Ministry of Economic Development

Manatū Ōhanga

**Non-Bank Deposit Takers (Tier II):
Summary of Submissions**

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Issue Reference	Summary of issue raised
Q10	Proposals have significant flaws. *Contagion risk:* can be addressed through trustees. Also liquidation of an ADT may create negative reputation risks for the RB if taking on the role. *Moral hazard:* Direction to directors & senior management by the RB present risk as a "shadow director" and the liability which attaches this. Liquidator or statutory manager would only be appropriate. Also, a failing ADT is unlikely able to transition back to a tier 2 NBDT. *Ability to require ADT status:* This power does not seem appropriate given NBDTs only comprise 7% of total system assets. Many credit unions have less than $1 mill & low profits. Trustee's will still want to supervise credit unions & building societies. *Security of funds:* NBDTs source their funds on a secured tiered basis. Bank standby funding for liquidity management is on first priority basis or on block assignment. Removal of the trust deed will be problematic and banks will not want to give up this security. Presumption that lender of last resort facilities will become available to ADTs *Implied government guarantee:* government supervision will create more moral hazard. Deposit rates may fall for ADTs but with no change in risk profile leading to greater distortion. *Compliance costs:* compliance costs will be high, particularly for the small NBDTs. Licensing will be a one off cost but trustee arrangement should not materially increase costs. Credit rating also with reporting may render compliance costs uneconomic for continuing business. Overall more problems created than solved. Pursuit of a homogenous regime may weaken depositor protection.
	Proposed requirements for ADT are adequate. Some amendments appropriate for credit unions under tier 2 given their unique financial structure and negative effects of the current legislation.
	Reserve comment until the credit union category is calibrated.
	General agreement with the proposed requirements for ADT & tier 2 NBDTs. However details such as minimum capital, capital ratio & ratings are still to be determined.
	If an ADT category is adopted, ADTs carry an approved status and by inference NBDTs carry a non-approved status. All NBDTs to maintain: • Minimum equity $2.0 • Minimum equity ratio of not less than 10% of tangible assets • Minimal & tight restrictions on related party transactions • Regular reporting of current financial information. Credit ratings not mandatory. External directors are significant costs.
	Support the proposed requirements for ADTs and Tier 2 NBDTs.
	ADT's proposed requirements: *Reserve Bank's role:* lack of clarity & detail on precise level of

	supervision. Resource & capacity of the RB are questioned as this may require more of a hands-on approach rather than that adopted by the RB for banks. Supervisory function may as a result be delegated to trustees. *Licensing:* not objection to fit & proper. *Minimum Capital:* agree to minimum capital but the precise level needs work (e.g. distinctive nature of activities). *Minimum Credit Rating:* opposed as it will produce significant additional costs with no good effect. *Capital adequacy:* support standardised framework for capital measurement. *Limit related party credit exposures:* support continuation of this requirement. *Limit exposure concentrations:* support *Nature of supervision:* not at all dissimilar to current trustee supervision. *Governance requirements:* should more align with companies. *Supervision of other NBDTs:* no comment as recommend they be an ADT category.
	Ratings option is in stark contrast to the observations about ratings. Ratings are costly (excessive) and disadvantage small entities. Small company with minimum equity base of $1.5mill & $15 mill would cost 2-3% of annual revenue. Mandatory only for ADTs.
	Minimum start-up should be $500K but thereafter at least 15% of total assets (excluding deferred tax). Absolute prohibition on related party lending. Half yearly external audit is unnecessary. Have little understanding of the business. The internal auditor & directors do. Having the trustee at the board table means the internal auditor can report to the trustee.
	Minimum equity requirements should be the same as banks which is 8% of its risk weighted exposures. The reasons given in the discussion document for a higher ratio are a poor generalisation. In this case the total assets are greater than TSB, Kiwi Bank, ABN Amro or Citibank and is AAA rated (parent). Don't currently offer deposits but if to do so see no reason why a higher level of capital should be held. Applying the Basell II framework will resulting in the requirement to hold a higher nominal amount of capital as compared to a registered bank. To then have a capital ratio greater than 8% will impose additional capital costs.
	RB as monitor will: • Differentiate between different types of finance companies

	• Risk weight assets based on quality • Favour higher equity ratios. Trustees have been useful & more appropriate. Need some enhancements: • Specific financial requirements • Half yearly & annual audit of financial statements • Wider statutory powers of investigation for trustees. *Implications of RB supervision:* Give the perception that ADTs are safe. The result may be more stringent covenants. Finance companies have traditionally serviced a market which banks have abdicated. This market has more risk therefore the RB may want to protect its reputation through restraining or restrictive requirements. *Ratings:* Ratings are a value judgement. Possible differing standards would allow inconsistencies. Public perception may be, based on approval from the RB, a safe investment. Two tiers and the perception of safety may result in a run from tier 2 companies leading to instability in the sector and potentially cause failures.
	Do not support the two tier structure rather an enhancement of the current position. Refer response to Qs 5-9. Regarding calibration: Minimum capital of $10mill Minimum capital adequacy 10% Minimum credit exposure of 5% No mandatory credit ratings
	BB rating 3% probability of default over 2 yrs – include a materially greater number of NBDTs than the investment grade of BBB-. If mandatory ratings – approval of ratings agencies on comparable measures. Claim some agencies have ratings outcomes, although contest are comparable, which would appear to demonstrate a higher probability of default. Do not advocate mandatory ratings regimes but do recognise the benefits of independently derived ratings for financial market development. Ratings are not an adequate substitute for adequate issuer disclosure or advice. Markets should develop sufficient levels of self-regulating standards if there is power symmetries. Educated investors will drive ratings demand as will reporting which aides comparison. Disagree that ratings will reduce moral hazard. Credit ratings are not a guarantee or quasi insurance. S&P ratings are: • Current opinion of current financial capacity. • Opinion and not verifiable fact. • Based on information supplied & sourced. No audit is conducted by S&P & reliance is placed on the issuer, its accountants, counsel & other experts. No duty of due diligence & cannot guarantee accuracy, completeness or timeliness.

	Distinction between ADT & DT should be done on the basis of those required to have credit ratings and those that don't.
	Currently substantial amount of information available. See benefit from additional disclosure directed towards risk/return trade off and ideally enabling comparison with other investment options. (maybe mandated tabular format). SC report on finance company disclosure may need mandatory effect. Believe the typical finance company investor is more financially literate than the average. However need to go some way. Pending education we believe ratings have a role but only from Fitch, Moody's and S&P. It is important that the ratings translate to enable comparison. Do not see benefit in common minimum standards. $2 mill as a minimum commitment is appropriate. Larger NBDTs the level should be dictated by a percentage (10%). Those with a rating below BB could increase to 12% to reflect this higher risk. Adopting banking supervisory tools runs the risk of removing diverse & dynamic businesses. RB has played a key role in transactional banking but not investment products. The two tiers may lead to increased risk of collapse. An ADT which fails to meet the threshold on a continuing basis (say because of a rerating of country risk – outside of control) the resulting demotion could create concern amongst investors. Ratings would provide a much more granular approach than the ADT/NBDT distinction. Prohibition on exposure concentration is inappropriate and disclosure should be sufficient. This is because NBDTs rely on a small number of loans with parties they know intimately. Not convinced on quarterly reporting. Concern about the one size fits all approach and recommend consideration of authorisation of specific products.
	ADT – do not support minimum capital of $5mill. A capital adequacy ratio would be far better for targeting solvency risk. It is a very imprecise mechanism. Recommend against the government undertaking positive assurance checks. Recommend against half yearly audit requirements. Prefer voluntary ratings. NBDTs obtaining a rating should not be required to disclose that rating. Counter productive
	Retain use of trust deeds & specific requirements: • Limited to financial intermediation • $1 million minimum • Capital adequacy (15% to $10mill, 12.5% up to 20mill, 10% thereafter in tier 1 capital. • Related party credit exposure (prohibition beyond 20% of capital). Where exceeded the related entity can seek to raise debt on its own balance sheet & be subject to greater investor scrutiny.

	• Limitation on credit concentration (not to exceed 25% to 35% of tier 1 & 2 capital to any single or related group). • Prohibition on using the term first ranking debenture stock (where material prior charges – limited to 2.5% of assets) • Inability to restructure debt to be recorded as performing. • Half yearly financial statements.
	The public will classify by its regulatory class rather than the business model. NBDT will become a negative classification and ADT an implied government approval. Opposed to ratings. Sensible capital adequacy etc is the best solution. Ratings are a second best.
	Fit & proper for all NBDTs $5mill start-up is small Higher level of Capital adequacy – say 10-15% of assets, possibly 10% of tier 1 equivalents. Question whether BB rating threshold is high enough.
	• Support fit & proper • Systems & controls would act as a barrier for start-ups. • Independent director & executive - provides no additional benefits over the status quo. • Small capital base – not problematic as the trust deed prescribes financial covenants. • Minimum capital ratios are flexible under trust deeds arrangements. Don't want to straight jacket the entity. • Present reporting is fine (un-audited half yearly and audited annual) • Does not support ratings (approximate costs: trustee ($10000) & auditor ($14000)
	Lack of clarity around the RB role. • No objection to fit & proper • Accept min capital but $5mill too low • Do not support credit ratings • Support standardised capital adequacy • Support limits on credit exposures • Support limits on exposure concentrations • Level of supervision not all that dissimilar to current trustees • Governance closer to companies.
	For NBDTs *Licensing:* sensible requirement (process may need some attention) *Fit & proper:* already implicitly done. *Systems & controls:* general assessment seems sensible. *Governance requirements:* should be substantially uniform across all NBDTs. *Minimum Capital:* absolute minimum of $2mill Trustee based supervision Ongoing public disclosure No Mandatory Ratings.
	$500K is too low for deposit takers.
	ADTs – the greater of $20mill or 12% of total assets. DTs – the greater of $5mill or 10% of total assets. Support appropriate minimum levels of governance & disclosure. Compulsory ratings.
	Comment only on ADT requirements. Recommend mandatory ratings for other NBDTs
	Build on the existing trustee model & question ratings but if beneficial there should be no carve outs.

	Support the enhanced trustee model & support licensing prudential capital requirements consistent with the sector. Do not support mandatory ratings or the mandatory requirement to disclose a rating.
	Welcome compulsory credit ratings – will help distinguish between low & high risk NBDTs. $2 million capital Half-yearly disclosure seems unduly onerous. Rather continuous disclosure, such as the NZX listing rules, is more appropriate. Minimum capital ratio or 10% for all NBDTs.
	• Retain trustee supervisory model. • $2mill minimum capital • Support compulsory credit ratings but no minimum threshold. • Oppose capital adequacy requirements. Propose a sliding scale based on the rating obtained (e.g. BBB = 8%, BBB- =10% etc). If to be increased it must be done across the board. These are only minimums so a 10% requirement would mean 13% in practice. Minimum of 15% would be trending towards 18-20%. To comply with 15% at least $100 million worth of Tier II capital would need to be raised. • Extra capital requirement is unlikely to be positive from a rating perspective & actually may place downward pressure due to inefficient capital use.
	ADT – no comment DTs – • Limited to certifying that there is satisfaction as to the skills & experience, adequacy of systems & controls and possibly the governance requirements (based on prescribed SC standards). • Agree that a minimum capital ratio should apply but not a fixed minimum. Rather flexibility. • Half yearly audited financial statements should be left to negotiation. • Do not support mandatory ratings but rather disclosure of its absence.
	• Current trust deed deals with many of the issues already. • Director & chairman test for independence would mean the chairman would have to step down and would restrict board members resulting in a loss of skills. • Capital ratios are too restrictive. Increased capital may actually not materially have changed the outcome for the recent failures. • Disclosure is currently carried out in accordance with the Companies Act, Financial Reporting Act & Securities Act. If there is a problem it is with this legislation. • Do not support mandatory ratings (BB would also be too low – it is below investment grade).
	• Preference for continuous disclosure. • Mandatory ratings may only be of benefit where there is no continuous disclosure. • Additional disclosure supported so long as it does not duplicate current listing disclosure requirements. • Liquidity & capital adequacy requirements are unnecessary with continuous disclosure. • Capital requirements may affect competitiveness. Costs may outweigh benefits. • Fit & proper may be difficult to administer/measure. • Listed companies already comply with connected lending provisions. • Question why a limit on exposures but support disclosure.

	• Don't seem to be much difference between ADT & DT categories so why the structure?
	Credit ratings add nothing but a hefty compliance cost. The sector will barely get an investment grade rating but in short this is already known. ADTs will market their status but their rating may still be lower than investment grade.
	• Standardised basel II is appropriate • Capital adequacy of 10-15% • Specified minimum capital adequacy as a trigger for the trustee. • Maximum credit exposure of 15% of tier 1 capital & option for higher is appropriate. • Extending requirements to lending quality, credit control, debtor management and type & quality of assets. Other enhancements: • Limit individual/group counterparty exposures as a percentage of equity • Transparency of advances to highlight diversification, geographic location & sectors represented. • Transparent audit requirements around systems & controls • Measures to enable assessment of liquidity risk, minimum levels of government securities, cash deposits & treasury securities, standby borrowing facilities • Clearly disclose maturity profile of loans & deposits. • Agree with local incorporation requirements. • Regulator to exercise discipline in terms of auditor appointment • Support disclosure of the fact they are not an ADT • Mandatory minimum rating with an exemption for small NBDTs. Threshold shouldn't be too high