

The Chair
CABINET

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

PROPOSAL

1. This paper responds to questions raised during the EDC consideration of the proposed Non-Bank Deposit-Taker (NBDT) regulation in relation to the impact on credit unions. It notes that credit unions perform very similar functions to other NBDTs, have a similar risk profile and should be regulated in a like manner as other NBDTs. It proposes that the proposed NBDT regulatory arrangements can be applied in ways that enable credit unions to retain their character while liberalising certain current credit union operational restrictions, and providing depositors with an appropriate level of protection.

ANALYSIS

2. Proposals relating to the Review of Financial Products and Providers: Regulation of Non Bank Deposit Takers were considered at the EDC meeting on 13 June 2007.
3. EDC (EDC Min (07) 11/15 refers) invited me to provide further information to Cabinet on 18 June 2007 on:
 - whether there is evidence to justify treating credit unions differently to other non-bank deposit takers; and
 - the status of other work underway relating to credit unions, particularly the government's review of the credit union provisions in the Friendly Societies and Credit Unions Act 1982.

Is there evidence to justify treating credit unions differently from other non-bank deposit takers?

4. A credit union, established under the Friendly Societies and Credit Unions (FSCU) Act 1982, is an unincorporated co-operative financial organisation set up to provide savings and loan facilities to its members who have a “common bond” permitted by the FSCU Act.
5. Unlike companies, mutual financial institutions are generally owned by their customers, and their management is made up of members. It can be argued that as a consequence the members take a close interest in the affairs of the mutual association, and management has a strong incentive to act in the interests of members, and that this justifies a lower level of supervision than for other non-bank deposit takers.

6 While these arguments provide some basis for treating credit unions differently from other non-bank deposit takers, I consider that these arguments are outweighed by the size of the industry and the need to ensure all investors, whether members of credit unions or other investors in non-bank deposit takers, are afforded similar levels of protection.

- Significant financial assets are invested in credit unions. There are 52 credit unions registered under the Friendly Societies and Credit Unions Act. Total assets of the sector amount to at least \$737 million (as at 31 December 2006), with membership in excess of 204,000.
- 38 of the unions are members of the NZ Association of Credit Unions (NZACU). These unions, including the Association have assets in excess of \$600 million, and membership exceeding 160,000.
- Six are members of the Manchester Unity Association of Credit Unions with total assets of \$74 million, and a membership in excess of 17,000.
- There are seven independent unions, the largest two having assets of \$56 million and \$19 million respectively. Membership of these unions amounts to in excess of 27,000.
- Credit unions are very similar to other NBDTs in terms of the functions they provide including lending, deposit-taking and the provision of other financial services. The two associations provide operating services for systems and internet banking for their member unions, while the NZACU and the two largest independent unions have an arrangement to access EFTPOS and ATMs. NZACU members are also offered credit card facilities and foreign exchange facilities.
- The most recent statistical data provided to the Reserve Bank indicates that 45% of credit union assets comprise unsecured consumer lending, including hire purchase credit. Less than 29% of assets relate to housing loans.
- They carry similar risks to many other NBDTs, including the risk that their members – depositors – could lose money in the event that a credit union fails. The ratio of capital to total assets ranges from 5% to 18%.
- There have been at least five failures or remedial restructurings of credit unions over the past ten years as a result of credit union distress.
- Credit unions are participating fully in the financial system, offering their members a product range that is similar in many respects to that offered by finance companies, building societies and banks. The need for adequate capital and other prudential requirements is just as great for credit unions as for other NBDTs, particularly given their relatively low level of risk diversification.

- The need for appropriate prudential regulation will be greater if the operational constraints on credit unions are reduced as part of the credit union reforms.

The status of other work underway relating to credit unions, particularly the government's review of the credit union provisions in the Friendly Societies and Credit Unions Act 1982 in the light of the non-bank deposit proposals

7 A one-tier regulatory framework has been proposed, where all NBDTs (including credit unions) continue to be supervised by trustee corporations under enhanced trust deed arrangements for debt issuers, and are subject to some additional minimum requirements. It is intended that these requirements be the same for all entities, including credit unions.

8 In respect of credit unions, prior to the review of financial products and providers, Cabinet agreed to (CAB Min (05) 14/4 refers):

- allow credit unions to determine their own common bond provided it is an objectively verifiable characteristic;
- allow charities and incorporated societies affiliated with the common bond to become Credit Union members;
- allow credit unions to determine their own minimum deposit amount;
- remove the requirement to specify service charges in credit union rules provided mechanism for levying the charges is specified in the rules; and
- allow credit union associations to extend new services to members without Ministerial approval.

These amendments were included in the Business Law Reform Bill, passed last year

9 Cabinet also previously agreed in April 2006 (CAB Min (05) 14/4 refers), in principle, subject to the review of financial products and providers, to allow credit unions to:

- have the equivalent flexibility to borrow and invest surplus funds and to hold land as any other NBDT, if credit union rules allow and if trust deeds are amended accordingly;
- raise capital by issuing securities to their members, if their rules and trust deeds allow it;
- have legal status so that they can have limited liability, own property, have perpetual succession, sue and be sued;
- utilise a conversion mechanism that would allow them to convert to a limited liability company provided credit union reserves are locked up for minimum of 5 years or applied for charitable purposes (subject to some restrictions on the use of the moniker "credit union"); and
- make it explicit that members of the committee of management owe directors' duties.

10 These changes did not proceed into legislation at the time because of the possibility that these decisions might need further consideration as a result of Review of Financial Products and Providers. The relevant area of the Review

is now complete (the non-bank deposit taker workstream) and no issues were raised that I consider as impacting on or requiring further consideration of the in principle decisions. I recommend Cabinet now confirm their in principle agreement, in light of the proposal that credit unions will now be subject to the NBDT regime.

- 11 Consultation feedback suggests that NZACU members, at least, will welcome the overall package, most particularly the removal of these limitations. I, as well as officials, have discussed the proposals for non-bank deposit takers with the NZACU and no major concerns were raised.

Credit ratings

- 12 One of the regulatory requirements proposed for non-bank deposit takers is that they would be required to obtain and disclose a credit rating. I recognise that some credit unions may find it difficult to meet the requirement for an ongoing credit rating, due to their small size and mutual nature. Similarly, the costs of obtaining a rating may also be significant for other small NBDTs.
- 13 Consequently, in the paper "Regulation of Non-Bank Deposit Takers", I have sought agreement for NBDTs to be required to obtain and disclose a credit rating, 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.
- 14 These options include (either individually or in combination) exemptions or qualified exemptions (for example restrictions on business) for small NBDTs; the application of ratings to a group of entities (such as affiliated credit unions); the possibility of negotiating reduced fees on a collective basis with the rating agencies.
- 15 For example, NBDTs with a balance sheet below a defined level, such as \$50 million of total assets, could be exempted from a rating requirement, but required to disclose the absence of a rating from an approved agency and restricted in the nature of alternative ratings they disclose. An exemption set at \$50m would have the effect of excluding all Manchester Unity credit unions and the independent credit unions.

RECOMMENDATIONS

I recommend that Cabinet:

- a. **note** that credit unions perform very similar functions to those of other non-bank deposit-takers (NBDTs);
- b. **note** that credit unions' business entails risks of a similar nature to those of other NBDTs and that they should be subject to appropriate prudential regulation similar to that of other NBDTs;
- c. **note** that the proposed reduction in operational constraints on NBDTs will expose credit unions to somewhat greater financial risks and hence there will be a greater need for credit unions to be regulated on much the same basis as for other NBDTs;
- d. **agree** that the supervisory framework structures outlined in the Cabinet paper on the regulation of NBDTs be applied in full to credit unions, 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;
- e. **confirm**, subject to the supervisory framework for the regulation of NBDTs being applied to credit unions, that the changes agreed to in principle by Cabinet in April 2006 (CAB Min (05) 14/4 refers) in respect of credit unions be adopted, namely:
 - allow credit unions to:
 - have the equivalent flexibility to borrow and invest surplus funds and to hold land as any other NBDT, if credit union rules allow and if trust deeds are amended accordingly;
 - raise capital by issuing securities to their members, if their rules and trust deeds allow it;
 - have legal status so that they can have limited liability, own property, have perpetual succession, sue and be sued;
 - utilise a conversion mechanism that would allow them to convert to a limited liability company provided credit union reserves are locked up for minimum of 5 years or applied for charitable purposes (subject to some restrictions on the use of the moniker "credit union"); and
 - make it explicit that members of the committee of management owe directors' duties; and
- f. **Agree** to the Minister of Commerce and the Minister of Finance announcing these decisions as part of the announcement of decisions on non-bank deposit takers.

Hon Lianne Dalziel
Minister of Commerce