

The Chair
CABINET ECONOMIC DEVELOPMENT COMMITTEE

REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS: REGULATION OF NON-BANK DEPOSIT-TAKERS

PROPOSAL

1. This paper seeks the agreement of the Committee to proposals for changes to the prudential regulation of non-bank deposit-takers (NBDTs), such as finance companies, building societies and credit unions. A subsequent paper on remaining details of the proposals will be brought to Cabinet in July.
2. The proposals in this paper include:
 - All NBDTs to be required to be licensed by a prudential regulator and to comply with minimum prudential, governance and fit and proper requirements at licensing and on an ongoing basis.
 - NBDTs to continue to be supervised by trustee corporations under the proposed enhancements to trustee-based supervision for debt issuers.
 - NBDTs to be required to obtain and publicly disclose a credit rating, subject to Cabinet report back by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers.
 - NBDTs to be subject to enhanced public disclosure requirements.
 - The Reserve Bank to be the prudential regulator of NBDTs, with the Securities Commission continuing to have responsibility for market conduct regulation and authorisation and supervision of trustee corporations.

EXECUTIVE SUMMARY

3. Non-bank deposit-takers (NBDTs) are entities whose core business involves offering deposits or deposit-like securities to the public and the provision of financial services. The NBDT sector comprises a wide range of financial institutions, including finance companies, building societies and credit unions.
4. The discussion document on NBDTs, issued in August 2006, noted that the current regulatory arrangements for NBDTs, while not fundamentally flawed, are inadequate in several respects. The deficiencies highlighted included inconsistency in regulatory requirements and supervision across different NBDTs, the absence of minimum entry requirements for NBDTs, and

insufficient information to enable depositors to assess and compare the risks of depositing with NBDTs.

5. The discussion document proposed some substantive changes to the regulation of NBDTs to address these problems, while still seeking to keep regulatory costs low and preserving diversity and flexibility in the NBDT sector. The proposals included a requirement for all NBDTs to be licensed and to meet minimum prudential, governance and fit and proper requirements, both at licensing and on an ongoing basis. It proposed a new (elective) category of NBDT, supervised directly by the Reserve Bank and required to meet a higher level of prudential standards, with other NBDTs continuing to be supervised by trustee corporations, but under enhancements to their trust deed requirements.
6. These proposals were aimed at promoting a sound and efficient financial system, by ensuring all NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs and promote depositor confidence, providing depositors with a clearer basis for distinguishing between lower-risk and higher-risk NBDTs, and resolving NBDT distress or failure in an orderly and timely manner, with minimum disruption to depositors and the financial system.
7. Submissions on the proposals expressed mixed views. There was widespread agreement on the identified deficiencies with existing arrangements and support for the proposed objectives for reforms. However, most submitters preferred to retain the existing trustee-based supervision arrangements, supplemented with some uniform minimum requirements, and were not supportive of a two-tiered structure.
8. Officials have assessed submissions received on the proposals and undertaken further analysis. As a result of this analysis, I am recommending that the Committee agree to revised proposals for the regulation of NBDTs, including:
 - A one-tier regulatory framework, where all NBDTs are supervised by trustee corporations, under the enhanced trust deed requirements for debt issuers. The enhanced trustee deed requirements will be implemented in the second tranche of RFPP arrangements later this year;
 - All NBDTs to be required to be licensed by a prudential regulator and subject to minimum prudential, governance and fit and proper requirements set and enforced by that regulator;
 - NBDTs to be subject to enhanced public disclosure requirements under the Securities Act 1978;
 - NBDTs to be required to obtain and disclose a credit rating from an approved rating agency, subject to a Cabinet report back by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers;

- The Reserve Bank to be the prudential regulator for NBDTs, with responsibility for licensing and de-licensing NBDTs in consultation with the Securities Commission, setting and enforcing minimum prudential and governance requirements in consultation with the Securities Commission, administering the fit and proper requirements, administering the ratings regime, and having the capacity to intervene in situations of serious NBDT distress or failure where the soundness of the financial system is at risk; and
- The Securities Commission to authorise and supervise trustee corporations, and to set and enforce public disclosure requirements for NBDTs, in consultation with the Reserve Bank.

BACKGROUND

Proposals released last year

9. One of the nine RFPP discussion documents released in August 2006 related to non-bank deposit-takers (NBDTs). These were defined as entities whose core business involves offering deposits or deposit-like securities to the public and the provision of financial services. The NBDT sector comprises a wide range of financial institutions, including finance companies, building societies and credit unions. They are currently regulated as debt issuers under the Securities Act 1978 in much the same way as other debt issuers. As such, they are required to be supervised by trustee corporations and issue prospectuses and investment statements. In addition, some NBDTs, such as credit unions, are regulated under specific legislation.
10. The discussion document on NBDTs highlighted a number of deficiencies in the existing regulation of NBDTs, including: the absence of minimum entry requirements for NBDTs, inconsistency in governance and prudential requirements across NBDTs, inadequate official oversight of trustee corporation supervision, inadequacies in public disclosures, and insufficient means for investors to assess and compare NBDT risk profiles.
11. The discussion document noted that NBDTs have special features that warrant a form of regulation that goes beyond that required for other debt issuers. These features include the following:
 - Many NBDTs perform bank-like functions, including providing on-call or short-term deposit facilities that are relied on for transaction purposes, the provision of payments facilities and the provision of foreign exchange services. These functions suggest that NBDTs should be regulated in some respects in a manner similar to that applicable to banks, while still facilitating continued diversity, flexibility and competitiveness in the NBDT sector;

- Unlike corporate bond and other debt issues, in which the funds are used to finance an issuer's own business, NBDTs, like banks, lend to many clients. This makes it particularly difficult for depositors to ascertain the true risk of an NBDT and provides a justification for additional prudential and disclosure-based regulation;
 - NBDTs are potentially vulnerable to contagion risk, whereby the distress or failure of some NBDTs could trigger acute distress or failure in others. This suggests the need for enhancements to the standard regulation of debt issuers, such as in respect of public disclosure requirements, ratings and distress management arrangements;
12. Reflecting these considerations, the discussion document proposed that all NBDTs would have to be licensed and subject to enhanced prudential, governance and fit and proper requirements. It proposed the creation of two tiers of NBDTs:
- The first tier – Authorised Deposit Takers - would be licensed and supervised by the Reserve Bank in a manner similar to that for registered banks, as a category of lower-risk deposit-takers. Any NBDT would be able to become an Authorised Deposit Taker, provided that it could meet the prescribed requirements; and
 - The second tier of NBDTs – comprising all NBDTs other than those that became Authorised Deposit Takers - would continue to be supervised by trustee corporations, overseen by the Securities Commission, but would be licensed as a deposit-taker by the Commission on the recommendation of the relevant trustee and subject to enhanced requirements, including minimum prudential, governance and disclosure requirements.
13. The discussion document suggested that building societies and credit unions be treated as distinct categories of NBDT and supervised directly by the Reserve Bank.
14. The proposals included a requirement that Authorised Deposit Takers obtain a minimum credit rating from a rating agency approved by the Reserve Bank. For second tier NBDTs, an option was proposed that they be required to obtain and disclose a credit rating from a rating agency approved by the Securities Commission.

Reactions from submitters

15. Submitters generally supported the proposed outcomes and objectives of NBDT regulation. Although submissions agreed that there were deficiencies in the existing regulatory requirements, most argued that the trustee-based framework generally works well and did not support fundamental change to regulatory arrangements. A strong preference was expressed by most submitters for retention of the trustee-based framework.

16. There was support for enhancements to the trustee-based framework, including the need for a standardised licensing framework for NBDTs, so that all NBDTs meet minimum requirements; a common measurement framework for assessing NBDTs' capital adequacy; minimum supervisory requirements for all NBDTs; improved oversight of trustee corporations; and more user-friendly and timely disclosures by NBDTs.
17. There were mixed, but generally negative, reactions to the proposal for a two-tier model. The main concerns were that a two-tier model could distort market pricing of NBDT products by providing an artificial wedge between the two tiers, and that the proposed Authorised Deposit Taker category would lose the benefits of trustee-based supervision and impose transitional costs on NBDTs. There were also concerns about the moral hazard risks associated with direct Reserve Bank supervision and the complications associated with a two-tier approach to regulating the NBDT sector.
18. There was some support for all NBDTs being required to obtain and disclose credit ratings, with some submitters arguing that ratings would be the best means of informing depositors on risk, and for strengthening market disciplines. However, most submitters opposed mandatory ratings on the grounds of cost and a concern that small NBDTs could be unfairly disadvantaged by the rating process.
19. Very few submitters supported the proposal that building societies and credit unions be supervised as a special NBDT category by the Reserve Bank. It was seen as unnecessary, with trustees being capable of supervising them effectively. Many submitters also argued that supervision by the Reserve Bank would confer a competitive advantage on building societies and credit unions and create a moral hazard risk.

COMMENT

PROPOSED CHANGES TO NBDT REGULATION

20. In light of the submissions and further consideration by officials, I am proposing a regulatory framework that retains the trustee-based framework for all NBDTs and avoids the creation of a multi-tiered structure, but which contains enhancements that go beyond those proposed for ordinary debt issuers, in line with the proposals for second tier NBDTs set out in the discussion document. I believe the revised proposals are justified, having regard to a number of considerations including the following:
 - a) A two-tier structure, as set out in the discussion document, while having merit in a number of respects, could create a risk of distorting market perceptions of the risk profile of NBDTs. In particular, it risks portraying Authorised Deposit Takers as being government-approved and second tier NBDTs as being of higher risk than may necessarily be the case. A two-tier structure therefore potentially weakens the efficiency of the NBDT sector and could impede the sound allocation and management of risks.

- b) The proposals in the discussion document would complicate the regulatory arrangements for the NBDT sector to a greater degree than is required to meet the proposed objectives. I am satisfied that a single tier model, where all NBDTs are subject to a uniform set of minimum requirements, and where all are supervised by trustees, would be a more cost-effective and less complex means of meeting the desired objectives.
- c) The proposal to require building societies and credit unions to be supervised by the Reserve Bank would further complicate the regulatory arrangements and create an artificial distinction between categories of financial institution on the basis of organisational form, notwithstanding their similarity of function with other NBDTs.

21. The revised proposals are set out below. In some areas, more detailed proposals will be brought to Cabinet in July for approval.

Regulatory objectives

22. As set out in the NBDT discussion document, the proposed objectives for prudential regulation of the NBDT sector are to promote a sound and efficient financial system by:

- Ensuring that NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs and promote depositor confidence;
- Providing depositors with a clearer basis for distinguishing between lower-risk and high-risk NBDTs; and
- Resolving NBDT distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.

Requirement to be licensed

23. Any entity, other than a registered bank, wishing to be a retail deposit-taker and provider of financial services would be required to be licensed as an NBDT. Licensing would be performed by the prudential regulator of NBDTs, which I am proposing will be the Reserve Bank.

24. Legislation will be required to define both a “deposit” (distinguishing this from other debt securities) and an NBDT, with provision for a regulatory agency – either the Securities Commission or Reserve Bank – to declare certain securities or classes of securities to be deposits where they should be treated as such in terms of the policy of the law. This is consistent with powers currently in the Securities Act 1978 and Securities Markets Act 1988, and provides an ability to ensure that like instruments receive like regulatory treatment. A regulatory agency – either the Securities Commission or Reserve Bank - would also need to have the ability to exempt entities from being NBDTs in some situations, such as where deposit-taking by a particular

entity is ancillary to its business and is immaterial in nature. Detailed proposals on this will be brought to Cabinet in July.

One-tier of NBDTs

25. All NBDTs would be supervised in a one-tier arrangement, where trustee corporations continue to be the supervisors. The standard enhancements for trustee-based supervision applicable to debt issuers would also apply in respect of NBDTs, subject to some additional requirements as set out below.

Role of trustees

26. Trustees would continue to have responsibility for setting appropriate financial and other covenants in the trust deeds, in negotiation with each NBDT, and for monitoring and enforcing compliance with these covenants. It is proposed that trustees will have enhanced powers to supervise NBDTs on the same basis as for other debt issuers. Proposals for these enhanced trustee powers will be set out in the second tranche of RFPP reforms later this year.

Minimum prudential, governance and fit and proper requirements

27. Minimum requirements would apply to all NBDTs at the time of licensing and on an ongoing basis. The requirements would be designed to promote greater consistency in supervision, and sound governance and risk management in the NBDT sector. The requirements would not be designed to prevent NBDT failures or to achieve a uniform level of risk across the NBDT sector. To do so would impose substantial compliance costs on the sector and reduce the scope for NBDTs to meet the needs of investors and borrowers.
28. The requirements would be prescribed in regulation and would be very similar to those proposed in the discussion document for second tier NBDTs. I am proposing that the requirements would comprise:
 - i Fit and proper requirements for NBDT shareholders with control or significant influence, directors and senior management. These would be designed to ensure that NBDTs are controlled and managed by persons with appropriate capability and experience and do not have serious criminal records. I am proposing that the prudential regulator of NBDTs would apply the fit and proper assessments, both at the time of licensing and on an ongoing basis, as they relate to capability and experience. The fit and proper assessments for criminal records would be conducted by the Registrar of Financial Service Providers, under the new proposed financial service provider registration framework.

This differs from the fit and proper proposals in the NBDT discussion document, which proposed that the fit and proper requirements be administered by the trustees (in liaison with the Securities Commission). The revised proposal – for the regulator to apply the fit

and proper assessments – reflects a number of considerations, including:

- The view that government agencies have now reached that it would be more efficient for the regulator to apply the fit and proper tests and that this would lead to greater consistency across NBDTs;
 - A recognition that fit and proper tests involve an exercise of regulatory or quasi-judicial authority, with the authority derived directly from statute, and that this is better exercised by a government agency than by a trustee; and
 - The views expressed by trustees that they do not think it appropriate that they administer fit and proper requirements.
- ii A requirement that an NBDT must demonstrate the capacity to manage its affairs prudently, in line with the nature of business it proposes to undertake. This would be determined by the trustee supervising the NBDT, both at the time of licensing and on a regular basis thereafter.
- iii A minimum dollar level of capital to demonstrate shareholder commitment and to ensure that the entity has sufficient capital to enable it to perform its intended functions prudently. The minimum requirement would be prescribed in regulation by the prudential regulator. I will report to Cabinet in July with the details of the proposed minimum capital requirement.
- iv A requirement that every NBDT must include in its trust deed(s) a minimum capital ratio, determined by the trustee, and that the ratio must be measured on the basis set out in regulation by the prudential regulator. This is intended to ensure that there is a consistent approach to the recognition and measurement of capital adequacy across all NBDTs. However, the trustee would continue to have responsibility to specify the level of the capital ratio for the NBDT it supervises, in negotiation with that NBDT.
- v Either disclosure of, or a limit on, credit exposures to parties related to an NBDT, such as shareholders with control or significant influence, and directors. Details on this proposal will be brought to Cabinet in July.
- vi Minimum governance requirements, including relating to a minimum board size and composition, and probably including a minimum number of independent directors and a non-executive or independent chairman. These proposed requirements would be designed to strengthen the governance arrangements in NBDTs, reduce the risk of corporate abuse by related parties and provide a stronger foundation for risk management within NBDTs. In addition, NBDTs that take the

form of mutual organisations (such as building societies and credit unions) will be subject to the mutuals governance enhancements scheduled for implementation in the second tranche of RFPP reforms later this year. Details on governance requirements for NBDTs will be brought to Cabinet in July.

Credit ratings

29. I am proposing that all NBDTs would be required to obtain and disclose a credit rating, subject to advice being submitted to Cabinet by 31 July 2007 year on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers. I believe that requiring NBDTs to obtain and disclose a credit rating from a rating agency approved by the prudential regulator of NBDTs would bring a number of important benefits, both to depositors and to the financial system as a whole:
- Ratings provide a relatively simple metric summarising, in one measure, the risk of an NBDT defaulting on its financial obligations. A rating therefore reduces the need for investors to try to understand more complex and voluminous financial information on NBDTs. Ratings would provide the most cost-effective means of enabling depositors to distinguish between higher and lower risk NBDTs and thereby make better-informed investment decisions. This is particularly so if ratings are disclosed prominently in public offer documents and advertisements in ways that can be readily understood by non-expert investors, backed by greater initiatives to promote financial literacy among investors.
 - Ratings would result in a better matching of risk and return, reducing the distortions that currently apply in the NBDT sector. This would facilitate more efficient, and potentially more productive, resource allocation in the financial sector and help to promote financial system soundness. At present, the absence of ratings in the NBDT sector hinders the ability of investors to make well-informed risk/return decisions.
 - Ratings would also strengthen market disciplines on NBDTs and reduce the need for a more intrusive form of regulation and supervision, both in terms of a reduced need for prudential restrictions on NBDTs and less detailed financial public disclosure requirements. In turn, this would reduce the regulatory costs for the NBDT sector relative to the situation where there are no required ratings.
30. I note that mandatory ratings are increasingly being used in many countries as an element in the regulation of financial institutions – mainly to enhance market disciplines, promote sound risk management and facilitate informed investor decision-making. The proposal to require NBDTs to be rated is therefore consistent with the approach being taken in a number of countries.

31. It is also consistent with the current requirements for registered banks in New Zealand, where all banks are required to maintain and disclose a rating from an approved rating agency. I also note that property and disaster insurers in New Zealand have for many years been required to obtain and publicly disclose a financial strength rating.
32. For a ratings requirement to be effective, it will need to be accompanied by a requirement for NBDTs to make clear, prominent and user-friendly public disclosure of their ratings. There will also need to be disclosure of comparisons between the rating scales of different rating agencies. I have asked officials to report back on how this kind of disclosure can most effectively be achieved.
33. Another essential element in making ratings an effective tool is the promotion of public understanding of what a rating is and how to use it. I believe there are various means by which public understanding of ratings can be enhanced, including through financial literacy initiatives (jointly between government and the private sector) and by encouraging the financial news media and other bodies to regularly highlight the importance of ratings and provide information on the ratings of NBDTs. Again, I intend to report back in July on the specific nature of initiatives that could be taken in these areas.
34. Requiring NBDTs to obtain and disclose a rating will involve costs for NBDTs – both in terms of the direct cost of the rating and the indirect cost of management time, systems and controls. I am advised that the costs of mandatory ratings are expected to be modest for most NBDTs, relative to their revenue, assets and liabilities. However, the costs could be more significant for very small NBDTs. Moreover, in the case of NBDTs that can only achieve a low rating, a ratings requirement could increase their funding costs and in some cases may place them under greater commercial pressure than is currently the case. This could lead to consolidation or rationalisation in the NBDT sector, depending on market reaction to ratings. However, this need not be a negative development; it may be a desirable outcome of better informed investor decision-making and efficient markets.
35. There are various options available to reduce the costs of ratings for NBDTs, including the possibility of exemptions for small NBDTs, the application of ratings to groups of entities (for example, groups of affiliated credit unions) rather than necessarily requiring ratings to be applied to all individual entities, and the possibility of reduced fees negotiated on a collective basis with the rating agencies. I have asked officials to explore these options and report back to Cabinet in July.
36. Overall, I believe the costs and risks of mandatory ratings are outweighed by the benefits and I therefore consider that a persuasive case exists for Cabinet to agree to the ratings proposal, subject to Cabinet making a final decision on this in July on the basis of more information on the means by which costs can be minimised.

Public disclosure requirements

37. As noted in the discussion document, it is proposed that NBDTs will be subject to enhanced public disclosure requirements administered by the Securities Commission. This could involve the adoption of more regular disclosure (possibly six-monthly), with more user-friendly formats and risk-focused disclosures. I have asked officials to report back to Cabinet in July with more details on the nature of the proposed disclosure arrangements for NBDTs.

Responding to NBDT distress and failure

38. Trustees will continue to have the primary role in responding to breaches of trust deeds and in taking action where an NBDT's solvency may be under threat. The Companies Office would also continue to have the capacity to conduct investigations under the Corporations (Investigation and Management) Act 1989. However, under the new arrangements, it is proposed that the NBDT prudential regulator be empowered to intervene in situations where the distress or failure of an NBDT could pose a threat to the soundness of the financial system. The details of this proposal will be brought to Cabinet in July.

PROPOSAL FOR RESERVE BANK TO BE PRUDENTIAL REGULATOR OF NBDTS

39. As set out in the accompanying paper "Institutional Arrangements for Prudential Regulation", it is proposed that the Reserve Bank would become the prudential regulator of NBDTs.
40. There are synergies and efficiencies in having one regulator with prudential regulatory responsibility for banks, insurers and NBDTs. There is also a need for a degree of consistency in prudential regulation across some of these categories of financial institution, including in respect of capital adequacy measurement, fit and proper requirements, ratings and corporate governance.
41. Allocating prudential regulation of NBDTs to the Reserve Bank also recognises that there are similarities in the way that banks and NBDTs operate and in the nature of their functions. The Reserve Bank is best placed to ensure consistency of regulation where appropriate and to deal with NBDT distress in ways that minimise disruption to the financial system. It is likely that, over time, NBDTs are likely to become more bank-like in their functions, and hence there is value in having one authority to oversee the sector.
42. As the prudential regulator of NBDTs, the Reserve Bank will be the authority that:
- a) Licenses and (subject to appropriate checks and balances) de-licenses NBDTs, in consultation with the Securities Commission;

- b) Prescribes and enforces compliance with the minimum regulatory prudential and governance regulatory requirements for NBDTs, in consultation with the Securities Commission;
- c) Applies the fit and proper requirements to NBDTs' owners (with control or significant influence), directors and senior managers;
- d) Prescribes the credit rating requirements;
- e) Provides advice and recommendations to the Securities Commission on the performance of trustee corporations in the discharge of their NBDT supervisory functions; and
- f) Can intervene to manage the resolution of NBDT distress or failure in situations where the NBDT's situation may pose a threat to the soundness of the financial system.

ROLE OF TRUSTEES

43. The trustees will continue to be the front-line supervisors for NBDTs. Their functions will include:
- a) Establishing a trust deed for particular offers of securities, in agreement with the NBDT;
 - b) Prescribing the financial, reporting and other covenants in the trust deed;
 - c) Enforcing trust deed covenants and supervising and monitoring NBDTs; and
 - d) Taking remedial actions to respond to breaches of trust deed requirements or financial distress in a NBDT, including advising the Registrar of Companies of any material breaches of trust deed covenants or emerging financial difficulties.

ROLE OF THE SECURITIES COMMISSION

44. As in the case of other aspects of trustee-based supervision (for example, debt issuers), it is proposed that the Securities Commission would retain responsibility for authorising and supervising trustee corporations. The Commission would also have responsibility for enforcing NBDT disclosure and advertising requirements under the Securities Act 1978, in consultation with the Reserve Bank. The obligation to consult the Bank before taking actions to enforce disclosure and advertising requirements would be designed not to constrain the Commission from properly performing its functions, including the ability to act promptly and unilaterally to suspend security offers.

FINANCIAL ACTION TASKFORCE REQUIREMENTS

45. The Ministry of Justice is leading the Financial Action Taskforce (FATF) Compliance Review, which will recommend legislative and regulatory reforms to improve New Zealand's compliance with the Financial Action Task Force 40 Recommendations on Money Laundering and 9 Special Recommendations on Terrorist Financing. The Ministry of Justice is proposing that a wide range of financial institutions, including NBDTs, be subject to regulation to combat money laundering and the financing of terrorism. Under these proposals, where a category of financial institution is prudentially regulated, it is proposed that the prudential regulator also be the regulator for FATF purposes. On this basis, the Reserve Bank would be the regulator of NBDTs for FATF purposes. Papers seeking policy approvals in relation to the FATF supervisory framework will be submitted to Cabinet later this year.

REVIEW OF CREDIT UNION LAW

46. The NBDT discussion document noted that the government's review of the credit union provisions of the Friendly Societies and Credit Unions Act 1982 (FSCU Act) would be put on hold until the conclusion of the Review of Financial Products and Providers. Once Cabinet decisions on the NBDT proposals have been made, these decisions will be factored into the FSCU Act review, with a view to ensuring a sensible coordination of legislative reforms for the credit union sector. Proposals will be brought back to Cabinet in due course.

LEGISLATIVE IMPLICATIONS

47. Legislation will be required to implement the proposed prudential requirements for NBDTs. The legislation is likely to take the form of a new Act, focused on prudential and associated regulation of NBDTs. It would set out, among other matters:
- The definition of a NBDT and scope for exemptions;
 - The requirement for an entity to be licensed as an NBDT in order to offer deposits to the public;
 - The powers of the prudential regulator of NBDTs and the purposes for which those powers may be exercised;
 - The minimum requirements for NBDTs, with scope for more specific matters to be determined either by regulation or set administratively by the prudential regulator.
48. It is proposed that legislation to give effect to the NBDT regulatory framework will be introduced later this year, subject to obtaining final Cabinet agreement to the detailed proposals in late July.

REGULATORY IMPACT STATEMENT

49. The Ministry of Economic Development confirms that the Code of Good Regulatory Practice and the regulatory impact analysis requirements, including the consultation RIA requirements, have been complied with. A RIS was prepared and MED considers the RIS and the RIA analysis undertaken to be adequate. A draft RIS was circulated with the Cabinet paper for departmental consultation purposes.

IMPLICATIONS FOR THE TREATY OF WAITANGI

50. There are no implications for the Treaty of Waitangi.

HUMAN RIGHTS

51. There are no implications in relation to the Human Rights Act.

FISCAL IMPLICATIONS

52. The fiscal implications of the proposals are discussed in the accompanying paper "Reviews of Financial Products and Providers and Financial Intermediaries – Overview Paper".

PUBLICITY

53. It is proposed that Cabinet's decisions in relation to NBDTs will be announced as part of the overall package of RFPP decisions, as proposed in the "Overview" Paper.

CONSULTATION

54. The proposals in this paper closely reflect the proposals set out in the NBDT discussion document released in August 2006, in respect of the "Tier 2 NBDTs" – those NBDTs that continue to be supervised by trustee corporations. The only significant differences relate to:
- The proposal that all NBDTs be required to obtain and disclose a credit rating from an approved rating agency. This was identified as an option, but was not a firm proposal, in the discussion document.
 - The proposal that the Reserve Bank be the prudential regulator of NBDTs, including the proposed role in licensing NBDTs, setting and enforcing minimum requirements for NBDTs and advising the Securities Commission on the supervisory performance of trustee corporations.
 - The proposal that fit and proper requirements be administered by the Reserve Bank, as prudential regulator of NBDTs, rather than by trustees.
55. Although the revised proposals are very similar to those in the discussion document, some stakeholders may view the proposal for the Reserve Bank to be the regulator, and its role in applying the fit and proper tests, as a

significant change in the nature of the regulatory arrangements for NBDTs. As such, there may be expectations that a second round of consultation should occur.

56. Given that the revised proposals as set out in this paper are very close to those in the discussion document, I do not think it necessary for a second consultation paper to be issued. The proposal that the Reserve Bank be the regulator of NBDTs does not substantively change the nature of the regulatory arrangements from those set out for second tier 2 NBDTs in the discussion document, even though some may perceive otherwise.
57. However, as noted above, there are a number of details still to be developed in respect of requirements relating to: administering the definition of NBDT and determining exemptions from the NBDT category: the minimum dollar level of capital: credit exposures to related parties: minimum governance requirements: credit rating requirements; and responding to NBDT distress and failure. I have asked officials to consult with trustees and some other stakeholders on these and the other matters covered in this paper and the result of these consultations will be included in the report back to Cabinet in July.

RECOMMENDATIONS

It is recommended that the Committee:

- 1 **Note** that non-bank deposit-takers (NBDTs) are different in some key respects from other debt issuers and that additional regulatory requirements are necessary in order to promote a sound and efficient financial system and assist depositors to better protect their interests in investing in the NBDT sector;
- 2 **Note** that the NBDT discussion document issued in August 2006 identified a range of deficiencies in the current regulation of NBDTs, including the absence of a licensing requirement and minimum prudential and governance standards, inconsistency in supervisory requirements across the sector, and an inadequate means of assisting depositors to identify and compare the risks of different NBDTs;
- 3 **Note** that the NBDT discussion document proposed a two-tier regulatory framework for NBDTs, with the first tier being supervised by the Reserve Bank and regulated to a uniformly applied minimum level, and a second tier supervised by trustee corporations where the level of supervisory requirements would vary, subject to some base level requirements, and that building societies and credit unions would be supervised by the Reserve Bank;
- 4 **Note** that submissions on the NBDT discussion document generally supported the need for a strengthening of NBDT regulation, including licensing and some minimum regulatory requirements, but expressed a desire to retain trustee-based supervision for all NBDTs in a single tier, and that there was little support for the proposed multi-tier structure;

- 5 **Note** that, in light of submissions and further analysis, the retention of a single tiered, trustee-based supervisory framework, bolstered by licensing and minimum regulatory requirements specified by a government regulatory authority, would be a more cost-effective and less distortionary means of achieving the desired regulatory objectives;
- 6 **Agree** that the objectives of prudential regulation of NBDTs should be to promote a sound and efficient financial system by:
 - 6.1 Ensuring that NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs and promote depositor confidence;
 - 6.2 Providing depositors with a clearer basis for distinguishing between lower-risk and high-risk NBDTs; and
 - 6.3 Resolving NBDT distress or failure in an orderly and timely manner, with minimum disruption to the financial system and depositors.
- 7 **Agree** to the following proposals:
 - 7.1 Legislation will be required to define both a “deposit” (distinguishing this from other debt securities) and an NBDT, with provision, where appropriate, for a regulatory agency – either the Securities Commission or Reserve bank – to declare certain securities or classes of securities to be deposits where they should be treated as such in terms of the policy of the law.
 - 7.2 Any entity, other than a registered bank, that meets the definition of an NBDT be required to be licensed by the prudential regulator for NBDTs, and supervised in accordance with the requirements for NBDTs, unless exempted from those requirements.
 - 7.3 A regulatory agency – either the Securities Commission or Reserve Bank - will need to have the ability to exempt entities from being NBDTs in some situations, such as where deposit-taking by a particular entity is ancillary to its business and is immaterial in nature.
 - 7.4 All NBDTs be supervised by trustee corporations under the enhanced trustee model applying to debt issuers and with additional requirements for NBDTs.
 - 7.5 Fit and proper requirements be applied to NBDT directors, senior managers and other persons with the ability to exercise control or significant influence over the NBDT.
 - 7.6 NBDTs be required to satisfy their trustee supervisors, at the time of licensing and on an ongoing basis, that they have the capacity to carry on their business in a prudent manner.

- 7.7 NBDTs be required to have and maintain a minimum amount of capital, as set out in regulation.
 - 7.8 NBDTs be required to include in their trust deeds a minimum capital ratio, determined by the trustee, and that the capital ratio be measured on the basis set out in regulation.
 - 7.9 NBDTs be required by regulation to disclose, or to be subject to a limit on, credit exposures to parties related to an NBDT, such as shareholders with control or significant influence, and directors.
 - 7.10 NBDTs be subject to prescribed minimum governance standards, set out in regulation.
 - 7.11 NBDTs be required to obtain and disclose a credit rating from a rating agency approved by the prudential regulator of NBDTs, subject to advice being submitted to Cabinet by 31 July 2007 on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers.
 - 7.12 NBDTs be subject to enhanced public disclosure arrangements pursuant to the Securities Act 1978, in the context of reforms to public offer document requirements in that Act.
- 8 **Agree** that as the prudential regulator of NBDTs, the Reserve Bank will be the agency that:
- 8.1 Licenses and de-licenses NBDTs, in consultation with the Securities Commission;
 - 8.2 Is responsible for setting by regulation and enforcing compliance with minimum prudential and governance regulatory requirements for NBDTs, in consultation with the Securities Commission;
 - 8.3 Administers fit and proper requirements for NBDT directors, senior managers and other persons with the ability to exercise control or significant influence over the NBDT;
 - 8.4 Administers the credit rating requirements;
 - 8.5 Provides advice and recommendations to the Securities Commission in respect of the performance by trustee corporations of their responsibilities for supervising NBDTs; and
 - 8.6 Has powers to intervene to assume control of the process for managing acute distress or failure of an NBDT in situations where the Reserve Bank is satisfied that this is necessary to avoid significant damage to the financial system.

- 9 **Agree** that the Securities Commission will have responsibility for:
 - 9.1 Authorising and supervising trustee corporations in respect of NBDTs; and
 - 9.2 Setting and enforcing NBDT disclosure and advertising requirements under the Securities Act 1978, in consultation with the Reserve Bank.

- 10 **Invite** the Minister of Commerce to report back to Cabinet by 31 July 2007 with detailed proposals relating to the above recommendations and on other matters that require approval:
 - 10.1 The proposed definition of a NBDT and whether the Securities Commission or Reserve Bank should administer this definition;
 - 10.2 The power to exempt an entity from being classified as a NBDT and whether the Securities Commission or Reserve Bank should have that power;
 - 10.3 The requirement for minimum capital;
 - 10.4 The requirements for related party exposures;
 - 10.5 Credit ratings requirements; and
 - 10.6 Powers to deal with NBDT distress and failure.

Hon Lianne Dalziel
Minister of Commerce

Regulatory Impact Statement - Proposal for Prudential Regulation of Non-Bank Deposit-Takers

This paper sets out the Regulatory Impact Statement for the proposed regulation of Non-Bank Deposit-Takers. It should be read in conjunction with the associated paper to Cabinet Economic Development Committee.

EXECUTIVE SUMMARY

The Discussion Document on Non-Bank Deposit-Takers (NBDTs) issued last year noted that there are deficiencies in the current regulation of NBDTs, particularly a lack of consistent minimum prudential and other regulatory requirements, the absence of fit and proper tests for senior NBDT office holders, and inadequate disclosure to enable depositors to identify and compare the risks of NBDTs. To address these problems, it is proposed that all NBDTs will be subject to a licensing requirement and be required to meet minimum regulatory requirements at licensing and on an ongoing basis, set and enforced by the Reserve Bank in consultation with the Securities Commission. It is also proposed that trustee-based supervision will be retained, but where trustees are subject to greater supervision by the Securities Commission. Disclosure requirements under the Securities Act will be strengthened and NBDTs will be required to obtain and disclose a credit rating from an approved rating agency, subject to satisfactory arrangements being in place to minimise the cost of ratings.

ADEQUACY STATEMENT

The Regulatory Impact Analysis Unit has reviewed the RIS and considers the RIS is adequate according to the adequacy criteria.

STATUS QUO AND PROBLEM

There are around 130 NBDTs currently operating in New Zealand – mainly finance companies, building societies and credit unions. They represent around 10% of total deposits and lending, and are growing in market share relative to banks.

NBDTs are currently regulated as debt issuers under the Securities Act in much the same way as other debt issuers. As such, they are required to be supervised by trustees and issue prospectuses and investment statements. Under those arrangements, trustees set the prudential, reporting and other requirements for each NBDT and have the power to enforce compliance and take remedial action where necessary. In addition, credit unions are regulated under specific legislation.

The Discussion Document noted that NBDTs have special features that warrant a form of regulation that goes beyond that required for other debt issuers, including:

- Many NBDTs perform bank-like functions, including providing on-call or short-term deposit facilities that are relied on for transaction purposes. This suggests that NBDTs should be regulated in some respects in a manner similar to that

applicable to banks, while still facilitating continued diversity, flexibility and competitiveness in the NBDT sector.

- Unlike corporate bond and other debt issues, in which the funds are used to finance the issuer's own business, NBDTs, like banks, lend to many clients. This makes it difficult for depositors to ascertain the true risk of an NBDT and provides a justification for additional prudential and disclosure-based regulation.
- NBDTs are potentially vulnerable to contagion risk, whereby the distress or failure of some NBDTs could trigger acute distress or failure in others. This suggests the need for enhancements to the standard regulation of debt issuers, such as in respect of public disclosure requirements, ratings and distress management arrangements.

The Discussion Document highlighted a number of deficiencies in the existing regulation of NBDTs, including: the absence of minimum entry requirements for NBDTs, inconsistency in governance and prudential requirements across NBDTs, inadequate official oversight of trustee supervision, inadequacies in public disclosures, and insufficient means for investors to assess and compare NBDT risk profiles. These deficiencies impede the ability to maintain a sound and efficient financial system, undermine competitive neutrality in the sector and have the potential to lead to a misallocation of resources and potential instability in the sector.

The NBDT sector has experienced some difficulties in recent times, with three finance companies having failed in 2006. Parts of the NBDT sector could be vulnerable to any significant weakening in the economy in the next year or two, potentially giving rise to more NBDT failures. Although it is unlikely that these would pose problems for the soundness of the financial system, they could lead to an erosion in confidence in the NBDT sector, with the potential for some NBDT failures causing instability for others. Significant turbulence in the NBDT sector could also lead to depositors migrating to banks, thereby reducing the overall competitiveness of the deposit-taking sector. The proposed reforms to NBDT regulation will not provide any quick solutions to this situation, but should help to foster the longer term soundness and resilience of the NBDT sector.

The retention of the status quo is not desirable for a number of reasons, including the following:

- The existing arrangements do not adequately meet the policy objectives. They fail to adequately promote sound governance and risk management practices within NBDTs or to provide depositors with a reliable and accessible means of assessing and comparing risks across the NBDT sector.
- The existing arrangements are not competitively neutral within the NBDT sector – there are inconsistencies in regulation of like-entities.
- The existing arrangements are not conducive to achieving market disciplines in the NBDT sector, mainly due to lack of user-friendly, timely and complete financial disclosures and lack of information that clearly identifies the riskiness of an NBDT.

- The absence of a licensing requirement creates a risk that an NBDT may be controlled or managed by persons with insufficient capacity to manage the NBDT in a sound manner, or by persons with significant conflicts of interest. This creates a risk of an NBDT being imprudently managed or used for purposes that benefit related parties at the expense of depositors.
- There are no minimum requirements for ongoing supervision, including prudential requirements relating to capital, constraints on lending to related parties, limits on exposure concentration or standardised triggers for prompt corrective action. The absence of these requirements reduces the capacity to promote a minimum level of prudential soundness in the NBDT sector and creates a risk of excessive or non-commercial lending to related parties

OBJECTIVES

The proposals seek to promote a sound and efficient financial system by:

- ensuring all NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs and promote depositor confidence;
- providing depositors with a clearer basis for distinguishing between lower-risk and higher-risk NBDTs; and
- resolving NBDT distress or failure in an orderly and timely manner, with minimum disruption to depositors and the financial system.

ALTERNATIVE OPTIONS

A number of options have been considered in assessing how the regulation of NBDTs could be improved to meet the proposed regulatory objectives. These are summarised below.

The criteria against which options to meet the objectives have been assessed are:

- which arrangements would best address the objectives;
- which arrangements would have least adverse impact on compliance costs for NBDTs and regulatory administration costs for government;
- impact on dynamic efficiency in the financial sector;
- implications for moral hazard risks;
- competitive neutrality;
- maintaining or enhancing market disciplines on NBDTs; and
- relevant international principles and best practice.

Option 1 – Uniform licensing and supervision for all NBDTs

Another option considered for the regulation of NBDTs is to require all NBDTs to be licensed and supervised in a uniform manner by a government agency. This would be similar to the type of arrangement that applies to deposit-takers in many countries.

Under this arrangement, any entity wishing to offer deposits or deposit-like securities to the public would be required to meet fit and proper and minimum regulatory requirements at licensing and on an ongoing basis. These would be set and enforced by a government regulator, which would monitor and supervise the NBDTs and respond to distress or failure situations. There would be no trustee requirements for NBDTs – a government agency would be the sole supervisor of NBDTs.

This option has benefits and costs:

- It would promote consistency in regulatory requirements across the NBDT sector and meet the principle of competitive neutrality and ensure that all NBDTs meet some minimum prudential, governance and fit and proper requirements, applied uniformly across the sector. This option would also facilitate some regulatory administrative efficiencies and synergies, given that one agency would regulate all NBDTs, rather than this being spread across a number of different trustee corporations.
- This option would also have a number of costs and risks. In particular, the application of uniform requirements across a diverse range of generally small and relatively riskier NBDTs could impose efficiency costs on the sector, potentially forcing some NBDTs out of business. It would not facilitate the diversity of NBDTs that currently exist under a trustee-based framework. Trustees can tailor supervisory requirements to meet the particular nature and circumstances of an individual NBDT, thereby facilitating a more flexible approach to the regulation of NBDTs.
- Another risk associated with this option is the moral hazard risk it could induce – ie NBDTs may have incentives to take higher risks if they or their depositors believe that government regulation and supervision implies a form of implicit guarantee.

For these reasons, this option is not considered to be cost-effective.

Option 2 – A two-tiered approach – as proposed in the Discussion Document

Under this option, all NBDTs would have to be licensed and subject to enhanced prudential, governance and fit and proper requirements, but regulated in two tiers:

- The first tier – Authorised Deposit Takers - would be licensed and supervised by the Reserve Bank in a manner similar to that for registered banks, as a category of lower-risk deposit-takers. Any NBDT would be able to become an Authorised Deposit Taker, provided that it could meet the prescribed requirements. They would be monitored by the Reserve Bank and the Bank would have powers to enforce compliance and intervene in situations of acute distress or insolvency.

- The second tier of NBDTs – comprising all NBDTs other than those that became Authorised Deposit Takers - would continue to be supervised by trustees, overseen by the Securities Commission, but with enhanced requirements, including minimum prudential, governance and disclosure requirements. Trustees would monitor NBDTs and have the powers to enforce compliance and intervene in distress situations. The Securities Commission would oversee trustees in the performance of their duties.

This option would enable NBDTs that meet a higher level of standards to be distinguished from other NBDTs. This could help depositors to distinguish between higher and lower risk NBDTs and potentially help to lift governance and risk management standards across the sector. It would avoid imposing uniform arrangements across all NBDTs and facilitate the continuation of trustee-based arrangements for those NBDTs that elect to remain in the second tier.

Notwithstanding these benefits, a two-tier structure could create a risk of distorting market perceptions of the risk profile of NBDTs. In particular, it risks portraying Authorised Deposit Takers as being government-approved and Tier 2 NBDTs as being of higher risk than may necessarily be the case. A two-tier structure therefore potentially weakens the efficiency of the NBDT sector and could impede the sound allocation and management of risks. This option would also complicate the regulatory arrangements for the NBDT sector to a greater degree than is required to meet the proposed objectives.

PREFERRED OPTION

The preferred option is to retain the benefits of a trustee-based supervisory framework, but with enhancements, with the following features:

- Any entity, other than a registered bank, wishing to be a retail deposit-taker and provider of financial services would be required to be licensed as an NBDT. Licensing would be performed by the prudential regulator of NBDTs, proposed to be the Reserve Bank. There will be scope to exempt entities from being regulated as NBDTs (but still being regulated as debt issuers) where, for example, their deposit-taking activities is immaterial in amount and is ancillary to their core business.
- All NBDTs would be supervised in a one-tier arrangement, where trustee corporations continue to be the supervisors.
- Minimum requirements would apply to all NBDTs at the time of licensing and on an ongoing basis, including fit and proper requirements, a minimum level of capital, a requirement that trust deeds contain capital ratios measured in accordance with a prescribed framework, and minimum governance requirements. Consideration is being given to either imposing a standardised maximum limit on credit exposures to NBDT related parties or introducing a standardised form of disclosure of related party exposures. The requirements would be designed to promote greater consistency in supervision, and sound governance and risk management, in the NBDT sector.

- All NBDTs would be required to obtain and disclose a credit rating (subject to the possibility of exemptions for small NBDTs). It is proposed that the Reserve Bank will be empowered by statute to prescribe credit rating requirements for NBDTs, including the nature of the rating that must be obtained and how it must be disclosed. The proposal for NBDTs to obtain a rating is subject to report back to Cabinet by end July on further details, including on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers
- NBDTs would be subject to enhanced public disclosure arrangements, potentially including six monthly disclosures, more user-friendly formats, and more risk-focused disclosure.
- The proposed arrangements would involve three coordinated elements of NBDT regulation:
 - Trustees would continue to be the supervisors of NBDTs, setting and enforcing financial and reporting requirements for NBDTs, and being responsible for taking remedial action in situations of NBDT distress or failure.
 - The Reserve Bank would be the prudential regulator of NBDTs, with responsibility for licensing NBDTs, prescribing and enforcing minimum prudential and governance regulatory requirements, in consultation with the Securities Commission, and administering the proposed credit rating arrangements and fit and proper requirements. It would also have the power to intervene in NBDT distress situations where the soundness of the financial system is at risk.
 - The Securities Commission would have responsibility for authorising and supervising trustee corporations and, in consultation with the Reserve Bank, for setting and enforcing NBDT disclosure and advertising requirements under the Securities Act.

In order to implement the preferred option, legislation will be required to empower the Reserve Bank to license NBDTs and recommend regulations specifying minimum prudential and other requirements for NBDTs, and to require NBDTs to obtain and disclose a credit rating. Legislation will also be required to amend some existing legislation governing some categories of NBDTs – specifically credit unions and building societies. Among other matters, this legislation will repeal those provisions in existing legislation that specify prudential requirements for these categories of NBDTs.

Further details on the NBDT proposals will be reported back to Cabinet by end July, including in respect of:

- the proposed definition of a NBDT and whether the Securities Commission or Reserve Bank should administer this definition;
- the power to exempt an entity from being classified as a NBDT and whether the Securities Commission or Reserve Bank should have that power;
- the requirement for minimum capital;

- the requirements for related party exposures;
- credit ratings requirements; and
- powers to deal with NBDT distress and failure.

Benefits of preferred option

The preferred option is expected to be the most cost-effective means of achieving the proposed objectives. Its benefits (relative to the status quo) are likely to comprise:

- Greater consistency in supervisory requirements across the NBDT sector and minimum requirements that will assist in promoting sound governance and risk management.
- Preserving the flexibility of trustee-based supervision and allowing financial and other requirements to be tailored to the nature and circumstances of individual NBDTs.
- Facilitating efficiency and synergy in regulatory oversight through the Reserve Bank.
- Providing depositors with much improved capacity to identify and compare risks in the NBDT sector, via ratings.
- Ratings are expected to strengthen market disciplines on the NBDT sector, assisting in promoting sound governance and risk management.

Costs and risks of preferred option

The costs and risks are expected to comprise:

- Minimum prudential, governance and fit and proper requirements will impose some compliance costs and operational constraints on NBDTs, but the proposed requirements have been kept to a minimal level and are not expected to impose significant costs.
- Trustees may increase their fees to NBDTs, given the enhanced role they will have under the proposed arrangements. However, trustee fees are a relatively modest proportion of total expenses for NBDTs and any increase is unlikely to be particularly significant relative to NBDTs' total assets, deposits or revenue.
- The Reserve Bank will not be charging fees for its regulatory functions, other than possibly charging a cost-recovery fee for licensing NBDTs. If a licensing fee is charged, it is likely to be relatively minor and is not likely to represent an impediment to entry into the NBDT sector. Any proposal for a licensing fee, including the level of any fee, will be brought to Cabinet for decision by end July.
- Credit ratings will impose additional costs on NBDTs. These are expected to be relatively modest in relation to NBDTs' revenue, assets and deposits. For an NBDT at the median of the range of NBDTs, the annual ratings fee is estimated at between \$25,000 to \$35,000, which would represent only around 0.02% of NBDT

total assets. In addition, there would be indirect costs associated with ratings, such as management time and provision of information to NBDTs. However, there are options available to minimise compliance costs for small NBDTs, including exempting NBDTs below a defined level (eg those with total assets below \$50 million) from a rating, applying ratings to groups of NBDTs where they are cross-guaranteed and exploring the possibility of lower fees for industry rating arrangements. The proposal for NBDTs to obtain a rating is subject to report back to Cabinet by end July on further details, including on satisfactory options for minimising the compliance costs of a ratings regime for NBDTs, particularly for small providers.

- Ratings could result in some (higher risk) NBDTs having higher funding costs as a result of investors having a clearer understanding of the risks involved in placing funds with those NBDTs. This could place commercial pressure on some NBDTs and potentially lead to consolidation in parts of the NBDT sector, including the possibility of some NBDTs merging with others or leaving the sector. This is not a negative outcome for the NBDT sector or for investors to the extent that it merely reflects more efficient awareness and pricing of risks by investors. Rather, it would reflect the consequence of better-informed risk/return decisions by investors.
- There will be transition costs for NBDTs to come into compliance with the proposed requirements. In most cases, trust deeds will need to be amended to come into compliance with some elements of the proposed requirements, such as the minimum prudential standards. Some NBDTs are unlikely to initially meet proposed governance requirements. A transition period will be allowed to enable NBDTs to meet the requirements and to enable trust deeds to be amended.
- In the absence of effective coordination across the three agencies (trustees, Securities Commission and Reserve Bank) there would be a risk of duplication or uncoordinated regulatory action, which could add to the compliance burdens for the NBDT sector and compromise regulatory outcomes. In order to avoid these risks, there will be clear delineation between the functions of the trustees, the Reserve Bank and the Securities Commission, together with robust information-sharing and coordination arrangements. The Privacy Commissioner will be consulted and their approval sought for any proposed information-sharing powers.
- The fiscal costs for the Reserve Bank associated with the NBDT proposals are estimated to be in the range of \$1 million to 1.5 million per annum on an ongoing basis (once the NBDT arrangements have been fully implemented).

It is considered that the benefits of the proposals outweigh these costs.

IMPLEMENTATION AND REVIEW

Legislation will be required to implement the proposed option. The legislation is likely to take the form of a new Act, focused on prudential and associated regulation of NBDTs.

It is expected that the legislation will be ready for introduction into Parliament by late 2007 or early 2008, with the aim of having the legislation enacted by September 2008. Commencement of the new arrangements is scheduled for 2010 and will be coordinated with other relevant elements in the RFPP arrangements.

Regulatory proposals as set out in the Preferred Option will be developed in consultation with stakeholders, including NBDTs and trustees. It is expected that much of this consultation will occur prior to the report back to Cabinet by end July.

Implementation of the arrangements will include the development of appropriate and transparent coordination arrangements between the Reserve Bank, Securities Commission and trustees.

The Reserve Bank's costs in performing its NBDT functions will be funded through its Funding Agreement, under the Reserve Bank of New Zealand Act.

CONSULTATION

Stakeholder Consultation

The review of NBDT regulation has been subject to extensive consultation with stakeholders, including many NBDTs, industry associations, trustees and consumer bodies.

Submitters on the Discussion Document generally supported the proposed outcomes and objectives of NBDT regulation. Although submissions agreed that there were deficiencies in the existing regulatory requirements, most argued that the trustee-based framework generally works well and did not support fundamental change to regulatory arrangements. A strong preference was expressed by most submitters for retention of the trustee-based framework, with the proposed enhancements.

There were mixed, but generally negative, reactions to the proposal for a two-tier model. The main concerns were that a two-tier model could distort market pricing of NBDT products by providing an artificial wedge between the two tiers, and that the proposed Authorised Deposit Taker category would lose the benefits of trustee-based supervision and impose transitional costs on NBDTs.

There was some support for all NBDTs being required to obtain and disclose credit ratings, with some submitters arguing that ratings would be the best means of informing depositors on risk, and for strengthening market disciplines. However, most submitters opposed mandatory ratings on the grounds of cost and a concern that small NBDTs could be unfairly disadvantaged by the rating process.

Although the revised proposals are very similar to those in the Discussion Document, some stakeholders may view the proposal for the Reserve Bank to be the regulator, and its role in applying the fit and proper tests, as a significant change in the nature of the regulatory arrangements for NBDTs. The proposal that the Reserve Bank be the prudential regulator of NBDTs does not substantively change the nature of the regulatory arrangements from those set out for Tier 2 NBDTs in the Discussion Document, even though some may perceive otherwise. Therefore a second full round of consultation is not required, but officials will consult some stakeholders –

particularly trustees and industry associations - in preparing the details of the proposals.

The proposal to implement a one-tier arrangement and to retain trustees as the supervisors is expected to substantially address most of the concerns raised by submitters. Concerns over the cost of mandatory ratings will be addressed through consideration of a possible exemption from mandatory ratings for small NBDTs and assessment of the feasibility of reduced industry-based rating fees.

Government Departments/Agencies Consultation

The following government agencies have been consulted on the proposals in this paper: Reserve Bank, Treasury, Ministry of Justice, Securities Commission, and the Ministry of Consumer Affairs. All these government agencies support the preferred option.