. This may be because: the investment statement can be a complex document, drafted by lawyers; and the level of financial literacy of some retail investors is low.

- Even if retail investors understand the content of the investment statement, it is questionable whether some read the document. This may be because the retail investor is likely to obtain information from a variety of other sources, for example, friends and family, bank manager, financial advisors, media, and product provider advertising and marketing documents.

- It is also questionable whether both an investment statement and prospectus are needed for all types of securities. Some stakeholders suggested that while the investment statement is useful for CIS (as it provides retail investors with basic information to compare different products), it is less relevant for equity and corporate debt (as it does not provide the material information that an investor in equity or corporate debt securities needs and these investors will always need to go further for information).

Content - Problems Identified

68. There is a concern that the current prescriptive regulations do not provide investors with enough of the right information. This makes it difficult for the investor to assess the level of risk exposure that an investment in a particular product has. Specific concerns raised in consultation were:

- There is a lack of transparency in the disclosure of cost and fee structures, particularly in relation to CIS.
- The investor is not able to easily assess the material risks of a particular product. The practice of some issuers is to disclose all risks, regardless of relevance. Others do not disclose enough about the risks of investing.
- The use of credit ratings. In particular, there is a concern that investors do not understand credit ratings. Also, there has been no consideration of whether the disclosure obligations should be eased if a credit rating has been obtained.

Initial and Continuous Disclosure - Problems Identified

69. The continuous disclosure regime was implemented in 2002 by the Securities Markets Amendment Act 2002.[4] At the time, the impact of the continuous disclosure regime on the Securities Act was not considered. Questions have been raised about whether the interrelationship between disclosure required under the Securities Act and the continuous disclosure required under the Securities Markets Act can be utilised to reduce costs for issuers.

Directions for Reform

70. The RFPP should consider:

- How disclosure should best be made in order to sufficiently inform investors without imposing unnecessary compliance costs on issuers. Specifically, the RFPP should revisit the two-document disclosure system and consider how disclosure can be focussed to provide the investor with the material information for different types of products. The RFPP should question whether the Securities Regulations should remain prescriptive or whether there is merit in moving to principles based disclosure requirements.
- The role of credit ratings. Specifically: whether there should be disclosure of whether a credit rating has been obtained or not and if it has, what the credit rating is and what it means; what impact a credit rating should have on the level of disclosure required; and whether any explicit recognition of credit ratings in the regulatory scheme would need to be limited to "recognised" credit rating agencies.
- Other means of ensuring investors have sufficient information to make appropriate decisions. For example, it is important that the RFPP consider measures to increase the financial literacy of investors and consider the recommendations of the Financial Intermediaries Task Force on the regulation of financial intermediaries.
- The disclosure requirements over the life of the security, to ensure that the security holders remain appropriately informed about the performance of their investment and that the obligations of initial and continuous disclosure do not produce unnecessary compliance costs.

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[4] The continuous disclosure provisions require public issuers, which are a party to a listing agreement with a registered exchange, to notify information about events of matters as they arise for the purpose of that information being made available to participants in the registered exchange's market.

Accountability for Disclosure

Problems Identified

71. Generally, the Securities Act does hold parties to public offers accountable for the accuracy of the information disclosed, with sufficient prohibitions and penalties to deter negligent and intentional misleading of investors. This accountability will be strengthened if the Securities Legislation Bill is passed. The Bill introduces civil pecuniary penalties for misleading and deceptive conduct under the Securities Act. The Bill also allows the Securities Commission to take proceedings, as appropriate, in cases where the loss or damage caused to a number of investors does not justify any one of them bearing the cost of litigation. In addition, the "Declaration of Contravention" mechanism set out in the Bill allows individual investors to pursue more easily a compensation claim by piggy-backing off a Commission case for a pecuniary penalty order where the Commission has already established that there was, in fact, a contravention of the law.

72. However, the lack of regulatory review of disclosure documents was identified by the FSAP report as a shortcoming in New Zealand's regulatory regime for securities.

73. In addition, particular concerns raised in consultation were:

- Some stakeholders have commented about the fact that the investment statement, unlike the prospectus, is not registered or lodged, and is not available from the Registrar. This comment has been made by both issuers and those who use the investment statement. Issuers favour the degree of certainty as to compliance that accompanies registration. Those who use the investment statement have expressed concern at the ability for an issuer to have more than one version of an investment statement at any one time.

- Some issuers provide poor quality prospective financial information and there is no independent review of prospective financial information. This is despite the Financial Reporting Standard 29 on Prospective Financial Information.

- Some stakeholders were concerned that the definition of "promoter" is too wide in that it captures parent companies who are not actively promoting the scheme. We have been advised by some stakeholders that this discourages offshore issuers from issuing in New Zealand.

Directions for Reform

74. The RFPP should consider:

- The appropriate registration and pre-vetting of the investment statement and prospectus. The RFPP should consider specifically how to balance regulatory review of disclosure documents and maintaining the accountability for those disclosure documents on the issuer.

- The appropriate duties and liabilities of issuers and other parties involved with the issuer (lawyers, auditors, underwriters and other professional advisers, directors, and promoters).

Education

Problems Identified

75. During the problem identification for the RFPP a number of people expressed concern at the financial literacy of New Zealanders. The Financial Intermediaries Task Force will raise education as one of its key concerns. The findings of the Financial Capability Survey being undertaken by ANZ/the Retirement Commission and MED which are due later this year should provide further information on the level of financial literacy in New Zealand.

Directions for Reform

76. A number of people are currently undertaking education campaigns in the financial services area. Some of the main work in this area includes the Retirement Commission's website based tool called "Sorted", the work being undertaken by NZQA and the work of Enterprise Trust. All other campaigns are considerably narrower in their focus. We note that as part of the Securing your Future package announced in the 2005 Budget, MED is currently leading the development of a financial education campaign for consideration in Budget 2006, which will be relevant to the planned launch of KiwiSaver on 1 April 2007. However, this too will be targeted. Officials plan to have further discussions with other agencies about whether something that is more comprehensive and wide reaching needs to be undertaken in relation to financial education.

Finance Companies

Problems Identified

77. Under current regulatory arrangements, finance companies are not subject to any form of licensing other than registration with the Registrar of Companies. Any person can set up a finance company by registering a company with the Companies Office. However, the Companies Office is not required to maintain a register of finance companies. Hence, although the Companies Office has information about each finance company, information about the entire sector is not readily available. Many finance companies offer term investments (which are debt securities) to the public and they are therefore required to appoint a trustee corporation and enter into a trust deed. Problems with inconsistencies in trust deeds and inadequacy of disclosure by finance companies have also been raised.

Directions for Reform

78. Supervision of finance companies needs to be strengthened to provide a stronger degree of protection to investors. For those finance companies that do not provide deposit or deposit-like facilities, we see a need to strengthen the trust deed requirements, by developing a set of minimum trust deed requirements; including a requirement for trust deeds to specify intervention triggers for the trustees, and for trustees to be subject to closer oversight by a suitable regulatory authority (see also the discussion on Trustee Corporations below). The issues raised in relation to disclosure by finance companies should be addressed under the other directions for reform for securities offerings discussed above.

Regulation of Collective Investment Schemes

Collective Investment Schemes - Problems Identified

79. The regulation of the different CIS is complex and inconsistent. Specifically:

- The Securities Act and Securities Regulations regulate CIS (bar contributory mortgages) in their capacity as issuers and regarding the disclosure documents provided to prospective and continuing investors. This regulatory regime in some cases overlays specific legislation which governs different CIS and this can be complex and confusing, for example, unit trusts are governed by the Unit Trusts Act 1960, group investment funds are governed by the Trustee Companies Act 1967 and some participatory schemes are governed by specific statutes (e.g., retirement villages are governed by the Retirement Villages Act 2003).

- Some CIS may be subject to outdated and overlapping requirements. For example, the Unit Trusts Act 1960 was not reviewed when specific Securities Act requirements for unit trusts were introduced in 1996. In addition, group investment funds are now being offered to the public as unitised funds by commercial fund managers under the supervision of a trustee company. The Trustee Companies Act 1967 has not been reviewed in light of this development.

- CIS are not regulated consistently. For example: contributory mortgage schemes have a lower level of prudential supervision and reporting requirements than unit trusts and participatory schemes; all CIS (apart from contributory mortgages and employer sponsored superannuation schemes) are subject to the disclosure requirements of the Securities Act, however the content of disclosure differs amongst the different categories of CIS; and the general responsibilities, standards of performance and duties of CIS issuers, trustees and statutory supervisors have a variety of sources (statute, common law, trust deeds and deeds of participation), with differing levels of protection for the investor.

80. The FSAP report identified a number of inconsistencies between the regulation of CIS in New Zealand and the IOSCO Principles of Securities Regulation. The key inconsistencies identified were:

- There are no detailed eligibility criteria for CIS operators;

- There is no oversight of contributory mortgage brokers;

- There is no programme for ongoing regulatory oversight of CIS operators. The regulatory scheme for CIS relies heavily on trustees to supervise the CIS operators. The FSAP report noted that this can be a cost-effective regulatory method. However, it pointed out the following concerns: regulators must rely on trustees to deal with inappropriate conduct at an early stage or raise concerns with the regulator; trust deeds and deeds of participation are negotiated between the trustee/statutory supervisor and the CIS operator and it is unclear whether there are any concerns with the terms negotiated; and there are no consistent and minimum regulatory standards regarding asset valuation, pricing and redemption.

Platforms – Problems Identified

81. The Financial Intermediaries Task Force noted the increased use of platform technology in the financial planning sector. A "wrap" is one type of platform, a custodial service through which the assets are held in the investor's name. Because the investor has direct ownership of specific assets (as opposed to a shared interest in assets) the wrap itself does not constitute a separate security interest and is not subject to the disclosure obligations in the Securities Act, nor the limited prudential requirements of the Unit Trusts Act 1960. The effect of this is that the

investor may not be informed about the cost and fee structures involved with wraps and other similar platforms and the impact of these on their returns.

Directions for Reform

82. The RFPP should consider:

- The appropriate regulation of different CIS. Specifically, the RFPP should consider how to achieve consistency of standards of regulation for the various classes of CIS.
- Whether the underlying statutes of the different CIS need to be reviewed and updated.
- How to enhance compliance with the IOSCO principles of securities legislation. Specifically: how to provide "fit and proper" criteria for CIS issuers; the appropriate monitoring of contributory mortgage brokers; adopting consistent regulatory standards regarding asset valuation, pricing and redemption; and the appropriate regulatory oversight of trustee companies, including reporting requirements to a regulator and the regulator's ability to remove a trustee company from an appointment.
- How to provide greater disclosure to the investor about the cost structures, performance and remunerations paid in respect of trust arrangements and other platform services.

Role of Trustee Corporations

83. Most of the trustee corporations are established by their own Acts of Parliament and derive their right to act as corporate trustees from these Acts. They currently have about $80 billion under supervision. The law requires that a trustee corporation (6 at present) or approved trustees holding appointment as trustees or statutory supervisors (collectively referred to as Corporate Trustees) be appointed to monitor the performance of business entities offering debt securities, CIS, or superannuation funds to member of the public. These entities include building societies, finance companies, credit unions, CIS, superannuation schemes, and retirement villages.

84. The powers and duties of a Corporate Trustee are set out in the trust deeds and case law as well as the Securities Act, Trustee Companies Act 1967, the Unit Trust Act 1960, Superannuation Schemes Act 1989 and the Retirement Villages Act 2003. For debt securities, they owe their duty to the debt security holders and their basic obligation is to exercise reasonable diligence to monitor the ability of the issuer to repay the debt. For unit trusts, a Corporate Trustee works with the manager and ensures that the manager adheres to the terms of the trust deed and the offer documents.

Problems Identified

85. We believe the trustee model is fundamentally sound. Corporate trustees play an important part in ensuring an efficient securities market. Some of the benefits that the trustee corporations and statutory supervisors provide are: they have considerable specialist expertise and knowledge of the non-Bank financial sector; they have good working relationships with the entities they regulate as well as the Securities Commission and Companies Office; they have a demonstrated capacity to resolve difficulties quietly behind the scenes, thereby avoiding large disruptions to the market; they can act as a collective voice for investors thereby reducing costs for investors and transaction costs for issuers. There have been few notable cases of institutional failure in the last 15 years or so attributable to alleged inadequacies with trustee

performance. Trustees also have strong commercial and reputation incentives to perform their role effectively.

86. However, some problems have been identified with the trustee corporation model. These relate to: the inability for government to collect whole sector data about the financial sector in order to monitor problems or issues; a lack of official oversight of trust deeds and the performance of trustees i.e. there is no obligation on trustees to report (e.g. annually) to investors on the performance of their role; and no adequate mechanism for disciplining the statutory-based authorised trustee companies in situations of inadequate performance of their role (e.g. de-authorisation or imposition of conditions), other than the capacity for investors to litigate against them. Many of these concerns were reflected in the FSAP assessment.

87. There are also inconsistencies across trust deeds. While variations in trust deeds are appropriate to a substantial degree, given the wide variety of issuers, some degree of standardisation may be desirable for some categories of non-bank financial institutions, particularly in terms of basic prudential requirements or intervention triggers. Similarly, greater consistency in regulatory practices, including monitoring, enforcement and intervention practices, may be desirable. Finally, some comments have been received that trust deeds are not sufficiently responsive to new risks. Some trust deeds have been in existence for a period of time and were tailored for a different business environment.

Directions for Reform

88. We would like to retain the benefits of the current regime of trustee corporations and statutory supervisors while addressing some of the problems identified above. We propose to consider the adoption of a co-regulatory model whereby trustee companies and statutory supervisors are retained with some oversight by a regulator. This could include more reporting to a regulator, giving the regulator the ability to register/deregister trustee corporations and others for the purposes of certain roles in the financial sector and to examine the trustee corporation and statutory supervisor's processes and procedures. It would not generally include second guessing trustee company or statutory supervisors' performance in relation to a particular issuer.

89. We consider that a level playing field should be created for the authorisation and de-authorisation of all trustees. Consequently, the desirability of retaining the existing provision in the Securities Act that confirms automatic trustee status on the four trustee corporations that are established by their own Acts of Parliament should be assessed.

90. In addition, further work needs to be done to address limitations of the trust deed as a regulatory tool for CIS and debt issuers, particularly for finance companies. A requirement that certain issues must be addressed through minimum covenants in the deed could be considered. Further work also needs to be done to consider whether trustee corporations should be given more authority to allow them to act more quickly and decisively. For instance, under existing law, trustee corporations can only obtain information from the auditors if the auditor has formed a view that the information requested is relevant to the exercise or performance of the trustees' powers or duties. Officials propose to work closely with the trustee corporations, statutory supervisors and the Trustee Corporations Association on these issues.

91. Finally, officials recommend that the co-regulatory model apply to CIS and debt securities, but, that as stated above, further work be undertaken on whether a co-regulatory model involving trustees should continue to be utilised for NBDTIs or whether there would be efficiencies in the prudential regulator providing direct supervision of these entities.

Problem Identification and Directions for Reform: Insurance and Superannuation

Overview

92. The regulatory regime for insurance has some positive features, such as a strong element of self regulation which has contributed to a stable insurance market over time. However elements of the regulatory regime are out of date (particularly the regime applicable to long term insurance policies such as life insurance), and inconsistent with international best practice (as reflected in the IAIS principles[5]). Long term insurance poses particular risks to policyholders due to the length of time the policy is held, the complexity of the actuarial calculations required by the insurer to maintain sufficient funds over time, the lack of transferability of some products, and the difficulty of obtaining replacement cover upon an insurer's failure in some cases, making effective regulation extremely important.

93. These features of long term insurance mean that tools such as disclosure and corporate governance may not be sufficient to protect policyholders from the potential failure of an insurer. Officials are recommending that prudential regulation be increased to enable better monitoring of the financial health of long term insurers and to contribute to their viability over time. This will both lessen the likelihood of policyholders being individually affected and of there being a shock to the insurance market through the failure of an insurer. Consideration of the most appropriate form of prudential regulation will include looking at the regimes applicable to overseas insurers, including Australia, to see where co-ordination can be achieved, and to minimise compliance costs where possible.

94. The regulation of short term insurance and superannuation is essentially sound. In relation to short term insurance we are proposing some changes to introduce a greater level of consistency, reduce compliance costs where possible and are also investigating whether a higher level of policyholder protection is necessary in this area. In relation to superannuation officials are considering grouping defined benefit superannuation schemes with long term insurance for regulatory purposes, with defined contribution schemes treated in a way which is more consistent with the regulation of CIS.

Short Term versus Long Term Insurance – Different Regulatory Approaches

Problems Identified

95. There is a wide range of different types of insurance. The simplest insurance policies are annually renewable and relate to discrete risks that do not impose any ongoing liabilities on insurers, for example car insurance. At the other end of the spectrum are insurance policies that are more complicated such as life insurance that operate over a very long time period, making the actuarial risk to the insurer difficult to calculate; there may be both an investment and a risk mitigation element to the policy; and it is often expensive or difficult to transfer between insurance providers.

96. The different types of insurance pose very different risks to consumers. It is very easy to cancel a car insurance policy and move to a different insurer. If an insurer fails the amount that

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[5] The principles agreed by the International Association of Insurance Supervisors (IAIS).

the policyholder has at risk is low, and it is usually easy for them to obtain replacement insurance from an alternative insurer on equivalent terms.

97. In contrast, the value of a life insurance policy is dependent on the insurer still being in existence and able to honour the policy many decades after the policy has been taken out. This means the consumer has an interest in the long term viability of the entity behind the product. In addition, under some policies such as income protection insurance or health insurance the consumer may not be able to obtain replacement insurance (either at all, or on equivalent terms) if the insurer fails and their health has deteriorated in the time since they first took out the policy.

Directions for Reform

98. Given the wide range of insurance available there is an acceptance of the need to regulate different types of insurance in different ways. The existing regulatory regime differentiates between life and general insurance for example. Officials consider that regulation should differentiate between types of insurance, possibly using a distinction between short term and long term insurance, although further work will be needed to confirm that this is the most appropriate split. This differentiation allows insurance types that share similar characteristics and that pose similar risks to consumers to be grouped together and regulated accordingly. This was also supported by stakeholders as an appropriate basis on which to regulate. Other options include splitting investment and non-investment insurance, although there is such a wide range of non-investment insurance that further differentiation would be required. It should be noted that many of the insurers in New Zealand are Australian companies or based in Australia. Thus the regulatory regime in Australia and the need to co-ordinate with that regime, and possibly with other regulatory regimes where appropriate, will also be a relevant factor when resolving this issue.

Application of the Framework to Insurance – Short Term Insurance

99. The outcomes the government is seeking from financial markets in relation to short term insurance are facilitation of effective risk management (i.e. the ability to mitigate and pool risk) and facilitating the effective allocation of credit and resources. This latter outcome is particularly the case where the presence of insurance supports trade and other business activity.

100. The reason for intervening in this area is primarily the presence of information asymmetries. Secondary reasons for intervening include expectations and confidence (there may be a higher expectation that insurance companies will be able to meet their financial promises because insurance is taken out to provide protection precisely when a person is in a position of vulnerability) and the potential for unfair or fraudulent conduct (I pay a premium now for a benefit to be paid out later).

101. The government's main objectives for the regulation of short term insurance are to promote well informed policyholders/consumers, to foster sound governance within insurance providers and to deter, detect and minimise the risk of unfair or fraudulent conduct including money laundering and other financial crimes.

102. There is still a remaining question over whether it is an objective for short term insurance to provide a well founded basis for investors to rely on financial promises being kept. If it is an objective there is also a question as to the extent to which interventions are needed to achieve this. This will depend on whether there is an expectation that short term insurers are more able to meet their promises than other financial institutions (putting aside NBDTIs).

103. The high transferability of short term insurance means that the collapse of a short term insurer is unlikely to cause significant hardship, as replacement insurance should be able to be obtained relatively quickly and easily in most cases. However, it may be that there is a greater expectation that regulation will achieve a higher level of institutional soundness over time in relation to insurers because of the risk mitigating role they play in society. Officials intend to explore this in more depth.

104. The most appropriate tools for short term insurance, which fit with the regulatory objectives include: disclosure (this is the key objective and disclosure is mainly focussed on the product due to the high level of transferability of product), conduct regulation, occupational regulation (of intermediaries, and possibly other pivotal roles such as trustees) and corporate governance requirements.

105. For your information attached as Appendix 3 to this report is a brief outline of the current regulatory regime for insurance.

Problem Identification and Directions for Reform – Short Term Insurance

106. The problems identified below build on work done in 2001 when MED reviewed the requirement for general and disaster insurers to obtain a financial strength rating and the requirement for all insurers to lodge a $500,000 deposit. This review lead to several recommendations for reform, however these reforms were postponed while the Law Commission reviewed the regulation of Life Insurance (completed December 2004) given that the Law Commission was also asked to comment on how their recommendations might affect general insurance. The Law Commission's work has also been taken into account when framing the problems and directions for reform in this paper.

Duplication of Regulation of Insurers Based Overseas and Protection of New Zealand Policyholders

Problem Identified

107. The insurance market in New Zealand is small and dominated by overseas companies or subsidiaries of overseas companies who are supervised in their home countries. The dominance of overseas insurers means that New Zealand consumers benefit, to some extent, from the prudential regulation carried out in the home countries of the parent companies. This overseas dominance may also make overseas regulation and overseas principles more relevant. The key issues are how New Zealand's regulatory regime can best co-ordinate with Australian regulation, and how the regime can avoid unnecessarily duplicating regulatory requirements imposed on insurers by their home countries.

108. Another issue that has been raised is whether there is sufficient protections for New Zealand policyholders should an overseas parent go insolvent. The current regulatory requirements provide room for money to be removed from New Zealand policyholders to the overseas parent.

Direction for Reform

109. Officials may consider treating Australian insurers as a special case, given CER and our commitment to closer co-ordination on business law under our MOU. This would, of course, be

subject to our international obligations in this area which may limit the extent to which we can treat Australian insurers differently from other overseas insurers.

110. There are several models that could potentially recognise equivalent requirements in an insurer's home jurisdiction in this area and address the issues of compliance costs and policyholder protection. In relation to Australia these could include: an APRA Supervisor model, requiring local incorporation, and trans-Tasman coordination structures to deal with any issues. Currently officials are undertaking work on what trans-Tasman coordination mechanisms may be appropriate for things like prudential regulation. Any work undertaken in developing a model for insurance, will inform, and be informed, by this other work stream.

Requirements for Entry Too Low – Insufficient Protection for Policyholders

Problem Identified

111. Feedback from some stakeholders indicated that it is too easy to establish as an insurer in New Zealand. To establish as an insurer the entity must pay a $500,000 deposit (although due to historical anomalies some insurers are permitted a smaller deposit). General property and fire insurers must also obtain a financial strength rating at an approximate maximum annual cost of NZ$30,000. Health and life insurers are not currently required to obtain a rating.

112. Low barriers to entry and New Zealand's current relatively light handed regulatory regime potentially creates a risk that insurers will be established without sufficient capital to support the risks that the insurers are agreeing to underwrite by issuing policies.

Direction for Reform

113. We still need to consider the issue of the ease of entry to the New Zealand insurance market. This is a difficult issue as raising barriers to entry reduces competition and can reduce innovation. This consideration will include us looking at the role of the existing $500,000 deposits lodged by insurance companies currently operating in New Zealand. The deposit requirement was reviewed by MED in 2001 in relation to non-life insurers and it was recommended that the requirement be dropped and all deposits refunded, due to the fact that the deposit was no longer fulfilling its intended function as a protection for policyholders. Stakeholder feedback was clear that the current $500,000 deposit is inadequate and that it would be better to either abolish the deposit requirement or substantially increase the deposit to meet the aim of policyholder protection (Australia requires a deposit of $10m for example, although this would likely be too high for New Zealand's smaller market).

Inconsistent Application of the Rating Requirement

Problem Identified

114. The financial strength rating allows consumers, intermediaries and analysts to assess the financial strength of the insurer over time. Because the ratings agency requires proof of adequate financial management systems it can be argued that requiring a rating also contributes to basic institutional soundness being maintained over time. The rating system was reviewed by MED in 2001 and it was recommended that the rating requirement be extended to all non-life insurance companies (mostly health and indemnity insurance providers). However, the implementation of this reform was put on hold while the Law Commission considered Life Insurance (completed December 2004).

115. In our discussions with stakeholders there was support from large and established insurance companies for retention of the rating requirement. Stakeholders that were required to obtain a rating complained that the exemptions created an uneven playing field. Smaller insurers, particularly health insurers, were not supportive of ratings due to the fact that can be difficult for small institutions to obtain a good rating.

Direction for Reform

116. We think consideration needs to be given to retaining the rating requirement, and extending the requirement to get a rating to all short term insurers (but not health, life and other long term insurers). Being essentially a disclosure based tool the rating requirement fits with the objectives of regulation of short term insurance. In addition, the rating requirement is simple, and provides some potential for an early warning system if the financial position of an insurer changes. Some stakeholders argued that if an insurer cannot afford the cost of a rating then that insurer does not have sufficient capital to be operating as an insurer. This is an area where we need to consult further with stakeholders.

Lack of Enforceable Solvency Standards

Problem Identified

117. The potential future financial obligations of an insurance organisation are different from those faced by other organisations in that they are difficult to quantify and are inherently uncertain. As a consequence there is a greater need for insurers to monitor their solvency over time. This is because of the uncertainty introduced by actuarial assessments and because future liabilities are always changing, affecting the insurer's position.

118. At present much of the general insurance industry adheres to a voluntary solvency standard, however the standard is not legally enforceable. The lack of mandatory solvency standards contributes to the lack of procedures for assisting orderly exit from the market, as solvency measures could be used as a trigger for the exit provisions.

119. In relation to the soundness of the insurer there may also be some need for a basic level of monitoring of the financial solvency of an insurer over and above that applicable to other non-insurance organisations because of the role that insurance plays in the financial sector, as a back stop when disaster hits.

Direction for Reform

120. In relation to short term insurance the likely directions for reform will involve making the existing voluntary solvency standards mandatory across the industry. Compliance with these solvency levels would likely be monitored by a central regulator. The main purpose of this regulation would be to ensure a basic level of institutional soundness and to provide an early warning of financial distress. There was also acceptance among stakeholders for introducing approved actuarial standards, compliance with which would be enforced by a regulator.

Variation in Legal Form of Insurers

Problem Identified

121. Another relevant feature of the insurance sector is the number of non-corporate insurers which are operating. For example, Southern Cross (health) and Manchester Unity (general insurance) are both friendly societies. Farmers Mutual Group (which offers general rural and

other insurance) is a mutual insurance association under the Mutual Insurance Act 1955, the only mutual still active in New Zealand.

122. Many of the organisations above are regulated by provisions in statutes that are specific to their institutional form, such as the Friendly Societies and Credit Unions Act 1982. This means that the applicable standards for reporting and other regulatory measures are different and there is no consistency across all insurers. This is currently an issue where differing requirements may lead to gaps in reporting or regulation that create risks for consumers.

Direction for Reform

123. As with the approach to NBDTIs there will be a need to impose some consistency of regulatory requirements across all insurers, regardless of institutional form. This will not mean that organisations will have to change institutional form but will likely mean some changes to the requirements under specific statutes to ensure that there are not gaps in the regulatory regime created by different institutional forms.

Insurance Contracts Reforms Outstanding

Problem Identified

124. In its final report on Life Insurance (November 2004) the Law Commission recommended reforms to the law governing insurance contracts. These reforms are an outstanding issue as they do not currently fall within the RFPP. The aim of the reforms is to make the law around insurance contracts fairer to consumers. Under the existing insurance contracts rules, policyholders must disclose all facts to an insurer that are material. A lack of disclosure allows an insurer to avoid an insurance contract and not pay out. This rule operates even if the non-disclosure is irrelevant to the claim. The operation of these rules can be extremely harsh and arbitrary.

125. Ideally the insurance contracts reforms would be implemented at the same time as reforms arising out of the RFPP. If this does not occur there is a real possibility that the benefits from the reforms will be undermined as there will still be a major regulatory issue outstanding.

Direction for Reform

126. The responsibility for progressing the insurance contracts reforms currently rests with the Ministry of Justice. However we understand that these reforms are not a priority at the current time. Officials plan to explore with the Ministry of Justice the possibility of these reforms being undertaken as part of the RFPP. This approach was supported by stakeholders and the Law Commission.

Application of the Framework to Insurance – Long Term Insurance

127. The following outcomes, objectives and regulatory tools are applicable in relation to long term insurance. The outcomes and reasons for intervening are the same as for short term insurance with the addition of the outcome of providing an environment that facilitates wealth accumulation.

The additional reasons for intervening are greater information asymmetries, (particularly given the actuarial assessments involved in pricing and issuing insurance and in managing insurers' liabilities over time), the complexity and long term nature of financial products; and the lack of transferability.

128. The government's main objectives for the regulation of insurance are those applicable to short term insurance as well encouraging soundly governed institutions and ensuring timely and orderly resolution of distressed institutions. The objective of ensuring consumers are well informed also applies here, although unlike short term insurance the focus is on ensuring policyholders have information about the provider, as opposed to the product.

129. The most appropriate tools for the regulation of long term insurance include all of the regulatory tools identified above as applicable to short term insurance, as long term insurance poses the same risks to consumers in relation to fraud, and the requirements for merit regulation. In addition, the following tools are particularly relevant for long term insurance: merit/occupational regulation: (additional merit/occupational requirement can be used to ensure that people managing long term insurance companies are adequately qualified and appropriate, contributing to the institution's soundness), stricter corporate governance requirements and prudential regulation to ensure the institution's financial strength over time.

130. Prudential regulation is appropriate in relation to long term insurance due to the information asymmetries, lack of transferability, and complexity of product whose value depends on the insurer managing very long tail liabilities and remaining in a position of financial strength over long periods of time.

Problem Identification and Directions for Reform – Long Term Insurance

131. A number of the problems identified for short term insurance are also applicable for long term insurance. These include: requirements for entry are too low, lack of enforceable solvency standards, the insurance contracts reforms, and the variation in legal forms of insurers. Additional problems have been identified with insurance for the reasons outlined above and these are discussed in detail below.

Insufficient Measures to Ensure the Financial Soundness of Long Term Insurers

Problem Identified

132. An insurer that is in the business of long term insurance is managing, at any time, liabilities that may have arisen many years in the past, as well as having to make provision for liabilities that may arise many years in the future. Calculating what this requires is extremely complex and requires regular actuarial assessments of past, present and future liabilities. There is scope for making the wrong assessment as to how much an insurer will need today for its future liabilities. Thus, some countries require long term insurers to hold extra reserves to ensure they have adequate capital to meet future liabilities. New Zealand's regime does not currently impose any mandatory capital adequacy standards.

Direction for Reform

133. We will need to consider whether capital adequacy standards (which look to future liabilities) are necessary over and above solvency standards (which reflect the organisation's *current* financial position). This question is linked to the issue of whether a deposit is required, as a large deposit requirement may make it unnecessary for insurers to hold capital stocks over time. Thus, there will be further consideration of what tools are appropriate to ensure financial soundness over time of long term insurers. This might also involve the regulator receiving

business plans or other documents which outline how the insurer is going to maintain financial health over the medium term.

Insufficient Powers to Intervene if an Insurer Becomes Distressed

Problem Identified

134. In New Zealand's current regulatory regime there is not one agency with oversight of the whole insurance industry and sufficient powers to intervene when an insurer shows signs of distress. This causes some concern for stakeholders as, in a small market like New Zealand's, the collapse of one insurer affects the trust and confidence in the whole market. Thus there was generally support for greater regulation in this area.

Direction for Reform

135. In conjunction with the introduction of some form of prudential regulation will likely be greater powers to intervene where an insurer's financial soundness falls below certain levels (such as the solvency standards outlined above). This would involve establishing procedures for rehabilitating insurance companies wherever possible as well as orderly exit provisions. There are clear synergies here between crisis management and exit provisions for banks, NBDTIs and for insurance companies and officials will be looking to take advantage of these synergies where possible.

Insufficient Oversight of Insurers

Problem Identified

136. At present there is no one regulator for insurance providing oversight of the whole industry. This may be a cause of several of the other problems identified; the lack of enforceable solvency or capital adequacy standards and the lack of powers to intervene when insurers show signs of distress. In addition, there is no central regulator that receives information from insurers, monitors financial soundness and has the power to take action where standards are not met. Existing reporting requirements go to a variety of regulators including the Registrar of Friendly Societies and the Government Actuary. Both the Registrar and the Government Actuary have limited powers to intervene if an insurer shows signs of distress and the tools available to them in these situations are somewhat blunt in their operation.

While there are sufficient tools at present to intervene if there was a serious problem, there is less scope for rehabilitating an insurer and having phased interventions tailored to the insurer's position which assist an insurer to return to a financially healthy position.

Direction for Reform

137. As outlined above we consider that there will probably be a need to establish a central prudential regulator which has oversight of the whole insurance industry, however further consultation is necessary. The establishment of solvency and capital adequacy standards is predicated on their being a central regulator which has adequate powers to enforce the standards and intervene where necessary. The role of the central regulator would include receiving regular reporting, monitoring of adherence to mandatory solvency and/or capital adequacy standards, and the ability for the regulator to obtain more information where necessary. Other tools would include powers of intervention where an insurer gets into a position of distress and regular reporting by the regulator about standards across the insurance industry as a whole, and the general state of the industry.

138. The Law Commission's report on Life Insurance recommended that a prudential supervisor be established for life insurance to monitor the financial condition of insurers. The Commission suggested that the supervisor could be a government monitor or a private sector policyholder agent. While officials will consider both options a government monitor has the advantage of allowing for synergies between long term insurance and other areas of the finance markets, such as overlaps in any prudential regulation of defined benefit superannuation schemes and NBDTIs. A government supervisor is also likely to have greater independence than a private sector agent whose fees are paid by the insurer. In addition, given the broad powers that are likely to be needed for such a regulator it may be preferable, in public policy terms, to give these powers to a publicly accountable agency.

Out of Date Regulation

Problem Identified

139. New Zealand's life insurance law is extremely out of date and inappropriate for current conditions. The principal Act was enacted in 1908 and consequently still requires insurers to report on matters that are now irrelevant such as loans on the organisation's investments in Indian and colonial government securities. The 1908 Act regime is out of step with international best practice.

Direction for Reform

140. The reforms suggested above would both update the law and bring it more into line with international principles of best practice (the IAIS principles).

Other Issues

141. The issue of reinsurance also needs further consideration. Due to the size of the New Zealand insurance market New Zealand companies are price takers in the reinsurance market, and have little control over this area. In addition, there are no New Zealand based reinsurers, which means the regulation of reinsurers poses particular challenges that officials still need to consider.

142. There are also a number of tax issues in relation to insurance which warrant consideration by Treasury and Inland Revenue.

Defined Benefit Superannuation Schemes

Problem Identified

143. There are two main different types of superannuation: defined benefit schemes and defined contribution schemes. Defined benefit schemes guarantee a specific rate of return for a member when they retire. This is sometimes expressed as a percentage of their salary upon retirement. Defined benefit schemes have been declining and are the minority of schemes in number, at only 51 schemes out of approximately 700 schemes in total (although due to the way they are funded and the greater use of these schemes in the past they currently hold the majority of superannuation funds). Many of these schemes are closed to new members. It is expected that the decline in defined benefit schemes will continue as they are more expensive and complex to run than defined contribution schemes.

144. The funding of defined benefit schemes is complicated, as the benefits payable are dependent on the life expectancy of the members. Thus, as with long term life insurance,

ongoing actuarial assessments are required in order to assess the appropriate funding levels for the scheme. One of the main issues for defined benefits schemes is ensuring that there is enough money in the fund to pay the benefits that to member's when they fall due. Some stakeholders were concerned that there were not enforceable solvency standards for defined benefit schemes in New Zealand and under-funding of these schemes.

Direction for Reform

145. Defined benefit schemes raise very similar issues to long term insurance in terms of assessing whether there is enough money now to meet future liabilities, information asymmetries for the consumer, ongoing monitoring over time and enforcement of minimum solvency standards. In addition, many of the outcomes, objectives and appropriate regulatory tools are the same. Thus, officials are considering grouping defined benefit schemes with long term insurance for regulatory purposes. This would likely involve introducing some form of prudential regulation, which is necessitated due to the lengths of time over which money is held, the complexity involved in assessing the quantum of funds to hold, and in some cases a lack of transferability. The impact of the failure of a scheme is also relevant in considering whether prudential regulation is appropriate. The failure of a scheme would be potentially devastating for individuals, especially if it was close to or after retirement.

146. This approach was supported by stakeholder consultation, which confirmed that there was a need to regulate defined benefit schemes differently from defined contribution schemes due to the actuarial aspect and greater complexity of these schemes.

Defined Contribution Superannuation Schemes

Problem Identified

147. The other form of superannuation scheme is a defined contribution scheme. Under this type of scheme a member contributes into an account, where the funds contributed are set aside for that individual. Employers may also contribute to the member's individual account. The money is invested and the money and the returns are available to the individual when they retire. The operation of defined contribution schemes is far simpler as the money contributed is kept in an individual account for each member. There are no actuarial calculations necessary. The main difference is that, unlike a defined benefit scheme, an individual does not know what sum they will have when they retire as it will depend upon their contributions and the rate of return over time. Defined contribution schemes make up the majority of new superannuation schemes.

148. While it was common in the past for the terms of a defined contribution scheme to include a lock-in of the funds saved this is increasingly less common. This is mostly because there are no longer tax advantages to saving in a superannuation scheme. For example, employer schemes usually restrict access to any funds saved while a person is working for the employer, but the funds are released in total when the person leave the employer. This may be 2-3 years after joining the employer. In addition, while most employer schemes do not allow total withdrawal while still in employment some allow one "in service" withdrawal, and so there is some limited access to funds prior to leaving that employer. As a consequence, the lock in of superannuation funds can vary greatly. This is significant as much of the justification for greater regulation of superannuation investments as opposed to other investments is the fact that funds are locked in. The great diversity of conditions applicable to superannuation funds present a challenge as schemes without significant lock in feel that their compliance costs could be reduced, whereas there is also a need to retain measures that protect consumers where funds are held for long periods of time.

Direction for Reform

149. We need to do further work on the regulation of defined contribution superannuation schemes. One option is to regulate a defined contribution superannuation scheme in the same way as other CIS where they are essentially the same. This would reduce compliance costs for schemes and may be justified where the scheme does not lock funds in to any significant extent. However we need to do further work as to whether this approach would be feasible as it would involve differential treatment of superannuation schemes depending on their features. It may be at odds with preferential treatment currently provided under law for employer superannuation schemes as opposed to other types of employer assisted savings schemes. This treatment is provided to encourage retirement savings and consideration of any changes would need to take into account any impact on this objective. Whether a scheme locks in funds is an additional relevant factor as where there is lock-in and/or a lack of transferability greater regulatory protections than those imposed on CIS are required. We need to do more work on what those protections might be, how they would be imposed and on which schemes.

Areas for Reform that Are Applicable across the Financial Sector

150. There are some problems identified and directions for reform that are required across the non-bank financial sector. These include:

- Recommendation 23 of the FATF Recommendations requires that directors and senior management of financial institutions subject to the Core Principles (the banking, insurance and securities sectors) should be evaluated on the basis of "fit and proper" criteria, including those relating to expertise and integrity." New Zealand has signed up to the FATF Recommendations and will need to show that it complies with recommendation 23. As there are no eligibility standards for many of the providers of non-bank financial services we will need to consider how we can implement these standards, recognising that these standards may be different across different institutions depending on the risk;

- There are currently a number of different registration requirements across financial institutions, and in some cases no registration requirements. In order to comply with the FATF recommendations for money laundering and also in order that there is good data about financial institutions, consideration will need to be given to how we can improve registration and reporting requirements to a regulator/s. Any registration regime will need to be simple and impose the least costs possible on financial institutions.

- Currently any institutional failures that require, for public interest reasons, mechanisms over and above those provided in liquidation or receivership laws are addressed through the Corporations Investigation and Management Act. If decisions are made that NBDTIs and insurance companies are regulated by a prudential regulator then different exit mechanisms, that are similar to other institutions prudentially regulated like banks may need to be employed; and

- Currently New Zealand does not use consumer/investor compensation and fidelity funds. In exploring options to address some of the issues discussed above officials will consider this as one available option and will analyse similar regimes in overseas jurisdictions.

Coordination with Australia

151. As stated above any reforms in this area will be developed within the framework of the MOU on Business Law Coordination. This means that there will be a presumption in favour of coordination, except in situations where there are good reasons for the law to be different.

152. In relation to securities offerings and CIS, a mutual recognition regime for securities offerings is currently being developed between Australia and New Zealand. Any new disclosure regime will need to achieve outcomes consistent with the Australian regime in order for the mutual recognition regime to be continued, consultation with Australia undertaken and opportunities for alignment of the regimes maximised.

153. In relation to insurance, where many insurers are branches or subsidiaries of Australian parents, and other institutions which operate trans-Tasman opportunities for closer coordination of trans-Tasman arrangements will also be carefully considered and consulted on.

Financial Intermediaries Task Force

154. The Financial Intermediaries Task Force (FITF) is reporting back to you at the end of July on issues and options relating to financial intermediaries. Officials have seen an earlier draft of the proposals for reform and are broadly comfortable with the directions proposed. While we appreciate that there is a desire in the sector to see the reforms progress as fast as possible, there are overlaps in relation to some of the issues raised by the FITF and the regulation of the rest of the financial sector (for example issues of registration, dispute resolution are common to all areas of the financial sector).

155. Officials are proposing to put up a more detailed paper advising the government on the process forward for the Task Force's recommendations in the near future. Essentially we will be proposing that the government make in principle decisions on the recommendations to give a level of certainty to the market about the general direction the government proposes to take in relation to the recommendations. This will enable the market to start to prepare for the reforms. However, a considerable amount of more detailed work still needs to be done on the recommendations and careful consideration of the links to this review considered.

Risks

Communications

156. As the RFPP impacts on a number of people within the financial sector there has been significant interest in this review. Officials have placed considerable emphasis on ensuring that there is good stakeholder buy in and effective utilisation of the expertise and knowledge of the financial sector.

157. Officials have emphasised that the RFPP will be an open and consultative process with interested parties being involved at the problem identification stage, options development stage through advisory groups, discussion papers and focus groups and running regular media briefings so background to the RFPP is understood and consequential reporting is clear.

158. In this vein officials are seeking your agreement to this paper being put on the MED website as part of the RFPP. We would also like to discuss with you whether you would like to make any announcements as a result of the completion of Stage One of the review.

Progress from Here

159. If you agree to the recommendations in this report then officials will move on to Stage Two of the RFPP which will be the development of options for reform. These options for reform will be developed in conjunction with advisory groups. The advisory groups will be made up of people from key industry organisations, industry participants, professional organisations and government bodies. The participants in the advisory groups will not be expected to attend as representatives of their organisations, but as people with industry expertise and knowledge, to provide advice to us on options development, costs and benefits of various proposals and implementation. It is intended that draft options for reform will be developed by the end of 2005.

160. Stage Three of the RFPP will then involve the release a discussion paper on the draft options for reform. Consultation meetings will be held to discuss the paper and to seek feedback. This would occur in the first half of 2006.

161. Stage four will then involve using the feedback received to develop policy proposals in conjunction with the advisory groups. We expect to send the policy proposals to Cabinet in late 2006, with legislation planned to be passed in 2008.

Recommended Action

We recommend you:

162. **Note** that the problems identified in this report and the directions for reform are only preliminary views and that a considerable amount of further work and consultation needs to be undertaken;

163. **Note** that officials believe that the current regulation of the financial sector is not fundamentally flawed, but that some areas where improvements could be made to the regulatory framework;

164. **Note** that the following recommendations 165 to 168 are needed in order for officials to undertake further work that officials are doing on the design of New Zealand's current regulatory regimes;

165. **Agree** that a more formal licensing and prudential supervision regime for non-bank deposit taking institutions is appropriate, with officials exploring the appropriate level of detail;

agree/disagree

166. **Agree** that the prudential supervision of long term insurance (appropriately defined) be increased, and that officials consider whether that supervision be undertaken by a government regulator;

agree/disagree

167. **Agree** to officials undertaking work on whether there should be greater oversight by an official regulator of Trustee Corporations;

agree/disagree

168. **Agree** that officials develop a more comprehensive registration and monitoring framework for the financial sector in order to comply with the Financial Action Task Force obligations;

agree/disagree

169. **Agree** to officials doing further work on the other more general directions for reform outlined in this report;

agree/disagree

170. **Agree** to officials placing this paper on the Ministry of Economic Development website;

agree/disagree

171. **Note** that officials will provide a more detailed paper advising the government on the process forward, and links to this review, of the Financial Intermediaries Task Force recommendations following receipt of the final report; and

172. **Note** that the next stage of the review will be the development of options for reform, which be undertaken in conjunction with advisory groups make up of industry and government agencies.

Kirstie Hewlett
Manager, Business Law
Regulatory and Competition Policy Branch

Appendix 1: Current Regulatory Arrangements for Non-Bank Deposit Taking Institutions

Sector Characteristics

1. Non-Bank Deposit-taking institutions are small in comparison with the banking sector, accounting for approximately 4% of total financial system assets.

Finance Companies

2. Unlike building societies, friendly societies and credit unions, finance companies do not have entity-specific legislation. They are limited liability companies whose principal business is the provision of financial services. Finance companies are the most significant non-Bank deposit-taking institution in that they collectively own approximately 3% of total financial sector assets. (Assets of overseas owned finance companies total $5.5 billion while those of domestically-owned ones amount to $8 billion).

3. Finance companies fill the gaps in the credit market left by the big banks including household lending (where finance companies provide over a third of consumer credit), higher-risk property lending and vehicle, plant and machinery leasing. The majority of finance companies are engaged in traditional lending activities of motor vehicle, vendor and consumer finance (77% of total assets) with some engaging in property development and commercial finance (22.8% of total assets).[6] Finance companies engaged in property development and investment have grown fastest amongst finance companies. The Reserve Bank has cautioned that "rapid recent growth can be a marker for greater risk in a slowing economy".[7]

Building Societies

4. There are 15 building societies with assets totalling $2,698 million or 1.2% of registered banks' assets. The sector is dominated by 3 building societies (Southland BS, Southern Cross BS and Ashburton BS) which collected own 79% of total sector assets.

Credit Unions

5. There are 56 registered credit unions. Total assets of all credit unions, excluding the two associations, amounted to $533 million. Overall reserves were $34 million, which represents 6.4% of total assets.

PSIS Limited

6. PSIS is incorporated under the Companies Act 1993 and is registered under the Co-operative Companies Act 1996.

Regulatory Arrangements

7. Non-Bank deposit-taking institutions are subject to the following three broad categories of regulation:

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[6] *Financial Institutions Performance Survey 2005*. KPMG. 2005 at page 45.

[7] Reserve Bank *Financial Stability Report*, May 2005.

- Regulation relating to their funding, financial reporting and lending activities;
- Regulation that relates to how they are organised; and
- Crisis management arrangements.

Legislative Framework for Fund-Raising

8. Finance companies raise funds through offers of short-term notes and debentures. Building societies and credit unions all issue "shares" to members, and all these offerings are regulated as debt offerings.

9. Debt securities offerings are required to comply with the provisions of the Securities Act 1978 and Securities Regulations 1983, specifically Section 33 of the Act and Schedule 2 of the Regulations. Section 33(1) of the Securities Act requires debt securities an offer of debt securities to the public for subscription to be accompanied by an investment statement and a registered prospectus (Section 33(1)). The Securities Regulations set out details that are required to be included in the prospectus and investment statement. All prospectuses are required to be registered by the Registrar of Companies before any offer of securities can be made to the public. The Registrar is obliged to refuse registration if he is of the opinion that the prospectus contains a statement that is false or misleading on a material particular or omits any material particular. An appeal may be made to the Securities Commission against the Registrar's refusal to register a prospectus.

10. In addition, no offers of debt securities can be made unless the issuer has appointed a trustee and both the issuer and the trustee has executed a trust deed for that security. Finance companies, building societies and all credit unions have appointed trustee corporations. The trust deed is required to be registered by the Registrar. The Registrar has a legislative obligation (Section 46) to ensure that the trust deed complies with the Act before registration. In practice, trustee companies act as front-line regulators of debt issuers.

11. Regulation 24 (and Fifth Schedule) deems certain clauses to be contained in all trust deeds. These clauses relate to trustees' duties, right of trustees to obtain information and meetings. The trustees have the following broad statutory duties:

- To exercise reasonable diligence to ascertain whether or not any breach of the terms of the deed or of the terms of the offer of debt securities has occurred and, except where it is satisfied that the breach will not materially prejudice the security (if any) of the debt securities or the interests of the holders thereof, shall do all such things as it is empowered to do to cause any breach of those terms to be remedied.
- To exercise reasonable diligence to ascertain whether or not the assets of the borrowing group that are or may be available, whether by way of security or otherwise, are sufficient or likely to be sufficient to discharge the amounts of the debt securities as they become due.

Legislative Framework for Financial Reporting

12. The Financial Reporting Act 1993 (FRA) requires issuers of securities to the public to prepare and file financial statements that comply with generally accepted accounting practice and give a true and fair view of their activities.

13. All credit unions are subject to the FRA but only a few friendly societies are classified as "issuers of securities". The Registrar of Companies monitors compliance with obligations of the

Financial Reporting Act 1993, particularly in relation to financial reporting (i.e. that financial statements comply with generally accepting accounting practice and give a true and fair view of their activities).

Legislative Framework for Lending Activities

14. The Credit Contracts and Consumer Finance Act 2003 (CCCFA) governs consumer financing activities (and to a lesser extent business credit) with effect from 1 April 2005. The CCCFA applies principally to "consumer credit contracts". For a contract to be a consumer credit contract, the borrower must be a natural person who enters into the contract primarily for personal, domestic or household purposes. Consequently, the CCCFA would apply to finance companies and credit unions. This Act has just come into force and will not be considered by this paper.

Specific Regulatory Framework for Building Societies, Friendly Societies and Credit Unions

15. In addition to these statutes, building societies and credit unions are subject to additional regulation in their home statutes.

16. Building societies are governed by the Building Societies Act 1965 (BSA). The BSA was substantially amended in 1987 when most of the restrictions were removed to allow them to provide services and develop revenue sources similar to other borrowing and lending institutions. The BSA contains provisions relating a building society's establishment, registration, incorporation, functions, rules membership, management and administration and conversion to a company. MED administers the BSA. The role of the Registrar of Building Societies was considerably reduced in the 1987 amendment to the BSA. The Registrar performs the following functions for building societies:

- Registers and certifies changes of name, changes of rules;
- Provides publicly available documents for inspection at regional companies offices;
- Accepts the annual returns, financial statements and auditors reports from building societies and keeps these on file.

17. Credit unions are governed by the Friendly Societies and Credit Unions Act 1982 (FSCUA). Unlike the BSA, it contains more restrictions on the activities on a credit union. Some restrictions include controls on credit unions' powers to borrow and invest, a single customer deposit limit of $250,000 and the requirement to establish and maintain a reserve fund.

18. The Registrar of Friendly Societies and Credit Unions' powers under the FSCUA Include:

- Approves credit unions' rules (new and amendments);
- Registers Credit Unions with power to suspend registration for non-compliance with statutory obligations;
- Produces an annual report;
- Examines and registers documents filed including annual returns and financial statements, with particular emphasis in the review process on solvency of the organisations and auditors' reports;

- Hears disputes and complaints referred to it by the credit union or its members;
- Registrar can restrict credit unions' business (i.e. by prohibiting a credit union from borrowing money, accepting subscription and payment for shares, lending money, repaying share capital and accepting new members) if the credit union is not complying with requirements of the Securities Act; and
- Powers under Section 126 and 137 and may take steps to wind up a credit union.

Crisis Management Arrangements

19. The trustee corporations act as front-line supervisors to non-Bank deposit-taking institutions mainly by monitoring compliance with the provisions of the trust deed. Minor or short-term breaches are normally addressed by accepting the institution's plan to restore compliance. Material breaches attract Section 11 of the Corporation (Investigations and Management) Act 1989 (CIMA). Section 11 requires a trustee for holders of securities issued by a corporation to advise the Registrar of Companies if a corporation is believed to :

- Be insolvent or likely to become insolvent or is in serious financial difficulties; or
- Have breached, or is likely to breach, the terms of the trust deed or of the offer securities in a significant respect.

20. The Registrar may give advice, assistance or directions to a corporation deemed to be at risk. Under CIMA, the Securities Commission has the power to recommend to the Minister of Commerce that a corporation be placed in statutory management. It is a measure of last resort. It applies to a corporation:

- That may be operating fraudulently or recklessly, or
- Where it is desirable to preserve the interests of shareholders, creditors, beneficiaries or the public interest, and
- Where there is no other lawful way to adequately protect these interests.

Appendix 2: Current Regulatory Regime for Securities Offerings and Collective Investment Schemes

Securities Offerings

1. The Securities Act 1978 regulates the offer of securities to the public for subscription by requiring disclosure of information to potential investors.

Application of the Securities Act 1978

2. The term "security" is defined as any interest or right to participate in any capital, assets, earnings, royalties, or other property of any person. The definition specifically includes: equity securities; debt securities; units in a unit trust; interests in superannuation schemes; and life insurance policies. All other types of security come within the term "participatory securities." Participatory securities covers a wide-range of investment schemes, for example, contributory mortgages, group investment funds, interests in retirement villages, some forestry ventures, and real estate syndicates.

3. The Securities Act only applies to offers to members of the public. There is no definition of who is a member of the public. However, the Act does set out certain offers that do not constitute offers to the public, for example, offers to wholesale or professional investors. In addition, the Act exempts a number of entities and activities from the application of the Act, or certain parts of the Act (for example, contributory mortgage schemes), and vests in the Securities Commission a general power to grant exemptions from compliance with the Act.

4. Certain types of security are also subject to specific legislation. For example, unit trusts are governed by the Unit Trusts Act 1960, superannuation is governed by the Superannuation Schemes Act 1989, and life insurance is governed by the Life Insurance Act 1908. The regulatory regime of the Securities Act overlays these specific statutes.

Disclosure

5. An issuer can not make an offer to the public, unless the offer is made by way of a registered prospectus, an investment statement, or an authorised advertisement.

6. An issuer must provide an investment statement to an investor before that investor subscribes for the security. The investment statement is intended as a short form summary of the key information that would be needed by a prudent but non-expert investor in making a decision whether to invest in a securities offering. The Securities Regulations 1983 set out the details of the information that must appear in an investment statement in respect of all the types of security covered by the Act. The regulations require that information be presented in the form of answers to the list of questions contained in schedule 3D to the Securities Regulations, for example, "what sort of investment is this?" An investment statement must be consistent with the registered prospectus.

7. An issuer can only offer securities to the public if the issuer has registered a prospectus relating to the offering with the Registrar of Companies. However, the issuer does not need to distribute the prospectus to investors until it is requested. The prospectus is intended to be a more detailed document, and is directed more at describing the underlying financial status of the issuer of securities. A prospectus must contain detailed information about the securities, the offer, the issuer, the promoters, and the directors. The regulations set out different requirements for the various types of security covered by the Act. A prospectus can form part of

or be combined with an annual report or any other document required by any enactment. While it may refer to financial statements registered under the Financial Reporting Act 1993, rather than incorporating them, a copy of those statements must be distributed with the prospectus.

Financial Reporting Act 1993

8. Issuers of securities to the public must file financial statements with the Registrar. Directors are responsible for ensuring a company's financial statements comply with GAAP and give a true and fair view. The directors must also ensure financial statements are completed within 5 months of the balance date of the company.

9. The Financial Report Act contains particular provisions concerning the preparation and registration of additional financial statements by directors of issuers of units in unit trusts and of participatory securities in relevant schemes, and for trustees of superannuation schemes registered under the Superannuation Schemes Act 1989, where liabilities of the issuer, trustee or scheme are limited to a separate fund.

10. Additional requirements are imposed on auditors. Auditors must make reports and the Financial Reporting Act sets out the requirements for their content and scope. If there is non-compliance with the Act, the auditor must report to the Registrar, who in turn reports to the ASRB and the Securities Commission.

Liabilities

11. The Securities Act aims to hold issuers and directors of issuers accountable for the accuracy of the information disclosed and to prohibit and penalise negligent and intentional misleading of investors.

Avoidance and Repayment Provisions

12. Any allotment of a security made where there is no registered prospectus at the time of subscription will be void. Any subscriptions received must be repaid to subscribers. Certain allotments will be voidable at the option of the subscriber, including any allotment made where the subscriber did not receive an investment statement before subscription.

Suspension, Cancellation and Prohibition

13. The Securities Commission has the power to cancel or suspend an investment statement and prohibit an advertisement for securities that: is likely to deceive, mislead, or confuse; is inconsistent with the registered prospectus; or does not comply with the Act or Regulations. Unlike prospectuses, investment statements are not registered and therefore not checked by the Registrar of Companies before distribution. The onus is on the issuer to ensure the investment statement complies with all relevant requirements.

14. The Securities Commission may also suspend or cancel a prospectus that is false or misleading in a material particular, or that omits a material particular. Although prospectuses are registered by the Registrar of Companies, acceptance for registration does not guarantee that it complies with the Act and the regulations. Although in practice the Registrar may pre-check a prospectus before registration, this does not mean the Registrar has approved its contents. The Registrar will check only to see whether, on the face of it, the prospectus meets the requirements for registration.

Civil and Criminal Liability

15. The Securities Act imposes civil liability on directors and promoters for misstatements in prospectuses and advertisements (including investment statements). The Act imposes criminal liability on the issuer (if an individual) or on every director of the issuer for "untrue statements" in advertisements (including investment statements) and registered prospectuses. The Act also imposes criminal liability on the issuer, directors, promoters, and principal officers of the issuer for certain offerings, distributions, or allotments in contravention of the Act. The Act is not a code. Directors, promoters, and issuers are potentially liable at common law for the tort of deceit or for making a negligent statement. There is also potential criminal liability under the Crimes Act 1961.

16. Under the Financial Reporting Act 1993, issuers commit an offence if their company's financial statements are not completed and signed within the time limit prescribed by the Financial Reporting Act 1993, or if they fail to comply with reporting standards. Directors of issuers commit an offence if financial statements are not audited or not delivered to the Registrar. The maximum penalty for these offences is $100,000. Directors will have a defence if they show that they took all reasonable and proper steps to ensure compliance with the Act. Every person who makes a material false statement in a financial statement is liable to a term of imprisonment of up to 5 years, or a fine of up to $200,000.

Supervision

17. All issuers of debt securities and units in a unit trust must appoint a trustee in respect of the security and both the issuer and the trustee must sign and register a trust deed relating to the security.

18. All issuers of participatory securities must appoint a statutory supervisor in respect of the security and both the issuer and statutory supervisor must sign and register a deed of participation relating to the security.

19. The Securities Act sets out the requirements for trust deeds in relation to debt securities and deeds of participation in relation to participatory securities. The Unit Trusts Act 1960 sets out the requirements for trust deeds in relation to unit trusts.

20. Trustees and statutory supervisors monitor the issuer's compliance with the trust deed or deed of participation. Under the Securities Act, if the trustee or statutory supervisor believes that the issuer and any guarantor of the securities are unlikely to be able to pay all money owing in respect of the securities when it becomes due or that the provisions of the deed are no longer adequate to give proper protection to the security holders, then it may apply for a court order. The court may make various orders, including amending the provisions of the deed, and restricting the activities of the manager.

21. Under the Unit Trusts Act 1960, the trustee may apply to the court for an order to remove a manager from office. The manager may also apply to the Court for an order that the trustee be removed from office.

Collective Investment Schemes

What Are Collective Investment Schemes?

22. The term "collective investment scheme" ("CIS") is not commonly used in New Zealand. It is intended to include all investment schemes of a collective or contributory nature. These include: unit trusts; contributory mortgages; group investment funds; participatory schemes;

superannuation schemes (discussed at Appendix 3); and life insurance (with an investment element) (discussed at Appendix 3). CIS are "securities" for the purposes of the Securities Act.

23. A unit trust is a scheme or arrangement that holds a portfolio of securities on behalf of investors who hold “units” in the unit trust. A unit is an interest or right to participate in any capital, assets, earnings or other property of the unit trust. Units represent the value of the assets of the trust divided into units of equal value.

24. A group investment fund is a collective investment scheme that is set up by either the Public Trust under the Public Trust Act 2001 or by a trustee company under the Trustee Companies Act 1967. Group investment funds were originally intended as a vehicle for trustee companies to pool individual trust funds for investment purposes, which would otherwise have been prohibited by trust law. More recently, group investment funds have been offered to the public as unitised funds by commercial fund managers under the supervision of a trustee company. Interests in a group investment fund are participatory securities, as they do not fall into any other category of security.

25. “Participatory security” is the generic term under the Securities Act for any security that is not an equity or debt security, a unit in a unit trust, an interest in a superannuation scheme, or a life insurance policy. It includes interests in all other types of collective investment or contributory schemes that fall within the definition of “security” in the Securities Act 1978 (e.g. group investment funds), including schemes offered in New Zealand by overseas issuers. This negative definition covers a wide-range of investment schemes, interests in which are classified as participatory securities. For example, forestry ventures, racing syndicates, film syndicates, and retirement villages.

26. In general usage, the term “contributory mortgage” is applied to any mortgage where the loan funds have been supplied by two or more lenders. The Securities Act (Contributory Mortgage) Regulations 1988 and parts of the Securities Act 1978 and Securities Regulations 1983 apply where the loan funds have been raised as a result of solicitation from members of the public.

Nature of the Industry

27. The Reserve Bank’s Managed Funds Survey (last updated March 2005) estimates $54.155 billion in funds under management in New Zealand. The survey obtains an estimated 90 percent of the total funds under management and includes unit trusts, group investment funds, life insurance and superannuation (excluding New Zealand Super Fund). Of the total funds under management, $16.471b were in unit trusts and group investment funds, $8.360 billion in life insurance, $17.855 billion in superannuation schemes and $11.470 billion in other funds.

Regulation

28. The Securities Act and Securities Regulations regulate CIS in their capacity as issuers and regarding the disclosure documents provided to prospective and continuing investors. The exception is the contributory mortgage, which is exempted from the disclosure provisions under the Act (bar those relating to advertisements) and is instead regulated by the Securities Act (Contributory Mortgage) Regulations 1988.

29. This regulatory regime, in some cases, overlays the specific legislation which governs different CIS. For example, unit trusts are governed by the Unit Trusts Act 1960, superannuation is governed by the Superannuation Schemes Act 1989, life insurance is

governed by the Life Insurance Act 1908, some participatory schemes are governed by specific statutes, for example, retirement villages are governed by the Retirement Villages Act 2003.

30. CIS are not regulated consistently. For example:

- *Prudential supervision*: Contributory mortgage schemes have a lower level of prudential supervision than unit trusts and participatory schemes. Under the Unit Trusts Act 1960, every unit trust must have a trustee, a manager and a trust deed to which the trustee and manager are both parties. Under the Securities Act, every participatory scheme must have a statutory supervisor, a manager and a deed of participation to which the statutory supervisor and manager are both parties. By virtue of exemption from the application of parts of the Securities Act, a contributory mortgage scheme is not required to have either a trustee or a statutory supervisor nor a trust deed or deed of participation.

- *Offer of securities and disclosure*: All CIS, apart from contributory mortgages and employer sponsored superannuation schemes, are prohibited from making an offer of securities to the public unless that offer is made in, or accompanied by, an investment statement, a prospectus or an authorised advertisement. However, the content of disclosure will differ depending on the category of CIS.

- *Duties of issuer/trustee/statutory supervisor*: The general responsibilities, standards of performance and duties of CIS issuers, trustees and statutory supervisors have a variety of sources, with differing levels of protection for the investor: statute (Unit Trusts Act 1960, Trustee Act 1956, Trustee Companies Act 1967, legislation specific to the participatory scheme, e.g., the Retirement Villages Act 2003); the general principles of trust law; and the trust deed or deed of participation.

- *Reporting*: All CIS must prepare and register annual audited financial statements under the Financial Reporting Act 1993. However, contributory mortgage schemes have a lower level of reporting than other CIS.

Appendix 3: Existing Insurance Regulatory Regime

1. Insurance is vital to well working financial markets. Insurance enables people and businesses to manage, pool and mitigate financial risks efficiently, such as in the event of death, property loss/damage, or poor health, increasing their ability to weather adverse circumstances and promoting financial stability. In addition, the ability to obtain appropriate insurance in many cases allows individuals and businesses to undertake activities that they would not be able to do without the presence of insurance as a risk mitigator (for example, where money is able to be borrowed subject to the collateral being insured). This supports wealth accumulation and economic growth, particularly where businesses are able to expand and grow as a consequence of the stability provided by insurance.

Insurance Industry Description

2. The New Zealand insurance market is small with most providers being subsidiaries of foreign owned companies. The predominance of overseas insurers is a strong characteristic of the life and general insurance industries. Conversely, the health insurance market is primarily comprised of New Zealand providers.

3. As at 1 March 2005 there were 41 life insurance companies offering policies in New Zealand. Out of this total, all but one significant life insurer had an Australian parent company. Total gross written premiums for life insurance totalled, as at 31 March 2005, $1.153 billion.[8]

4. The total number of general and fire insurance companies, brokers and captive insurers in New Zealand, as at 1 March 2005, was 125. Total gross written premiums for the general and fire insurance industry, to September 2004, were $2.843 billion.[9]

5. Health insurance in New Zealand is dominated by domestic based insurers. There are a total of 15 health insurers but there is one primary provider – Southern Cross which holds 70% of the market. Earned premiums in health insurance sector, in the quarter ending 31 December 2004, were $160 million.[10] Most health insurers have a non-corporate form (i.e. friendly societies).

6. Both the ACC and EQC alter the New Zealand insurance market significantly by removing the long tail nature of much insurance business. In relation to international markets, this factor provides a unique insurance market for New Zealand and the need for a regulatory environment sensitive to these characteristics.

Regulatory Coverage

7. Registered insurance companies are regulated only if they offer insurance products to New Zealand consumers. Insurers registered as companies in New Zealand but solely offering products overseas do not fall under the regulatory framework for insurance providers.

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[8] See http://www.isi.org.nz/Qtrly%20Statistics/TraditionalRiskBus31.03.2005(Sum1).pdf last accessed 21 July 2005.

[9] See http://www.icnz.org.nz/media/review-2005/industry-statistics.htm last accessed 21 July 2005.

[10] Source: Health Funds Association of New Zealand.

Deposit Requirements

8. Every entity commencing business as an insurer after 26 August 1974 is required to lodge a deposit of $500,000 with the Public Trustee. The initial rationale behind lodging the deposit was to provide some level of consumer protection if the insurer were to become insolvent. This has evolved over time and today is seen more as an entry requirement for an insurer to the industry.

9. Insurers established prior to 26 August 1974 are able to deposit a lesser amount but this amount is dependent upon the insurance type being offered.

Financial Reporting

10. *Life Insurance Companies:* Life insurers are currently subject to two reporting regimes. The first regime is in accordance with the *Life Insurance Act 1908*. Life insurers are required to produce an annual, audited statement of its revenue account and financial position. An actuary must then investigate the financial position and provide an abstract of the resulting actuary's report. Within 9 months of the investigation, a statement of the company's life insurance and annuity business is required to be prepared. All of these are lodged with the Chief Executive of MED and passed on to the Government Actuary. The second regime is the *Financial Reporting Act 1993* (FRA) as, for the purposes of this Act, life insurers are issuers of securities. This involves full reporting (compliance with appropriate accounting standards), an audit of financial reports and lodgement for public viewing.

11. *General Insurance:* General insurers are also subject to two reporting regimes. Every insurer that has lodged a deposit must also prepare, at the close of each financial year, a set of audited financial statements that are lodged with the Chief Executive of MED and passed on to the Government Actuary. Schedule 2 of the Insurance Companies' Deposits Act 1953 specifies the information that must be provided.

12. *General Insurance (corporate form):* Insurers that are incorporated companies must also comply with the FRA by preparing audited financial reports (level of reporting detail depends on size). There is no public lodgement of these accounts.

13. *General Insurance (non-corporate form):* General insurers that do not have a company structure (i.e. an incorporated society or friendly society) are subject to reporting requirements under specific legislation dealing with their corporate form, but not the FRA. This legislation, such as the Friendly Societies and Credit Unions Act 1982, commonly impose obligations to prepare annual, audited financial accounts.

Disclosure

14. The primary disclosure obligations in the insurance industry arise under the *Securities Act 1978*. Currently only life insurance products with an investment element are subject to these disclosure obligations, which are principally the investment statement and prospectus regime. All other products (risk only policies) do not fall under this regime. The Law Commission has recommended that disclosure requirements under the *Securities Act 1978* be expanded to all insurance products.

15. Insurers subject to ratings requirements are subject to disclosure requirements surrounding the rating they receive. This is discussed below.

Ratings Requirements

16. Disaster and general insurers offering policies in New Zealand are required to have a current rating from one of the approved agencies – AM Best, Standard & Poor's and Fitch Ratings. Ratings must be registered with the Registrar, within five days of receipt, and disclosed to consumers before entering into or renewing a contract of insurance. Any downgrade must also be disclosed within 10 days of issue. Life insurers are exempt from the ratings regime as are insurers who are neither disaster nor general insurers that elect, in writing to the registrar, not to be rated under the Act (for example health insurers). Insurers electing not to be rated must disclose this material fact to the consumer.

17. Failure to comply with the Act involves enforcement of monetary fines on companies and directors. Consumers are also able to cancel insurance coverage if a current rating is not disclosed when it should be.

Self Regulation

18. Self regulation is an important element of the regulatory regime in New Zealand. The Insurance Council has developed its own solvency standards and requires mandatory adoption by its members (approximately 90% of the industry). This provides a real protection for policyholder in the area of general insurance. However there is a wide differential in industry standards for example, the Health Funds Association of New Zealand Inc have been working towards establishing solvency standards for some time. These, when finalised, will not form a mandatory obligation for its members.

19. The Insurance and Savings Ombudsman scheme has proven a successful tool for the regulation of the insurance industry. Despite criticism of its restricted ambit, it has provided a free redress mechanism for consumers dissatisfied with the performance of their insurer in fulfilling its obligations.