

OFFICE OF THE MINISTER
OF COMMERCE

The Chair
CABINET ECONOMIC DEVELOPMENT COMMITTEE

CREDIT UNION REVIEW

PROPOSAL

- 1 The purpose of this paper is to seek approval for legislative changes to the Friendly Societies and Credit Unions Act 1982.

EXECUTIVE SUMMARY

- 2 In November 2003, the New Zealand Association of Credit Unions (“**NZACU**”) and Manchester Unity (“**MU**”), which jointly represent approximately 90 percent of New Zealand credit unions, reached agreement on proposals to reform the Friendly Societies and Credit Unions Act 1982 (the “**Act**”). Their proposals are embodied in a *Statement of Agreed Principles* (attached as Annex A) and fall under the following broad headings:
 - Qualifications for Admission to Membership;
 - Trust Deed Duplication;
 - Capital; and
 - Legal personality and validity of action.
- 3 In my earlier submission to the Cabinet Economic Development Committee (“**EDC**”), I highlighted the potential negative impact that some of the proposals may have on investor protection, competitive neutrality, sound governance and risk management. Consequently, I recommended against accepting those proposals. Bearing in mind the long gestation of this review and the value the government places on credit unions’ contribution to the financial sector, on 25 August 2004, Cabinet invited the Associate Minister of Finance (Hon David Cunliffe) and me to discuss the proposals with officials, with a view to accommodating the credit unions’ proposals as far as possible without exposing investors to significant unmanageable risks.
- 4 On the basis of that discussion, I recommend that Cabinet approves the following proposals:
 - a remove the requirement to specify service charges in credit unions’ rules, provided a mechanism for levying charges is still spelt out in the rules;

- b allow each credit union to determine the minimum deposit holding of each member, while retaining the statutory limit as a default provision;
 - c allow credit union associations to extend new services to credit unions without Ministerial approval;
 - d allow each credit union to determine its own common bond as a basis of membership, provided that the Registrar of Friendly Societies and Credit Unions (the “**Registrar**”) is satisfied that the bond is an objectively verifiable characteristic and is specified in the credit unions’ rules; and
 - e allow charities and incorporated societies affiliated with the common bond to become credit union members.
- 5 I also recommend that Cabinet agrees in principle that credit unions and their trustee supervisors should be able to vary certain statutory restrictions on borrowing, investment and capital reserves. However, further analysis of this proposal will be required to ensure that permitting any variation will not expose investors to increased risk.
- 6 I remain concerned that the proposal to allow credit unions to issue capital instruments that are non-withdrawable, transferable between members and ranked ahead of ordinary shares creates significant risks that cannot readily be mitigated. Nonetheless, I support credit unions’ objective of finding alternative ways of achieving their capital reserve requirements and consider that other options should be investigated and explored with the industry.
- 7 I also remain concerned that the proposal to incorporate credit union management committees as a board would undermine the mutuality of credit unions and create additional governance risks that may impact negatively on members. However, I note that incorporation of the credit union as a whole remains a viable option under a modified version of the Companies Act 1993.
- 8 In addition to the proposals put forward by the credit unions, I also recommend that Cabinet agree in principle to introduce a conversion mechanism for those credit unions that wish to convert to an alternative governance regime such as the Companies Act. While the industry has expressed divergent views on this matter, the current alternative of passing a special purpose Act each time a credit union wants to convert is not an appropriate use of parliamentary time.
- 9 The paper does not consider whether, in light of the recommended changes, credit unions should continue to enjoy a tax exemption. No decisions are being made on this issue at this stage.
- 10 I anticipate that NZACU may be disappointed that its proposals have not been accepted in entirety. However, the package I have outlined will address most of the industry’s concerns. It will also provide a mandate for further work with the industry to refine or explore alternatives to the few proposals that, in their current form, would introduce excessive governance and/or prudential risks.

Industry Background

- 11 Credit unions are regulated primarily by the Act. Since 2001, credit unions have also had to comply with the Securities Act 1978 requirement to enter into a trust deed with a trustee company, which acts as a front-line supervisor. The Ministry of Economic Development (“MED”) intends to consider the need for the Securities Commission to have additional oversight of trustee companies, as part of its review of the Securities Act, which is due to commence in mid 2005. (trustee companies supervise other participants in the financial sector so the issue of additional oversight needs to be considered in that wider context).
- 12 Traditionally, credit unions have certain features that, in combination, set them apart from other deposit taking institutions. They are member-owned cooperatives established to provide savings and loans within the membership. Each member has one vote regardless of the amount of a member’s deposits. They do not issue capital stock and, instead, build capital by retaining earnings. They may only serve customers that meet a common bond requirement (such as residing or working in a particular locality).
- 13 Over the last decade, the number of credit unions has fallen from 160 to around 57, including the two associations of credit unions: MU and the NZACU. The decline in numbers has come from amalgamations and closures driven by increased compliance and operating costs and, in some cases, management failings and misconduct. At the same time, the number of credit union members has remained fairly stable at around 180,000 to 190,000 and total assets have grown from around \$350 million to around \$490 million. This is very small by financial sector standards. The major trading banks each have assets in the tens of billions of dollars. The largest building society, Southland Building Society, has assets of \$1.5 billion (three times the entire credit union movement). Currently, credit unions service about 0.3 percent of the household loan market.

History of Review

- 14 The impetus for the review has come primarily from NZACU, which believes that the Act is outdated and unduly restrictive. MU has, until recently, maintained that reforms sought by NZACU were unnecessary.
- 15 The review dates back to around 1995 when The Treasury consulted on the possibility of adopting a two-tier regime under which credit unions with more than \$5 million assets would incorporate under the Companies Act 1993. The proposal met with objections from the industry and was not pursued.
- 16 In 1998, the Ministers of Revenue and Commerce reinitiated the review, focusing on whether: it was necessary to have specific legislation to recognise credit unions; the appropriate legal form for credit unions was that of a company under the Companies Act 1993; and credit unions should continue to enjoy a tax exemption.
- 17 Submitters were unanimously of the view that specific legislation for credit unions should be retained in order to protect their special character. While there was general agreement that the Act had a number of problems, there was wide

divergence as to their cause and extent and the review was suspended. At this stage, the credit union sector was advised that broad ranging consensus was a prerequisite for reform.

- 18 In 2000, the government decided to defer a review of credit unions' tax status. No decisions are being made on the tax status of credit unions at this stage.
- 19 In December 2002, MED released another public discussion document, focusing primarily on proposals by NZACU to amend four areas of the Act: membership qualifications, legal status and validity of action, capital, and trust deed duplication. MED also sought feedback on the impact of those proposals on competitive neutrality in the financial sector and the need for a "conversion mechanism" to enable credit unions to choose to migrate to alternative governance regimes such as the Companies Act, if they would better suit members' needs and goals.
- 20 MU continued to object to most of NZACU's proposals. Subsequently, at the request of the former Minister of Commerce, Hon. Lianne Dalziel, the two associations developed a *Statement of Agreed Principles*. This document was submitted to the Minister in November 2003. To a large extent, it incorporates the NZACU proposals that were consulted on in 2002. One key feature of the proposals is that they are generally permissive rather than prescriptive, so individual credit unions would be able to weigh up costs and benefits in deciding whether to implement them.

Review of the Banking and Insurance Sector

- 21 The Treasury, the Reserve Bank and MED are in the early stages of scoping a review of aspects of the regulatory framework for the banking and insurance sector. The review will include consideration of a range of issues including whether the existing regulatory arrangements for banks and life insurance companies are appropriate and whether there is scope of greater trans-Tasman coordination or harmonisation.
- 22 Although the review may raise issues or identify principles and objectives that are applicable to all deposit takers, officials do not envisage that it will address small deposit takers such as credit unions unless there is a decision to create a single prudential regulator for all financial institutions or the review identifies competition or competitive neutrality problems that warrant action. Should the situation change, officials consider that the statutory amendments recommended in this paper would be unlikely to conflict with or foreclose any possible outcomes from the financial sector review.

The Joint NZACU-MU Proposals to Amend the Act

- 23 The intention of the *Statement of Agreed Principles* is that the proposals it contains should form the basis of amendments to the Act. NZACU considers the proposals to be minor and has, on occasion, expressed an assumption that agreement within the industry means that the proposals would be adopted automatically by the government. While my predecessor had clarified that this is not the case, the government wishes to consider the proposals in good faith, with

a view to accommodating the industry's objectives as far as possible. Where it is not feasible to adopt a particular proposal, I recommend that officials should work with the sector to identify lower risk alternatives that go as far as possible towards meeting the credit unions' underlying objectives.

- 24 In analysing the current proposals, primary consideration has been given to the following objectives: investor protection; competitive neutrality; sound governance and risk management; contestability of the sector; ease of exit; facilitating adaptation of changing conditions; compliance costs; and regulation administration costs.

Membership Qualifications

Current requirements

- 25 The Act limits membership of credit unions to people who meet a membership qualification rule that gives rise to a common bond – i.e. a common employer, residing or working in a particular locality, or membership of another association such as a trade union. The Registrar of Friendly Societies and Credit Unions (the “**Registrar**”) can also approve an admixture of those qualifications or any other qualification that gives rise to a common bond.

Joint proposal

- 26 The joint proposal suggests that credit unions should be free to determine their own membership qualification. Instead of approving the qualification, the Registrar should merely confirm that it is objectively verifiable (e.g. based on residence in a defined area rather than support for credit unions' values) and is sufficiently identified in each credit unions rules. The proposal also suggests that charities and incorporated societies should be able to join a credit union if they share an affiliation with the common bond of that credit union.

Comment

- 27 The benefits of this proposal are that it would facilitate credit unions' growth and make cooperative, lower cost savings and loan facilities available to more people. It would also overcome some of the problems that credit unions have encountered when they wanted to merge or move into rural areas that are not well served by any financial institutions. The Registrar reports that several mergers have taken place in recent years. Generally, these have been driven by the need to achieve the economies of scale needed to meet the costs of new technologies and the introduction of Securities Act trust deeds. A few credit unions have closed because the Registrar was not satisfied that proposed mergers would give rise to a common bond. The limits of geographical boundaries, have also, in some cases, prevented existing credit unions from extending their services to underserved communities that could not support their own credit union.
- 28 The extension of services to charities and incorporated societies would also facilitate growth by opening up a new market, albeit, one that shares the credit

unions' "not for profit" philosophy. It would give those organisations an additional choice of financial service provider.

- 29 The potential for growth could raise issues about competitive neutrality, which may need to be considered in the context of the proposed tax review. The proposal also alters some of the fundamental characteristics that define credit unions as different from other financial service providers. Credit unions will be able to adopt any objectively verifiable membership criteria they wish, provided it is not inconsistent with the Human Rights Act. Technically, a credit union could open its membership to all people living in New Zealand. However, I consider that the most significant issue for the purposes of the current review is the possibility that credit unions' current governance, supervision and risk management structures are not strong enough to support considerable growth in membership, should it occur as a result of relaxing the bond requirement.
- 30 Early architects of the credit union movement regarded the common bond as a risk management tool, ensuring that those making lending decisions would know more about applicants and borrowers would be reluctant to default. However, the efficacy of the common bond as a risk management tool nowadays is not so certain. While it may hold true for very small credit unions, it is unlikely to work for large credit unions, particularly those whose membership criterion is based on locality, which may cover a whole region or a large city. So for many credit unions, it is already unlikely that the common bond requirement serves its original purpose.
- 31 The lack of investor protection afforded by the common bond and other features of credit unions' governance structure has contributed to a number of instances where credit unions have ended up in financial difficulty, to the detriment of their members. The introduction of independent trustee supervisors in 2001 appears to have had a marked, positive effect on credit unions' stability. However, it is possible that the buoyant economy is also assisting credit unions in maintaining adequate liquidity, so the effectiveness of current management processes and regulatory disciplines is not likely to be fully tested until a contraction in the economy places pressures on credit unions. Significant growth means that more individuals and organisations may be adversely affected by the failure of an individual credit union and the consequent economic impact on the community concerned may be noticeably higher.
- 32 Any risks that may be exposed by relaxation of the common bond can be monitored and, if necessary addressed on three fronts. The first is the role trustee supervisors, which, as already mentioned appears to have improved credit union management processes considerably. Secondly, as previously noted, MED will be able to consider the need for stronger government oversight of the trustee supervisors, during its review of the Securities Act. Thirdly, credit unions' governance provisions (such as the duties of trustees and committees, disclosure obligations, and the ability of creditors to petition for a wind-up) can be reviewed to ensure that they are as robust as those applicable to building societies and finance companies.
- 33 It should also be noted that, if, during the course of the review of the banking and insurance sector in the government decides to introduce a new regulatory body

for insurers, it may consider extending that body to credit unions and other small financial institutions.

- 34 On balance, I believe that the risks associated with the proposal can be monitored and managed. They are therefore outweighed by the benefits of facilitating the growth of credit unions so I propose that credit unions be allowed to set their own objective common bonds and to offer services to charities and incorporated societies that meet their common bond. I also propose that consideration be given to the need to strengthen credit unions governance provisions.

Trust Deed Duplication

Current requirements

- 35 The Act prescribes the following controls on credit union borrowing, investing reserve ratios, and fee-setting:
- Credit unions may borrow - for short terms and for restricted amounts – only from other credit unions, friendly societies or associations of credit unions or by way of an overdraft from a registered bank.
 - Credit unions cannot hold land or buildings for investment purposes. Surplus funds may be invested in accordance with the investment provisions of the Trustee Act 1956, or with an association of credit unions. Otherwise they must be kept on current account with a bank. Credit unions may make temporary loans to each other with the prior approval of the Registrar.
 - A portion of each credit unions profits must be retained as capital to offset any losses on loans to members. Credit unions with at least four years operating experience and total assets of more than \$500,000 must maintain a general reserve of at least 5 percent of those assets. Otherwise, credit unions generally have to have reserves of 10 percent or be building their reserves to that level by setting aside a certain percentage of gross earnings each year.
 - Service fees must be set out in a credit unions rules. These rules can only be amended by special resolution of all the members, which means that fee changes can only be made if 75 percent of eligible voters vote in favour of the change.

Joint proposal

- 36 The joint proposal suggests that the restrictions on investment, borrowing and reserves should not apply if these matters are addressed to a no lesser standard in a credit unions Securities Act trust deed. The joint proposal also suggests that credit unions should be allowed to adjust fees as permitted by their rules.

Comment

- 37 I agree that the requirement to amend fees by special resolution is impractical and prevents credit unions from responding to business needs as they arise. Credit unions should be permitted to determine their own rules for fee setting. This would enable credit unions to retain the current voting rule, if they wish to do so, or to authorise the management committee to set fees from time to time.
- 38 NZACU has taken the view that the restrictions on investing, borrowing and reserves conflict with or duplicate the trust deeds. In practice, there is no real conflict. The law does not prevent a trustee from imposing a higher standard than the Act, and in fact the trust deeds entered into by credit unions generally do contain requirements that mirror or are stricter than the Act. However, it should be noted that neither the Act nor the Securities Act requires trust deeds to address these matters. Any restrictions imposed by a trust deed are voluntary commitments agreed between each credit union and its trustee supervisors.
- 39 Provided the law is amended to make it clear that trust deeds must address these matters, I agree that, in principle, prudential requirements in the Act could be replaced by trust deed provisions. However, it will be necessary to carefully consider whether (a) the current statutory requirements are useful, (b) whether the Act should provide a minimum standard or whether credit unions and their trustee supervisors should have scope to negotiate lower standards and (c) whether any other safeguards, such as a requirement to report variations to the Registrar, are desirable. Any decision to vary any requirement in the Act must ensure that existing governance and prudential requirements are not diluted inappropriately and unacceptable risks are not introduced. In the case of investment powers, for example, allowing the trust deeds to waive the investment provisions of the Trustee Act 1956 could result in a lower standard of care with consequent risks to depositors. In the case of borrowing restrictions, safeguards may be needed to ensure that managers do not overexpose the credit union through unsound borrowing decisions.
- 40 It is also necessary to consider the implication of enabling credit unions to avoid the current statutory restriction on investing in building and land. Credit unions' primary purpose is to provide low cost savings and loans services to their members. To support that purpose, the World Council of Credit Unions ("**WOCCU**") recommends that 70 to 80 percent of a credit unions assets should be invested in loans to members and a reasonable percentage should be kept in liquid investments to meet members' withdrawal and loan demands. Investment in less liquid assets should be strictly limited. Permitting investment in property could lead to reductions in liquidity and in the amount of money available for loans to members. Consequently, making the current statutory restrictions optional may not be appropriate. However, at least for some credit unions, it may be possible to permit a limited amount of investment in property without undermining the fundamental purpose of credit unions or creating liquidity risks.
- 41 In view of the fact that the trust deed regime seems to be working well as a *de facto* front-line supervisor, I propose that the government agree in principle to allow credit unions to vary statutory borrowing, investment and capital reserve

requirements, subject to further analysis and confirmation that this would not expose members to unjustifiable risks.

Capital

Current requirements

- 42 Credit unions can only raise money by accepting deposits, charging interest on loans and investing surpluses. Although the Act says members' deposits are shares, technically, and for the purposes of the Securities Act, they are debt securities because they are withdrawable on demand. Each member must have a minimum of \$10 in "shares", which are in fact deposits, as a condition of membership.

Joint proposal

- 43 The joint proposal suggests that credit unions should be allowed to offer equity shares to their members. These would be non-withdrawable, transferable between members and, at the option of the credit union, preferred over deposits in a winding up of a credit union. Credit unions should also be able to determine their own minimum "shareholding" (i.e. deposit) requirements.

Comment

- 44 I understand that the objective of gaining authority to issue shares is to create a source of funding that would make it easier for credit unions to meet their capital reserve requirements. Although the Act requires established credit unions to maintain a 5 percent reserve, under their trust deeds, most credit unions have a reserve requirement of 7.5 to 10 percent. The reserve must be built from profits on loans and investments so it is difficult to maintain in rapid growth periods.
- 45 While I generally accept that credit unions would benefit from measures that enhance their financial stability, the proposal raises significant concerns. The idea that such investments should be recognised as capital yet preferred over the "ordinary" shares of the credit union is problematic. Generally, capital serves as a buffer to absorb losses and, in the case of deposit taking institutions, to protect depositors. However, the preference could mean that the shares would rank ahead of deposits in a winding up. This would negate the purpose of the capital reserve. It could even increase the incentives for depositors to withdraw their funds if they have fears over a credit unions soundness, potentially destabilising the credit union.
- 46 Trading such shares outside a credit unions membership circle would be inconsistent with the cooperative principles and fundamental purpose of credit unions. If, on the other hand, trading is limited to within the circle of membership, it seems unlikely that many credit unions would provide a viable market. Investors may find that they need to wait for some time to sell their shares. In a worst case scenario, they may be unable to divest their shareholdings except in a winding up of the credit union - an event that normally stems from financial failure and sometimes results in a loss to members. While the risk can be mitigated by adequate disclosure, I am concerned that many credit union

members will be relatively unsophisticated investors who may not fully appreciate the risks of this type of investment.

- 47 For these reasons, I do not recommend this proposal. However, I am sympathetic to credit unions' desire to fund growth by finding alternative sources of capital. I therefore recommend that officials work with the industry to identify lower risk alternatives that may help credit unions achieve this objective to the extent possible.
- 48 I agree that credit unions should be able to determine their own requirements for the minimum amount that each member must deposit. As a safeguard, I recommend that credit unions be required to specify the minimum in their rules. Any change would therefore need to be approved by special resolution. This would mitigate the risk that the management committee could unilaterally raise deposit requirements to a level that excludes low-income members.

Legal Status and Validity of Action

Current requirements

- 49 Credit unions do not have full legal personality. The Act requires credit union assets to vest in trustees who hold the assets for the benefit of members and have specific duties relating to investing surplus funds. On a day to day basis, credit unions are administered by a committee of management that is analogous to a company board of directors.

Joint proposal

- 50 The joint proposal suggests that, just as trustees of charitable trusts can incorporate as a board under the Charitable Trusts Act 1957, the management committee of a credit union should be able to incorporate as a board. It would therefore be able to hold assets and represent the credit union and the role of trustees would be obsolete.

Comment

- 51 Over the years, a variety of reasons for this proposal have been put forward. At one stage NZACU proposed the development of its own regulatory body and said that incorporation and removal of the trustees would be necessary to enable the regulator to take control of credit unions in a crisis situation. More recently, NZACU has said that incorporation of a management board would remove any uncertainty or conflict between the trustees and management committee roles. The industry has also said incorporation would resolve any uncertainty about contracts with credit unions. NZACU favours incorporation of the committee rather than the credit union as a whole, on the basis that it retains the mutual nature of credit unions.
- 52 Officials advise that incorporating the management committee as a board would in fact have the effect of undoing the mutuality of credit unions by legally separating the board from the rest of the credit union. The proposal would also introduce uncertainties about the relationship between the committee and the

credit union as a whole. Unlike the trustees of charitable trust boards, credit union management committees serve a clearly identifiable group of “owners” who are not involved in the day to day running of the business. Like the shareholders of any company, the members need a governance regime that clearly defines their relationship with and rights in regard to the organisation’s management. Legally separating the management from the members would therefore weaken credit unions governance structure significantly. For these reasons I do not recommend incorporation as a board.

- 53 I note, however, that the possibility of incorporating credit unions was thoroughly researched during the 1998 review, when officials recommended that credit unions should be able to incorporate under a modified version of the Companies Act 1993. This option continues to be feasible should the industry wish to reconsider it.

Current requirements

- 54 The Act also controls the activities of associations of credit unions by requiring them to seek the approval of the responsible minister when they wish to provide certain services specified in the Act.

Joint proposal

- 55 The joint proposal suggests that each association should be able to decide what services it can offer, in accordance with its rules, and that associations should be able to provide services to non-members as long as they provide services primarily to credit unions.

Comment

- 56 While I believe the Act should continue to specify the kinds of services that credit union associations can provide, I see no need to continue requiring them to obtain ministerial approval before offering those services. I recommend that this provision be repealed.
- 57 I note that an earlier version of this paper considered the possibility of permitting the associations to provide services to non-members. Officials advise me that this was based on a misinterpretation of the joint proposals so it not necessary to make any decision on the matter.

Other issues

- 58 [...]
- 59 [...]redit unions generally agree with the joint proposals relating to the common bond, the removal of limitations on investment and borrowing, and the ability to offer equity shares. [...]
- 60 At present, one credit union has expressed the wish to convert from the credit union regime to an alternative regime. Because the Act does not provide a framework for conversion, a special Act of Parliament is needed to allow a credit union to move to a different regime without having to dissolve and start again.

This is time-consuming and costly for the credit union concerned as well as for the government.

- 61 I am aware that NZACU opposes the introduction of a conversion mechanism because of concerns that conversion could be misused to allow reserves to be distributed. The industry may also be concerned about the potential “loss” of members. However, I believe that conversion is a matter for the members of each credit union to decide, not for the Association; and valuable House time should not be used for such matters. In the interests of efficiency, I recommend that ‘in-principle’ approval be given for the Act to be amended to facilitate conversion to alternative regimes such as the Companies Act and/or the Building Societies Act.
- 62 I note that such conversions give rise to some tax issues. In the past, these have been resolved by the special legislation enacted for the credit union concerned. Officials will need to develop the proposal further to address these issues as well as determining which regime or regimes credit unions should be able to convert to.
- 63 [...]
- 64 [...]
- 65 [...]On the whole, the introduction of trust deeds has significantly improved credit unions’ standard of governance. This has undoubtedly come at a price for credit unions but I believe it has provided a much safer system for the individuals who save with them. Other non bank deposit taking institutions are subject to the same regime and I am not convinced that it should be altered because it restricts credit unions’ growth or trustee fees are charged on a commercial basis.
- 66 In addition, I do not consider it feasible to create a special government unit solely for supervising credit unions [...]. The industry is too small to justify its own supervisory unit and it would probably be beyond the industry’s means to meet the cost of it.
- 67 As previously noted, questions relating to the efficacy of the trustee supervisor regime can be addressed in the proposed review of the Securities Act, while the broader issue of the benefits of a government regulator may also be considered in the context of the review of the banking and insurance sector.

CONSULTATION

- 68 The Reserve Bank of New Zealand, the Treasury, the Inland Revenue Department, the Securities Commission, and the Registrar of Credit Unions were consulted about the proposals discussed in this paper.
- 69 The issues considered by the 2002 discussion document were essentially similar to the proposals outlined in this paper. NZACU members generally supported changes to the common bond, allowing share offers and variation of statutory restrictions on borrowing, investment and capital reserves, allowing associations to offer new services without ministerial approval, and allowing incorporation.

Most NZACU members did not support the introduction of a conversion mechanism. As previously noted, Manchester Unity members generally opposed all of the proposed changes until the two associations reached agreement as outlined in their *Statement of Agreed Principles*.

- 70 The New Zealand Bankers' Association, the Financial Services Federation, did not support any reforms unless credit unions tax exemption is reviewed. The Law Society and the Investment Savings and Insurance Association noted that if credit unions are allowed to expand beyond their traditional and unique community purpose, the tax exemption would give them an unfair advantage. The Law Society also objected to the relaxation of the common bond requirement unless credit unions are placed under the same governance and supervision standards as other deposit-takers. While agreeing that there may be room for modernising restrictions on borrowing, investment and reserves, the Law Society supported the retention of statutory "minimum" standards.

FISCAL IMPLICATIONS

- 71 The proposals recommended in this paper have no fiscal implications.

HUMAN RIGHTS

- 72 The proposals recommended in this paper have no human rights implications.

LEGISLATIVE IMPLICATIONS

- 73 Amendment to the Friendly Societies and Credit Unions Act would be necessary to give effect to these proposals.

REGULATORY IMPACT AND COMPLIANCE COST STATEMENT

- 74 A Regulatory Impact Statement has been prepared in respect of the following recommendations:
- a. to modify the statutory requirement so that credit unions are able to determine their membership qualifications;
 - b. to remove the statutory requirements on borrowing, investment and reserves provided the trust deed provisions on these matters would require credit unions to adhere to a standard that is not lower than those currently set out in the Act;
 - c. to permit credit unions to raise capital by issuing instruments which will have features in addition to the existing share capital provided these instruments do not expose investors to excessive risks; and
 - d. to provide a mechanism for facilitating credit unions' conversion to alternative governance regimes.
- 75 The other recommendations are of a minor or machinery nature that do not substantially alter existing statutory arrangements.

76 A business compliance cost statement was not required.

PUBLICITY

77 Once Cabinet has reached a decision on the proposals outlined in this paper, I will inform MU and NZACU of Cabinet's decision and issue a press statement announcing the government's policies to the general public. The Hon Dr Michael Cullen is also speaking at NZACU's annual conference, in September, and may wish to address this topic.

RECOMMENDATIONS

78 It is recommended that the Committee:

- 1 **Note** that MU and NZACU have developed a joint proposal on four aspects of the Friendly Societies and Credit Unions Act (the "**Act**") that they wish to see reformed: membership qualifications, legal status and validity of action, capital-raising, and trust deed "duplications".
- 2 **Note** that while some of those proposals are significant and give rise to governance and competitive neutrality issues, the government has considered them in good faith, with a view to accommodating the industry as far as possible without introducing unacceptable risks.
- 3 **Note** that the following amendments would address the majority of MU and NZACU's concerns, without introducing excessive risks.
- 4 **Agree** to the following changes to the Act:
 - 4.1 the statutory requirements for qualifications to membership in a credit union will be modified to remove existing restrictions on membership so long as the rules of the credit union contain an objectively identifiable common bond;
 - 4.2 credit unions will be permitted to extend their membership to charities and incorporated societies that meet the common bond requirements;
 - 4.3 the statutory requirement that credit union associations obtain Ministerial approval for the provision of new services to their members will be replaced with a provision enabling associations to provide any services that are permitted by the Act and specified in their rules;
 - 4.4 the statutory requirement that each member must hold a minimum of \$10 "shares" will be a default provision and credit unions will be permitted to determine and specify a higher minimum deposit requirement in their rules; and
 - 4.5 credit unions will be permitted to determine and specify in their rules their own processes for setting service fees.

- 5 **Note** that credit unions' governance regime may need to be strengthened to facilitate stronger risk management capacity in an environment where credit unions will be able to provide financial services to larger numbers of customers than is currently the case, and where credit unions will be operating under fewer regulatory restraints.
- 6 **Direct** officials to review credit unions' governance provisions (such as the duties of trustees and committees, disclosure obligations, and the ability of creditors to petition for a wind-up) to ensure that they are as robust as those applicable to building societies and finance companies and **invite** the Minister of Commerce to report back to Cabinet on any amendments that may be advisable, by March 2005.
- 7 **Note** that credit unions have sought the ability to vary, through their Securities Act trust deeds, statutory restrictions on borrowing, investment, and (to a no lesser extent) capital reserves, and that further work is required to determine whether credit unions should be able to negotiate standards that are lower than those currently proscribed by the Act.
- 8 **Agree in principle** that some or all statutory restrictions on borrowing, investment and reserves could be varied by credit unions and their trustee supervisors, provided any permitted variation would not expose credit union members to unjustifiable risks.
- 9 **Direct** the Ministry of Economic Development to consider whether and how restrictions could be varied without exposing credit unions to unjustifiable risks and **invite** the Minister of Commerce to report back to Cabinet, by March 2005, with appropriate recommendations.
- 10 **Note** that while permitting credit unions to raise capital by issuing instruments that are non-withdrawable, transferable and preferential would introduce undue risk, the government supports their underlying objective of finding alternative sources of capital to facilitate their growth.
- 11 **Direct** the Ministry of Economic Development to work with the industry to identify alternative measures that may assist credit unions in meeting their capital requirements, and **invite** the Minister of Commerce to report back to Cabinet on possible options by March 2005.
- 12 **Note** that at present it is necessary for credit unions to obtain a special Act of Parliament to facilitate conversion to alternative governance regimes.
- 13 **Agree in principle** to provide a statutory mechanism for facilitating credit unions' conversion to alternative governance regimes.
- 14 **Invite** the Ministers of Commerce and Revenue to report back to Cabinet, by March 2005, on the details of the conversion mechanism.

Hon Margaret Wilson
Minister of Commerce

ANNEX A: STATEMENT OF AGREED PRINCIPLES FOR CREDIT UNION AMENDING LEGISLATION

Prepared by the Association of Manchester Unity Credit Unions and the New Zealand Association of Credit Unions, December 2003.

Executive Summary

- The New Zealand Association of Credit Unions (“the NZACU”) has proposed amending legislation for the Friendly Societies & Credit Unions Act 1982 (“the FSCU Act”) in four key areas. The NZACU outlined the suggested amending legislation in a paper dated December 2001.
- The Ministry of Economic Development issued a Discussion Paper in December 2002 on Friendly Societies and Credit Unions Act 1982: Possible Options for Reform which incorporated questions for discussion based on the NZACU’s proposals.
- The NZACU has, in conjunction with the Ministry of Economic Development, completed over the last four years, particularly in 2001, a full round of consultation, including with the Association of Manchester Unity Credit Unions (“AMUCU”), the Financial Services Federation, PSIS and the Inland Revenue Department, on these four key areas requiring legislative change.
- As a result of a meeting with the Minister the Honourable Lianne Dalziel, representatives from the Ministry of Economic Development and from AMUCU on the 6th November 2003 agreement was largely reached on all of the points originally raised as comprising the four key areas requiring legislative change.
- At the suggestion of the Minister the AMUCU and the NZACU were invited to discuss points of common agreement in relation to the proposed changes. This paper outlines the agreed principles between the two Associations.
- The Associations have agreed on the principles applying to all legislative changes and similarly agree that their implementation should proceed at the earliest opportunity and that the changes as so agreed will not prejudice any other party given that all the changes, apart from allowing credit unions to enjoy perpetual succession and a common seal, are elective and enable credit unions to continue exactly as they operate now.

Proposed Areas for Legislative Amendment

1. *Qualifications for admission to membership of a credit union.*
 - To enable charities and incorporated societies affiliated with the common bond to become members of credit unions but to retain the restrictions on corporate membership.
 - To clarify the State regulatory supervision of self-designated credit union mutual groupings.
2. *Legal personality and validity of action.*
 - To clarify credit unions’ legal status.

- To remove any unnecessary duplication between trustees and directors of credit unions.
- To clarify credit unions' ability to own property including land.
- To remove the necessity for Ministerial approval before Associations of credit unions can provide services to member credit unions.

3. *Capital*

- To remove limitations on credit unions being able to raise capital from within their membership to underpin their financial security and meet Securities Act trust deed financial ratios.

4. *Trust Deed Duplication*

- To amend the current legislative restrictions on borrowing, investment, and reserves to allow these matters to be governed to a no lesser standard by the Securities Act Trust deed.
- To remove the requirement to stipulate the actual amount of fees and charges in the rules of credit unions.

Amendment Analysis

Qualifications for admission to membership of a credit union

Summary of Amendments:

- To clarify the State regulatory supervision of self-designated credit union mutual groupings.
- To enable charities and incorporated societies affiliated with the common bond to become members of credit unions but to retain the restrictions on corporate membership.

Proposal:

- Amend Section 100(d) and Section 102 of the FSCU Act to remove the requirement for Registrar approval other than to only register credit union rules, which contain an objectively identifiable "common bond" within the ambit of the section.
- Amend Section 106 to enable charities and incorporated societies affiliated with the common bond to become members of a credit union.

Agreed Position:

- The Associations agree that the common bond is important to the operation of credit unions and that it is appropriate to restrict membership of a credit union to those associated by an identifiable common bond.
- The Associations agree that the current legislation is subjective in nature and that the FSCU Act should be amended to require credit unions to have an objectively identifiable common bond but subject to the judgment as to whether such has been sufficiently identified in the rules of a credit union still resting with the Registrar.

- The Associations agree that charities and incorporated societies should be permitted under the rules of a credit union to become members of the credit union provided they share some affiliation with the common bond of the credit union.

Legal personality and validity of action

Summary of Amendments:

- To clarify credit unions' legal status.
- To remove any unnecessary duplication between trustees and directors of credit unions.
- To clarify credit unions' ability to own property including land.
- To remove the necessity for Ministerial approval before associations of credit unions can provide services to member credit unions.

Proposals:

- The corporate status of charities, which preserves the distinct trust nature of the charity, is considered by the Associations to be suitable for credit unions. In other words, credit unions would remain, to protect their essential mutual status, as they are now under specific legislation, but with the trustees for the time having body corporate status in a similar manner to the Charitable Trusts Act. If properly understood in this context, to grant this type of corporate identity to the committee of management of a credit union is not inconsistent with credit unions remaining indistinct from and representative of the body of their members.
- Associations of credit unions should be able to provide services to credit unions without Ministerial approval.

Agreed Position:

- The Associations agree that the FSCU Act should be amended to allow credit unions to have perpetual succession and a common seal with any necessary consequential changes in the FSCU Act relating to trustees but so that credit unions may still, if they choose, retain trustees.
- The Associations agree that the necessity for Ministerial approval before associations of credit unions can provide services to member credit unions should be removed so long as provision for such services is made in the Association's rules and the Association is restricted to providing services primarily to credit unions

Capital

Summary of Amendments:

- To remove limitations on credit unions being able to raise capital from within their membership to underpin their financial security and meet Securities Act trust deed financial ratios.

Proposals:

- Amend Section 107 of the FSCU Act to provide that:
 - Shares do not have to rank equally. This will allow for a distinction between equity capital and investment capital in a Credit Union.
 - Equity shares can be made non-withdrawable, that is, non-refundable on a member withdrawing from a Credit Union. This will provide a permanent capital base for a Credit Union.
 - Investment equity shares can be transferable and able to be evidenced by a certificate. This will meet normal investment expectations.
- Section 106(2) FSCU Act, which currently provides that equity capital is limited to \$10 per member, should be amended to allow the members to set an appropriate limit.

Agreed Position:

- The Associations agree that, if the members of a credit union decide, and make provision in the rules, a credit union should be entitled to issue capital instruments which are non-withdrawable (that is repayable at the option only of the credit union), transferable (but only to other members of the credit union) and otherwise issued on terms as agreed by the credit union members including, if they so choose, a preference in respect of those capital instruments over ordinary shares of the credit union on a winding up.
- The Associations agree that Section 106(2) of the FSCU Act should not have a specified limit but that such limit should be up to the members of each credit union to decide and shall be specified in the rules of each credit union

Trust Deed Duplication*Summary of Amendments:*

- To amend the current legislative restrictions on borrowing, investment, and reserves to allow these matters to be governed to a no lesser standard by the Securities Act Trust deed.
- To remove the requirement to stipulate the actual amount of fees and charges in the rules of credit unions

Proposals:

- Amend Section 109 of the FSCU Act.
- Amend Sections 113 and 117 of the FSCU Act.
- Amend Section 119 of the FSCU Act.
- Amend Section 105(4) of the FSCU Act by removing the requirement for the amount of fees and charges to be stated in the Rules of a credit union.

Agreed Position:

- The Associations agree that Section 119 of the FSCU Act should be amended to exclude its application if the limitations provided for in this Section is otherwise provided for to a no lesser standard in a credit unions Securities Act trust deed.
- The Associations agree that Sections 109, 113, and 117 should be amended to exclude their application only if the Securities Act Trust Deed contains provisions for borrowing and investment by the credit union.
- The Associations agree that Section 105(4) of the FSCU Act should be amended by removing the requirement for the amount of fees and charges to be stated in the Rules of a credit union but so long as the mechanism for levying fees and charges is still stated in the Rules of the credit union.

Regulatory Impact Statement

Statement of the nature and magnitude of the problem and the need for government action

There are around 55 credit unions in New Zealand and two associations of credit unions: Manchester Unity and the New Zealand Association of Credit Unions (“**NZACU**”). Credit unions have a combined membership of around 180,000 to 190,000 people and combined assets of around \$490 million, which is very small by financial sector standards (the major trading banks each have assets in the tens of billions of dollars). Credit unions service about 0.3 percent of the household loan market. These figures reflect the fact that credit unions are cooperatives and serve a community-based, niche market for savings and loans. This encourages them to keep service costs and interest rates as low as possible, making them particularly accessible to low income earners. They also provide a socially valuable alternative to profit driven financial service providers.

A review of the Friendly Societies and Credit Unions Act (the “Act”) is being undertaken as a result of the NZACU’s belief that the Act is outdated and unduly restrictive. In November 2003, NZACU and Manchester Unity (which between them represent almost all of the credit unions in New Zealand) put forward a set of joint proposals for amending the Act. The Government has agreed to consider those proposals in good faith and accommodate them as far as possible without compromising investor protection.

The Act requires each credit union to restrict membership to individuals that have a common bond such as a common place of residence or work, or affiliation with another organisation. Incorporated entities cannot belong to credit unions. While the common bond is a special feature of credit unions, it limits their capacity for growth. Evidence provided by the Registrar of Credit Unions confirms that on at least one recent occasion, the common bond requirement has prevented an existing credit union from opening a branch in a small rural community that has no access to banking services. In recent years, several credit unions that were in financial difficulties or were unable to meet increased compliance costs were forced to close because the common bond requirement prevented them from amalgamating with other credit unions. As a result of these incidents, the industry has lobbied intensively for changes to the common bond requirement.

To protect members’ interests, the Act contains restrictions on borrowing, investment and capital reserves. In particular, credit unions can only borrow from banks and other credit unions and this may increase their cost of credit. It is less clear how other restrictions, such as the requirement to invest according to the provisions of the Trustees Act 1956 or the capital reserve, give rise to a problem and credit unions have not, to date provided any evidence to support their concerns. Since 2001, credit unions have also been required by the Securities Act 1978 to enter into trust deeds with a trustee company that acts as a frontline prudential supervisor. The trust deeds may also impose prudential restrictions, though this does not create a direct conflict with the Act. Nonetheless credit unions have lobbied strongly for the ability to vary the statutory restrictions through their trust deeds.

Should credit unions wish to convert to an alternative governance regime (such as the Companies Act or the Building Societies Act) that would better serve their members needs and expectations, they cannot readily do so unless a special Act of Parliament is passed. This is a time-consuming and costly exercise which is not a good use of government and parliamentary resources. To date, one credit union has converted under a Private Member’s Bill. It is understood that, at present, another large credit union wishes to convert.

Statement of the public policy objective(s)

The public policy objective is to improve the efficiency of the Act and facilitate credit unions' growth, while safeguarding the interests of credit union members and maintaining competitive neutrality in the financial sector.

Statement of feasible options (regulatory and/or non-regulatory) that may constitute viable means for achieving the desired objective(s)*Status Quo*

The Act limits credit union membership to individuals who have a common bond such as a common employer or place of residence. The Registrar of Credit Unions must be satisfied each credit unions common bond complies with the Act. Organisations cannot become members. The Act also imposes prudential restrictions on credit unions, such as limiting their powers to borrow and invest money. It also requires each credit union to retain a percentage of their profits as a capital reserve. The reserve is used to protect member's deposits and investments against losses caused by loan defaults. The Securities Act requires credit unions to enter into trust deeds with trustee supervisors. While it does not specifically require the trust deeds to include provisions relating to borrowing, investment or reserves, in practice, the trust deeds may address these issues in a manner that is consistent with or stricter than the provisions of the Act.

Credit unions have a tax exemption that assists them in meeting their capital reserves and offering competitive interest rates.

Credit unions that wish to move to alternative governance regimes such as the Companies Act or the Building Societies Act can only do so by Act of Parliament.

Preferred Regulatory Option

It is proposed that the Act be amended to:

- permit credit unions to determine their own common bond, provided it is objectively verifiable (eg. membership of a labour union as opposed to supporting credit unions' values) and specified in their rules;
- permit credit unions to offer financial services (eg. savings accounts, loans) to charities and incorporated societies that meet the common bond requirements;
- allow credit unions and their trustee supervisors to vary statutory restrictions on borrowing, investment and (to a no lesser extent) capital reserves (while this potentially extends the sources from which credit unions can borrow, alters the nature of investments they can make, and would confirm that the statutory reserve requirement is a minimum standard, further work needs to be done to ensure that any changes that the government may contemplate do not unduly increase the risk to investors); and
- provide a statutory mechanism for conversion to alternative governance regimes (the mechanism, which is yet to be determined, will need to address matters such as the transfer of assets and liabilities and related tax issues).

Statement of the net benefit of the proposal, including the total regulatory costs (administrative, compliance and economic costs) and benefits (including non-quantifiable benefits) of the proposal, and other feasible options

Government

The relaxation of the common bond test will facilitate growth in an industry that is motivated to provide affordable services to low income communities and communities not currently served by banks. It will also reduce the amount of time and other resources that the Registrar of Credit Unions has to expend on considering proposed mergers and common bond changes that do not clearly meet the current statutory requirements. These costs have not been quantified because the Registrar's activities and expenses are not broken down to this level.

The Government may collect less tax to the extent that business shifts from other financial service providers to credit unions. Removing the need for special legislation to allow credit unions to convert to alternative regimes will eliminate the unnecessary use of government and parliamentary time and resources.

Credit unions

Allowing credit unions to determine their own common bond and to offer services to non-profit entities that meet the common bond requirement will facilitate mergers and enhance credit unions' potential for growth. This may, in turn, enhance their ability to achieve economies of scale that will help them to absorb the costs of new technologies and regulatory compliance. Because the common bond of each credit union must be specified in its rules, credit unions that wish to change their common bond would need to amend their rules. This requires a special resolution of members, which could be proposed at the credit unions normal annual general meeting. The process provides a safeguard for existing members in that the common bond can only be changed if 75% of eligible and voting members agree.

If the relaxation of the common bond leads to a significant membership growth, the failure of a credit union would affect more people and the consequential economic impact would potentially be greater for the affected region. The introduction of trustee supervisors in 2001 appears to have considerably reduced the risks of failure in the industry. However, the buoyant economy may mask potential problems arising from existing weaknesses in credit unions' current governance and risk management structures. These risks can be monitored to some extent by the Registrar of Credit Unions. As part of its review of the Securities Act 1978, due to begin in 2005, the Ministry of Economic Development will also be able to consider the need for the Securities Commission to have greater oversight of trustee supervisors generally. It is also proposed the officials review credit unions' governance structures (eg trustees and managers duties) to ensure they are as robust as building societies and finance companies.

Allowing the Act's prudential requirements to be varied by trust deeds may give credit unions additional flexibility to negotiate prudential restrictions that reflect their individual risk profiles. To take advantage of this option, credit unions would be likely to need to obtain specialist legal advice and pay costs arising from the amendment of their trust deeds. Credit unions are likely to seek variations only when it is in their interest to do so, so any costs should be offset by other advantages. However, further analysis of this proposal is required, to ensure that investors are not exposed to undue risks. A further Regulatory Impact Statement (and Business Compliance Cost Statement, if necessary) may be prepared for decisions that follow from this work.

A statutory conversion mechanism would allow credit unions to move more easily to alternative regimes if they wish to operate in ways not permitted by the Act. To take advantage of this option, credit unions would be likely to need to engage specialist legal and accounting advisors. Further analysis of this proposal is required, to identify all of the elements necessary to ensure

that the mechanism is effective. Again, a further Regulatory Impact Statement (and Business Compliance Cost Statement, if necessary) may be prepared for decisions that follow from this work.

Other financial service providers

Banks and finance companies have expressed concern that credit unions already receive a competitive advantage from their tax exemption. Some say that the advantage permits credit unions to better their competitors' interest rates by up to 0.5%. If credit unions are permitted to determine their own common bonds and serve not for profit entities, the advantage may well be magnified to the detriment of competitors. This would go against the policy objective of maintaining competitive neutrality in the financial services sector.

Society

The relaxation of the common bond test should make the option of saving with credit unions more widely available and should assist the provision of financial services to communities that currently lack adequate access to savings and loan facilities. It will also give charities and incorporated societies more choice of financial service providers.

Statement of consultation undertaken

Stakeholder consultation

In December 2002, the Ministry of Economic Development released a discussion document focusing on proposals for reform put forward by the NZACU. These included relaxation of the common bond requirements and trust deed variation of statutory prudential requirements. While most NZACU members were strongly supportive of these proposals, Manchester Unity and the Hibernian Credit Union disputed the need for any reforms.

The Financial Services Federation and the Bankers Association indicated that their primary concern is that credit unions should not have a tax exemption that is not available to their competitors. The Law Society and the Investment Savings and Insurance Association noted that if credit unions are allowed to expand beyond their traditional and unique community purpose, the tax exemption would give them an unfair advantage. The Law Society also objected to the relaxation of the common bond requirement unless credit unions are placed under the same governance and supervision standards as other deposit-takers. While agreeing that there may be room for modernising restrictions on borrowing, investment and reserves, the Law Society supported the retention of statutory "minimum" standards.

As a pre-requisite for further work on the review, NZACU and Manchester Unity were invited to develop a consensus around issues that they wanted addressed. In 2003, they reached agreement on a refined version of NZACU's original proposals for relaxing the common bond and prudential restrictions. A small number of credit unions [...] supports the introduction of a conversion mechanism. The need for this mechanism was also canvassed in the 2002 discussion document and feedback made it clear that credit unions' views on the subject are strongly divided. Nonetheless, it is believed that the barrier imposed by the need for special legislation should be removed.

Government departments/agencies consultation

The Reserve Bank, the Treasury, Inland Revenue, and the Securities Commission were consulted in the development of these proposals. The Reserve Bank raised a significant concern that allowing a relaxation of the common bond increases the risks arising from inadequacies in credit unions' current governance and risk-management structures – it is

proposed that this be addressed by reviewing credit unions' governance structures. Inland Revenue noted the need to consider tax implications in developing a conversion mechanism.

The Registrar of Credit Unions was also consulted in the development of these proposals and voiced concern that relaxing the restrictions on investment in real estate would adversely affect credit unions' liquidity and tie up money that would otherwise be available to fund loans to members.