

The Chair  
**CABINET ECONOMIC DEVELOPMENT COMMITTEE**

**REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS: MUTUALS'  
GOVERNANCE**

**PROPOSAL**

- 1 This paper seeks agreement to proposals regulating governance requirements for mutual financial institutions to be implemented as part of the Review of Financial Products and Providers (the Review). Agreement is also sought for amendments which result from the previous Cabinet decision that building societies and credit unions, which are mutuals, are to be regulated under the deposit taker regulatory framework.

**EXECUTIVE SUMMARY**

- 2 The Review aims to develop an effective and consistent framework for the regulation of non-bank financial institutions. This paper outlines a package of proposed measures to implement a unified governance regime for mutual financial institutions. These governance requirements are aligned with those in the Companies Act. The mutuals covered by the proposals are building societies and credit unions, and some friendly societies and industrial and provident societies. As there are now no entities incorporated under the Mutual Insurance Act 1955 the paper proposes that the Mutual Insurance Act 1955 be repealed.
- 3 Two types of mutuals, credit unions and building societies, are included within the definition of a deposit taker in the Reserve Bank of New Zealand Amendment Bill (No 3) which is currently before the House. The paper includes proposals for amendments to remove any overlapping or conflicting requirements between the Friendly Societies and Credit Unions Act 1982 (FSCU Act) and the Building Societies Act 1965 (BS Act) and the Reserve Bank of New Zealand Amendment Bill (No 3). The proposals also complete the second stage of the review of provisions applying to credit unions under the FSCU Act.
- 4 The third aspect of the measures outlined in the paper is a series of proposals to standardise and modernise the registration provisions applying to mutuals to align with the current framework for registration regimes for companies and other corporate forms.

**BACKGROUND**

- 5 A range of mutual organisations (that is, organisations established by members to provide services to members) have been established under different

legislation with differing requirements. The mutuals being considered in the Review are those that provide financial services. A mutual financial institution is a mutual registered under the mutuals legislation which is also a registered financial service provider, as defined under the Financial Service Providers (Registration and Dispute Resolution) Bill which is currently before the Finance and Expenditure Committee.

- 6 These mutual financial institutions are currently subject to the Industrial and Provident Societies Act 1908 (IPS Act), the Mutual Insurance Act 1955 (MI Act), the BS Act and the FSCU Act. Industrial and Provident Societies are societies usually consisting of the owners of small businesses who, while continuing to operate independently, become part of this larger entity for mutual benefit. Building Societies provide bank-like savings and home loans to members. Credit unions provide members with loans for everyday purposes. Friendly Societies are funded by subscriptions from members for their welfare and that of their families during sickness or on the death of a member.
- 7 In the first stage of the Review a series of issues were identified in relation to the governance standards of Non-Bank Deposit Taking Institutions (NBDTs). Comments were received about the varying governance standards relating to NBDTs, with many market participants suggesting that the governance regime set out in the Companies Act 1993 provided a better system for ensuring accountability, through shareholder remedies and processes for the appointment and removal of directors.
- 8 An earlier review of the FSCU Act undertaken in 2004 identified, among other issues, that:
  - the governance regime for credit unions was not as robust as that for companies and, to a lesser extent, building societies;
  - there were weaker statutory rules relating to the accountability of directors; and
  - there were fewer statutory qualifications for credit union directors and fewer statutory controls on their appointment and removal than for directors of companies.
- 9 Improvements to the governance requirements for mutual financial institutions will contribute to the following outcomes:
  - well governed financial institutions;
  - robust structures for the management of risk;
  - explicit processes through which investors/consumers can hold management accountable and have effective redress; and
  - appropriate management of competing interests.

## Previous consideration

### *Review of Financial Products and Providers*

- 10 On 23 August 2006, EDC considered proposals to release a series of discussion documents as part of the Review of Financial Products and Providers [EDC Min (06) 13/7 refers]. These included a discussion document on mutuals' governance.
- 11 In June 2007, Cabinet agreed to a two step approach to introducing legislation to implement the findings of the Review of Financial Products and Providers. The second tranche of decisions was to include decisions necessary to consolidate regulation of mutuals' governance. The report back date for the mutuals' governance proposals was deferred until 31 July 2008 [EDC Min (07) 29/20 refers].
- 12 Submissions on the 2006 discussion document generally supported the proposed base line governance requirements for mutual financial institutions. Submitters noted that many mutual financial institutions have already implemented such governance arrangements on a voluntary basis.

### *FSCU Act Review*

- 13 The FSCU Act review was initiated in response to suggestions from the New Zealand Association of Credit Unions for amendments to the Act. The issues considered in the FSCU Act review were specific to credit unions. In 2005 Cabinet agreed to the following in principle changes to the FSCU Act, subject to the outcome of the Review of Financial Products and Financial Providers [EDC Min (05) 9/7 refers]:
  - To amend the current statutory restrictions on borrowing, investment of surplus funds and investment in land to default provisions from which credit unions can depart, to the extent that their rules allow them to do so and their trust deeds are amended accordingly.
  - To include provisions that specify matters that must be included in trust deeds of credit unions that depart from any of the default provisions on borrowing and investment, including: giving trustee supervisors a first ranking security charge over the assets of the credit union; and other ratios or provisions that adequately monitor and address the risks posed by these new activities, including provisions to ensure that investments are consistent with credit unions' objects, within its rules and have regard to the need for diversification and balance in credit unions' investments.
  - To include a requirement that the trustee supervisor to certify to the Registrar of Friendly Societies and Credit Unions (the Registrar) that it is satisfied that the trust deed as amended complies with the new provisions in the Act.
  - To change the current restriction on credit unions issuing one class of shares, i.e. members deposit shares, to a default provision so that credit unions may

issue additional securities to their members if their rules permit provided these securities must be transferable among members and investing members should have a reasonable exit mechanism so that they are given the opportunity of not being locked into the investment (an example being a share repurchase obligation on the credit union), do not compromise equality of voting among members and ensures that such securities rank behind members' deposits and creditors in the event of a winding up. Such offer of securities will be deemed offers to the public and will be subject to full disclosure requirements of the Securities Act 1978.

- To amend the Act to specify directors' duties owed by members of the committee of management such as the duty to act in good faith and in the interests of the credit union, to exercise a power for a proper purpose, to comply with the Act and the credit unions' rules, not to engage in reckless trading, duty not to agree to the credit union incurring an obligation unless the director believes at that time on reasonable grounds that the credit union will be able to perform the obligation when it is required to do so, duty to exercise the care, diligence and skill that a reasonable director would and the power to rely on certain persons and certain information/advice.
- To grant legal status to credit unions so that they have limited liability, can own property, have perpetual succession and sue and be sued in their own name. Consequently, the role of trustees as officers of the credit union will become redundant and will be removed.
- To provide for a conversion mechanism modelled on that in the Building Societies Act to allow credit unions to convert to limited liability companies.

- 14 Cabinet confirmed its in principle agreement in June 2007, in light of the decision that mutual financial institutions that are deposit-takers will be licensed and subject to prudential regulation by the Reserve Bank. This was part of Cabinet decisions on the regulation of non-bank deposit-takers [CAB Min (07) 21/10 refers]. At that time, Cabinet agreed that the FSCU Act would be amended to remove existing prudential and operational constraints on credit unions.

#### **COMMENT**

- 15 A key objective of the Review is to develop an effective and consistent framework for the regulation of non-bank financial institutions that promotes confidence and participation in financial markets and results in a sound and efficient financial sector. While all credit unions and building societies are financial institutions, not all friendly societies and industrial and provident societies are involved in providing financial services (for example those societies that are working men's clubs or taxi co-operatives). The governance requirements will be specified in a single piece of governance legislation for all mutual financial institutions. I do not propose to impose the requirements for financial institutions on the remaining mutuals, many of which are very small and do not present the same level of risk as the financial mutuals. Accordingly, the existing governance requirements will remain in the mutuals legislation, but will be expressly excluded from applying to institutions that provide financial services.

- 16 I propose to include in the Bill the necessary amendments to implement the previous Cabinet decision to remove existing prudential and operational constraints on mutuals that are deposit-takers and thereby to complete the second phase of the Review of the FSCU Act. To standardise and update the operational provisions in the mutuals legislation relating to registration of the various types of mutuals, I also propose that the Bill include provisions aligned with the current framework for registration regimes for companies and other corporate forms.

### **Repeal of Mutual Insurance Act 1955**

- 17 At the time when the consultation took place, it was proposed that the base-level governance requirements would apply to mutual insurers incorporated under the Mutual Insurance Act 1955. Since that time, the Farmers Mutual Group Act 2007 has been passed, removing the only mutual insurer incorporated under the 1955 Act. Consultation with stakeholders has found no reason to retain the Mutual Insurance Act. The Act was designed to apply to associations of farmers and rural property owners, who wished to provide mutual insurance cover for their properties against fire. Insurance products and markets have evolved since then, with the result that there is no association operating under this Act, and it is not likely that one would be established in the future. Accordingly I propose that the Act be repealed.

### **Governance measures for mutual financial institutions**

- 18 For the mutuals' governance framework, I propose consolidated base-level provisions for mutual financial institutions on:
- the role and responsibilities of the board;
  - directors' duties and remedies for breaches of them;
  - qualifications of directors;
  - election and removal of directors;
  - disclosure of directors' and executives' remuneration;
  - members' participation and voting at general meetings;
  - members' participation in major changes;
  - requirements for conduct of member meetings;
  - content and distribution of annual reports;
  - directors' disclosure of interests; and
  - the appointment, rights and duties of auditors.

### *Role of Board*

- 19 I propose that each mutual financial institution must have a board of directors (which may also be known as a committee of management). The business and affairs of the mutual must be managed by, or under the direction or supervision, of the board. As in the Companies Act, the board will be able to delegate its powers, with the board retaining responsibility for the exercise of the power. This is a basic requirement giving clarity about who is responsible for the management of a mutual. It is necessary so that the strengthened governance requirements are imposed on the appropriate people.
- 20 In line with the rights of directors under the Companies Act, directors will have rights to access the mutual's records in order to fulfil their responsibilities. I propose that, as in the Companies Act, the right of access will be subject to restrictions to ensure that it is used only in the mutual's interests and for the purpose of carrying out the director's duties.

### *General Directors' Duties and Remedies for Breaches of them*

- 21 I propose that directors of mutual financial institutions should owe the same general duties to the mutual and its members as directors owe to companies and their shareholders, and have the same ability to rely on third party advice. These include the duty to act in good faith and in the interests of the mutual, to exercise a power for a proper purpose, to comply with the Act and the mutual's rules, not to engage in reckless trading, duty not to agree to the mutual incurring an obligation unless the director believes at that time on reasonable grounds that the mutual will be able to perform the obligation when it is required to do so, duty to exercise the care, diligence and skill that a reasonable director would and the power to rely on certain persons and certain information/advice. The same restrictions and qualifications that apply to directors of companies will apply.
- 22 The mutual itself or a member of the mutual may take legal action against directors to enforce these duties, including injunctions and compensation. The rules of the mutual may specify alternative forms of obtaining redress against directors, such as arbitration, as long as they are binding.
- 23 It is proposed that indemnities and insurance for breaches of these duties should be restricted, as they are under the Companies Act.

### *Qualifications of Directors*

- 24 I propose that similar statutory qualifications for directors (or the committee of management) of mutual financial institutions to those that apply under the Companies Act should be adopted. Namely, minors, undischarged bankrupts and persons banned under the Companies Act, Securities Act, Securities Markets Act or Takeovers Act, or who are banned from holding a similar office in another jurisdiction, are to be disqualified from being directors, and the court should have the power to order that a person may be prohibited from being a director.

### *Election and Removal of Directors*

- 25 Directors must be appointed by an ordinary resolution of members (and, if relevant, voting shareholders), and may be removed by an ordinary resolution of members. An ordinary resolution is one passed by 50 percent of the members entitled to vote and voting on the issue (or by 50 percent of the votes cast in accordance with the voting provisions in the mutual's rules). Provisions equivalent to those in the Companies Act relating to incoming directors, how directors cease to hold office and providing that a director's acts are valid even if their appointment was defective will also apply.

### *Disclosure of the Remuneration of Directors and Executives*

- 26 I propose a requirement that a mutual financial institution's board must only authorise remuneration for directors it considers, on reasonable grounds, is fair to the mutual. Directors' remuneration should be disclosed in the mutual's annual report.
- 27 The number of executives earning more than \$100,000 should be disclosed, in bands of \$10,000.

### *Participation and Voting at General Meetings*

- 28 Each member may attend all general meetings of the mutual financial institution.
- 29 At those meetings each member must have one vote, unless the rules of the mutual financial institution specify otherwise. The rules may not restrict the right to voting on the basis of age, except for those under 18 years of age.
- 30 Providing the flexibility for mutuals to agree on alternative voting provisions will allow building societies that wish to list on securities markets such as the New Zealand Exchange Limited's New Zealand Alternative Market (NZAX) to agree that voting will be on the basis of numbers of voting securities held rather than numbers of members. A number of building societies now issue shares to the public, as well as those held by the members of the society. The conflict between the voting provisions of the Building Societies Act and those required by the listing agreement has caused problems for building societies that wish to have their securities quoted on a registered securities market. The flexibility that I propose will ensure that this conflict will not arise in the future in respect of mutuals.

### *Member Participation in Fundamental Corporate Changes*

- 31 It is proposed that the rules of a mutual financial institution, if any, may only be amended by a special resolution of members.
- 32 Major transactions must be approved by a special resolution of members. A major transaction has a value of 50 percent or more of the gross assets of the mutual.
- 33 A special resolution is one passed by 75 percent of the members entitled to vote and voting on the issue (or by 75 percent of the votes cast in accordance with

the voting provisions in the rules). Again, this approach would be consistent with the Companies Act.

#### *Equitable Conduct of Member Meetings*

- 34 Good corporate governance requires that meetings of members must be conducted in a manner which encourages member participation.
- 35 So that members can be informed about meetings of the mutual, I propose that notice of the time and place of any general meetings must be sent to each member, at least 10 working days in advance. The notice (which may be sent electronically) must:
- set out the business of the meeting and any resolutions to be voted on at the meeting;
  - contain such information as a member might reasonably require to form a reasoned judgement in relation to the resolutions.
- 36 Minutes must be kept of all members' meetings, and copies kept of all resolutions. Members are to be able to obtain copies of these on request.
- 37 I propose that members of mutual financial associations should have the same rights to discuss the management of the company at a general meeting of members, and propose resolutions for consideration by the members, as shareholders of companies have under the Companies Act.
- 38 Auditors of mutual financial institutions must be given notice of, and be entitled to attend and speak at, general meetings in line with the requirements of the Companies Act.
- 39 Members are to be able to appoint proxies to attend and vote at general meetings, or, subject to the mutual financial institution's rules, cast votes by post.

#### *Content and Distribution of Annual Report*

- 40 For members to be able to monitor the performance of those managing the institution, timely and accurate disclosure needs to be made on all material matters regarding the mutual, including the financial situation, performance, and governance.
- 41 To effect this disclosure, I propose that mutual financial institutions should distribute to all members at least 20 working days before the annual general meeting, either an annual report or a notice (which may be sent electronically) containing a statement:
- that the members have a right to receive, free of charge and on request, a copy of the annual report;
  - that the members may obtain the annual report by electronic means and how they may obtain it;

- as to whether the board has prepared a summary version of the annual report; and
- if there is a summary version of the annual report, a statement:
  - that the members have a right to receive, free of charge and on request, a copy of the summary annual report.
  - that the members may obtain the summary annual report by electronic means and how they may obtain it.

42 The annual report or summary annual report must be signed by two directors and must contain, at a minimum:

- Financial statements which comply with the Financial Reporting Act 1993, or summary financial statements produced in accordance with GAAP as it relates to summary financial information;
- The information required to be disclosed on directors' and executives remuneration;
- New disclosures of interests by directors; and
- As is the case for companies, information about donations made, names of directors, audit fees, and other fees paid to the auditor for non-audit work.

*Disclosure by Directors Interested in Transactions with the Mutual*

43 I propose that directors must disclose any interest they or a related party may have in a transaction involving the mutual financial institution, unless it is in the ordinary course of the mutual's business. Any disclosures should be made available to members through the mutual's interests register.

44 As in the Companies Act, I propose that directors should be able to vote on any such transaction, unless the mutual's rules prohibit it. If directors are allowed to vote, the transaction may be avoided within three months of disclosure to members if it is unfair. The exception in the Companies Act, that a transaction cannot be avoided if the mutual receives fair value for it will also apply.

*Appointment, Rights and Duties of an Auditor*

45 The provisions in the Companies Act relating to the appointment, rights and duties of auditors should apply to all mutual financial institutions. In summary:

- a mutual must appoint an auditor at each annual meeting;
- the auditor must be qualified as a chartered accountant and be independent of the mutual;
- the auditor must make a report to members on the financial statements of the mutual;

- the board must ensure that an auditor has access to the accounting records and other documents of the mutual;
- the board must ensure that an auditor is permitted to attend members' meetings and may be heard on any matter that concerns him or her as auditor.

46 Under the Companies Act, companies need not appoint an auditor at an annual meeting if all shareholders unanimously agree not to. I do not consider that an equivalent provision is appropriate for mutual financial institutions as they are in a different situation from a closely held company with very concentrated ownership. They are likely to have a significant number of members and the auditor's report is an important part of the information that members can use to monitor the mutual's performance.

47 The FSCU Act currently provides an exemption from the obligation to appoint an auditor for friendly societies and credit unions with assets less than \$20,000 and less than \$20,000 total receipts and payments in the preceding financial year. As imposing the obligation to appoint an auditor would impose substantial compliance costs on these very small entities, I propose to retain this exemption.

### **Offence provisions**

48 I propose that the legislation will include offence provisions for failure to comply with the governance requirements including, but not limited to:

- Failure to give notice to the registrar of changes to directors;
- Failure to appoint an auditor;
- Failure to make an annual report available; and
- Failure to disclose a director's interests.

49 I propose a maximum penalty of a fine not exceeding \$10,000 for the most serious of the proposed offences, with a lower penalty of \$5,000 for less serious offending. They are similar to penalties found in the Companies Act 1993.

### **Consolidation of governance requirements**

50 I propose that all the base-level corporate governance requirements for mutual financial institutions be consolidated in new legislation. However, to the extent that some mutual institutions do not provide financial services (e.g. some industrial and provident societies and some friendly societies), governance requirements would remain in the Mutuels Legislation, but would be expressly excluded from applying to institutions that provide financial services.

51 This approach will provide certainty to those mutual financial institutions applying the corporate governance requirements. It will also be simpler to deal with any changes that are made in the future to the consolidated corporate governance requirements, as only one Act will need to be amended.

## **Legal status of mutuals**

- 52 Unlike the other mutuals, friendly societies and credit unions are currently unincorporated associations rather than bodies corporate. As they have no legal personality, they are not able to own property, have perpetual succession, or limited liability, among other things. Cabinet decided [EDC Min (05) 9/7] that credit unions would be granted legal status so that they have limited liability, can own property, have perpetual succession and sue and be sued in their own name. Hence the FSCU Act will be amended so that all credit unions have a full legal personality.
- 53 In the case of friendly societies, I propose that they be given the option of having a full legal personality. The provisions in the FSCU Act apply to a range of societies established for a variety of purposes including benevolent societies and working men's clubs. The cost of imposing a requirement for separate legal personality on all 176 branches and societies registered under the Act would not be justified. Friendly societies which provide financial services will be required to meet the base-level governance requirements, adapted appropriately for their lack of legal personality.
- 54 I propose that, where a society does not have separate legal personality, the directors' duties will be owed to the members as a whole. Remedies for breaches may be taken by individual members of the society against the directors or, with the leave of the Court, members may take action on behalf of the mutual (derivative actions) and on behalf of members with the same, or significantly the same, interest in the matter (representative actions). This reflects the general position under the Companies Act.

## **Friendly Societies maximum cover for life assured**

- 55 The New Zealand Council of Friendly Societies submitted that the maximum gross sum that can be paid by a society for life or endowment insurance should be increased from \$60,000 to \$100,000. The FSCU Act provides that the amount can be changed from time to time by the Governor General by Order in Council. The level was set at \$60,000 in 1998. One of the purposes of friendly societies is to provide life insurance benefits to a member's family on the death of a member. These benefits may be used to reduce liabilities such as a mortgage. I consider that an increase from \$60,000 to \$100,000 is warranted to enable friendly societies to provide an appropriate level of assistance in the event of the death of a member.

## **Registration systems**

- 56 The BS Act, IPS Act and FSCU Act all include requirements for the entities established under the Act to register and for the Registrar to operate a public register. The different registration provisions currently have some of the attributes of a modern registration system, but they are inconsistent, contain gaps, and in many cases contain outdated language and concepts.
- 57 I propose that the Bill update the provisions relating to registration of the various types of mutuals, to align with the current framework for registration regimes of

companies and other corporate forms. This would include updating provisions relating to the manner and form in which the register may be kept (including electronically), as well as standardising and updating the provisions covering the maintenance of the register, the process of registration, access to information held on the register, the powers of the Registrar and any other necessary provisions for the proper administration of the register.

- 58 I propose that the registers established under the BS Act, IPS Act and FSCU Acts (“the registers”) should be standardised to provide for the same registration requirements for each of the different entities. For mutuals which provide financial services, the registers would also need to contain some information relating to the increased governance requirements, in particular the requirement to appoint directors.
- 59 I propose that each register should be administered by a Registrar, who should have the ability to delegate some of his or her role to Assistant and Deputy Registrars. Some of the Acts have not been amended to reflect the fact that registers are now kept in a central location and are not always paper-based. I propose that the registers should have the ability to be kept in a form that the Registrar considers best for the purpose for which they are established. In particular, there should be the ability for the registers to be kept in electronic form. The registers should be available at all times, unless for reasons which are specified in regulation, it is not possible for them to be available.
- 60 The Acts currently provide for the collection of a variety of information for inclusion on the registers, and in some cases it is unclear what information actually forms part of the registers. It is proposed that the registers should contain basic, necessary details that will give sufficient information for members, as well as third parties who have business dealings with the mutuals, without imposing an unnecessary administrative burden on the members.
- 61 In line with recent developments in relation to information held on public registers, I propose that the ability for the public to search the registers should be specified, as well as the purpose of the search power, and the search criteria. Searches for personal information that are not carried out in accordance with these purposes will be an interference with the privacy of an individual under the Privacy Act 1993.
- 62 I propose that, in order to effectively operate the registers and maintain the integrity of the information on the registers, the Registrar should have the following powers: the power to correct the register, the power to direct changes to registered information, the power to refuse registration for certain specified matters (for example, the non-payment of fees), the power to charge fees for registration functions, and the power to remove a mutual from the register, or suspend its registration in certain cases, and the power to deregister a mutual at the end of its life.
- 63 In order to ensure that the information on the registers is up-to-date and accurate, the registers contain a number of requirements for reports and returns to the Registrar. I propose that there should be an obligation on the mutuals to file annual returns, the content of which should be prescribed in regulations. The

annual return requirement will be confined to verifying the information which is held on the register. In addition, there should be a requirement to notify the Registrar of changes to material information on the register, such as the location of the registered office.

- 64 The Acts currently provide for various forms of public notice. I propose that there should be a regulation-making power enabling the manner and form of public notice to be prescribed. This will enable some flexibility and future-proofing, so that the most appropriate and effective form of public notice can be prescribed from time to time.
- 65 Finally on the subject of registration, in order to ensure compliance with the registration requirements, I propose that the Registrar will have the power to carry out inspections of the mutuals along the lines of the current inspection powers in the Companies Act. There should also be penalty provisions for failures to comply with the registration requirements, in line with other modern registration regimes such as those contained in the Companies Act 1993, and the Limited Partnerships Act 2008.

#### **REGULATION OF NON-BANK DEPOSIT TAKERS**

- 66 As noted above, building societies and credit unions are included within the definition of a deposit taker in the Reserve Bank of New Zealand Amendment Bill (No 3) which is currently before the House. Some amendments are required to remove duplicated or conflicting legislative requirements between the mutuals legislation and the deposit takers supervisory framework.

#### **Credit Unions**

- 67 Under the FSCU Act, the Registrar of Friendly Societies and Credit Unions has a range of operational powers which relate to matters of a prudential nature for credit unions. These are to:
- approve bank overdrafts for a period greater than 6 months at a time;
  - approve borrowings from other credit unions or associations greater than one year;
  - approve term loans to members of a union in excess of 10 years for secured loans and 5 years for unsecured loans;
  - approve the use of security instruments which is currently limited to mortgages, guarantees or promissory notes;
  - approve the holding of land for longer than six months, if acquired through the exercise of a security interest;
  - approve the amount and form of security to be provided by officers of the credit union; and

- approve the utilisation of the union's general reserve, apart from being used to offset realised losses
- approve arrangements for credit unions to contribute to guarantee funds and arrangements for the support of credit unions in financial difficulty.

68 All of these provisions were included in the FSCU Act to provide a constraint on credit unions in the absence of prudential supervision. However, the reforms in the Reserve Bank of New Zealand Amendment Bill (No. 3) create a prudential regime for NBDTs including credit unions and these constraints will consequentially become redundant. Therefore I propose that the FSCU Act be amended so that when the deposit taker regulatory framework comes into effect, the Registrar no longer has these powers.

69 The FSCU Act provides that the Minister may fix the maximum amount of any loan that a credit union may make to a member. I propose that the Act be amended so that the Minister no longer has this power, as when credit unions are required to meet the deposit taker regulatory requirements it will not be necessary.

#### *Deposit limit*

70 The FSCU Act includes a provision limiting the amount that a member may have as a deposit with a credit union to \$250,000. Before the introduction of the trust deed regime for credit unions in 2000, the deposit limit acted to limit the funds at risk and the credit unions' exposure to large depositors. When credit unions become subject to the deposit taker regulatory framework, with the Reserve Bank as the prudential supervisor, and taking into account that they will continue to be subject to the Securities Act requirements to have a trust deed and be supervised by a trustee, I consider that it is not necessary to retain the deposit limit in legislation. Accordingly, I propose to remove the limit.

#### *Capital raising restriction*

71 The in principle Cabinet decisions on the FSCU Act review, which were confirmed in June 2007, provided that credit unions will be allowed to issue additional securities to their members that:

- Are transferable among members;
- Have a reasonable exit mechanism so that members are not locked into the investment;
- Do not compromise equality of voting among members; and
- Ensure that such securities rank behind members' deposits and creditors in the event of a winding up.

72 The New Zealand Association of Credit Unions has submitted in relation to these proposals that, if credit unions are unable to acquire permanent equity capital

from members, they will be unable to comply with the minimum capital requirements for deposit takers, to be prescribed in regulations.

- 73 The key characteristic of capital-raising for credit unions is maintaining the mutuality of the credit union. This means that the capital must be raised from within the membership, and that voting rights among members are not compromised. At present, members' deposits with the credit union (which are withdrawable) are considered to be their shares in the credit union. In terms of the ability of the credit union to lock members into an investment, I propose to amend the requirement that shares in a credit union shall be withdrawable, to a requirement that a credit union may issue withdrawable and non-withdrawable shares, to the extent that its rules allow it to do so. The non-withdrawable shares will form the permanent capital. While maintaining mutuality, this will allow credit unions more flexibility in capital raising, recognising that credit unions will be required to meet the capital requirements imposed under the deposit takers regulatory framework.
- 74 The previous Cabinet decisions on the credit union provisions of the FSCU Act [EDC Min (05) 9/7 and CAB Min (07) 21/10] agreed that the trustee supervisor would be required to certify to the Registrar of Friendly Societies and Credit Unions (the Registrar) that it is satisfied that any amendments to trust deeds of credit unions that depart from the default provisions on borrowing and investment comply with the new provisions in the Act. As the Reserve Bank will be responsible for the prudential supervision of credit unions, I consider that it is more appropriate that the trustee supervisor provides the certification to the Reserve Bank.

### **Building Societies**

- 75 Under the BS Act, for building societies that issue bonus balloting shares, the Registrar and Act have imposed some minimum standards in terms of the maximum prize pool and prize amount. The registrar of building societies may require an actuary's certificate in respect of appropriations by ballot for terminating societies, or societies with bonus share schemes, or companies that have terminating or bonus securities and may, if the rules of such societies are not complied with, apply to have the society placed into liquidation; or if a company, apply to have the company placed into liquidation.
- 76 As these types of schemes are no longer being initiated by building societies, I propose to remove the provisions from the Act, with a transitional provision so that any schemes still in operation may continue.

### **Implementation and transitional arrangements**

- 77 There are a number of factors that will need to be taken into account in the implementation of the policy proposals contained in this paper. The unified mutuals' governance framework is linked to other financial sector reforms under the Review, in particular to two Bills that are currently before the House. The provisions on the registrar's functions in relation to credit unions are affected by the changes to the Reserve Bank's prudential role. The move to standardise the provisions on registration systems and registrar's functions will also require

detailed consideration of the impact caused by the differing governance requirements for friendly societies and industrial and provident societies, depending on whether or not they provide financial services. Should any issues arise during the drafting process regarding anomalies or inconsistencies between the various Acts, a further report may be necessary.

- 78 Sufficient time will need to be provided for the mutual financial institutions affected by the new governance requirements to put the requirements in place. The governance requirements and other changes to the mutuals legislation will also need to be coordinated with the coming into force of the deposit takers regulatory framework (and relevant regulations) and the financial service provider registration requirements. For this reason I propose that the legislation should commence at a date or dates set by Order in Council, and may bring different provisions into force at different times.

### **CONSULTATION**

- 79 In preparing this paper, the following departments and government agencies have been consulted: the Reserve Bank, the Treasury, the Office of the Privacy Commissioner and the Securities Commission. The Department of the Prime Minister and Cabinet was informed.
- 80 A discussion document was released in August 2006 as one of nine documents in the review of Financial Products and Providers. The submissions received on the discussion document were considered in drafting this paper.

### **FISCAL IMPLICATIONS**

- 81 The proposals in this paper have implications for the functions carried out by the registrars of the various types of mutual entity. Standardising and modernising the registration systems will streamline this work. The proposals will not result in any funding implications as the total number of mutuals registered is only around 500.

### **HUMAN RIGHTS**

- 82 Overall the proposals in this paper do not appear to be inconsistent with the New Zealand Bill of Rights Act 1990, or the Human Rights Act 1993. However, if any issues do arise officials from the Ministry of Economic Development and Ministry of Justice will work together to ensure that the legislation is consistent with the Bill of Rights Act.

### **LEGISLATIVE IMPLICATIONS**

- 83 The proposals recommended in this paper will require new legislation. The proposals will be contained in a Mutuals' Governance Bill [ ]. I am also proposing the repeal of the Mutual Insurance Act 1955.

**PRIVACY IMPLICATIONS**

- 84 Officials from the Ministry of Economic Development will work with the Office of the Privacy Commissioner to ensure consistency of the legislation with the Privacy Act 1993 during the drafting process.

**REGULATORY IMPACT ANALYSIS**

- 85 The Ministry of Economic Development (MED) 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.

**PUBLICITY**

- 86 Once Cabinet has reached a decision on these proposals, I propose to announce the decisions in a media statement. It is intended that this paper be placed on the Ministry of Economic Development website.

## RECOMMENDATIONS

87 It is recommended that the Committee:

- 1 **Note** that the framework regulating the governance requirements of mutual financial institutions is part of the Review of Financial Products and Providers.
- 2 **Note** that a Mutuals' Governance Bill is included in the 2008 Legislation programme in Category [ ].

### Provisions relating to Mutuals' Governance

- 3 **Agree** to the following proposals to be incorporated in a new Bill which will implement a governance framework for mutual financial institutions:
  - 3.1 Each institution must have a board, which must manage the business and affairs of the institution.
  - 3.2 The board will be able to delegate its powers, while retaining responsibility for the exercise of the power.
  - 3.3 Directors will have rights to access the institution's records, with the right of access to be subject to restrictions to ensure that it is used only in the mutual's interests and for the purpose of carrying out the director's duties.
  - 3.4 Directors of mutual financial institutions should owe the same general duties to the mutual and its members as directors owe to companies and their shareholders, and have the same ability to rely on third party advice. The same restrictions and qualifications that apply to directors of companies will apply.
  - 3.5 The mutual itself or a member of the mutual may take legal action against directors to enforce these duties, including injunctions and compensation. The rules of the mutual may specify alternative forms of obtaining redress against directors, such as arbitration, as long as they are binding.
  - 3.6 Indemnities and insurance for breaches of these duties should be restricted, as they are under the Companies Act.
  - 3.7 Statutory qualifications for directors should be equivalent to those in the Companies Act, and the Court should have the power to order that a person may be prohibited from being a director.
  - 3.8 Directors must be appointed (and may be removed) by an ordinary resolution of members. Provisions equivalent to those in the Companies Act relating to incoming directors, directors ceasing to hold office and validity of directors' actions will also apply.

- 3.9 A mutual's board must only authorise remuneration for directors that it considers, on reasonable grounds, is fair to the mutual. Directors' remuneration should be disclosed in the mutual's annual report.
- 3.10 The number of executives earning more than \$100,000 should be disclosed in bands of \$10,000.
- 3.11 Members may attend all general meetings of the mutual, and must have one vote at the meetings, unless the rules of the mutual specify otherwise.
- 3.12 The rules of a mutual may only be amended by a special resolution of members. Major transactions must be approved by a special resolution of members.
- 3.13 Mutuels must give notice to members of general meetings, and minutes and copies of all resolutions must be kept, and must be available to members on request.
- 3.14 Members must have equivalent rights to discuss the management of the mutual and propose resolutions, as shareholders have under the Companies Act.
- 3.15 Auditors must be given notice of general meetings, and be entitled to attend and speak at general meetings as is required in the Companies Act.
- 3.16 Provisions concerning the content and distribution of the annual report consistent with those in the Companies Act will apply.
- 3.17 Directors must disclose any interest they or a related party may have in a transaction involving the mutual, unless it is in the ordinary course of the mutual's business. Disclosures should be made available to members through the interests register.
- 3.18 Directors should be able to vote on any such transaction unless the mutual's rules prohibit it. Related provisions on the avoidance of unfair transactions, in line with those in the Companies Act, will apply.
- 3.19 There shall be the following offences for breaches of the governance requirements including but not limited to:
  - 3.19.1 Failure to give notice to the registrar of changes to directors;
  - 3.19.2 Failure to appoint an auditor
  - 3.19.3 Failure to make an annual report available; and
  - 3.19.4 Failure to disclose a director's interests.

- 3.20 There will be a maximum penalty of a fine not exceeding \$10,000 for more serious offences, with lower fines for less serious offences.
- 4 **Note** that the governance provisions in existing mutuals legislation will be retained for mutuals that do not provide financial services.
- 5 **Agree** that the legislation will commence at a date or dates set by Order in Council providing sufficient time for mutuals to meet the requirements, and to coordinate the commencement with other related regulatory changes.

### **Implementation of previous Cabinet decisions**

- 6 **Note** that the Mutuals' Governance Bill shall include legislative amendments needed to implement:
- The Cabinet decisions made in September 2007 on the regulatory framework for non-bank deposit takers as they apply to credit unions and building societies [EDC Min (07) 19/1];
  - The Cabinet decisions on the review of the Friendly Societies and Credit Unions Act 1982 confirmed in June 2007 [CAB Min (07) 21/10].

### **Amendments to existing mutuals legislation**

- 7 **Agree** that provisions relating to registration of the various types of mutuals in the Building Societies Act 1965, Industrial and Provident Societies Act 1908 and Friendly Societies and Credit Unions Act 1982 be standardised and made consistent with the current framework for registration regimes (as in the Limited Partnerships Act 2008). These will include:
- 7.1 The role of the registrar, ability to delegate to an assistant or deputy registrar;
- 7.2 Ability for the registers to be kept in electronic form;
- 7.3 Provisions specifying the information to be included on the registers;
- 7.4 The ability for the public to search the registers, as well as the purpose of the search power, and the search criteria;
- 7.5 The powers of the registrar to correct the register, direct changes to registered information, refuse registration, charge fees for registration functions, remove a mutual from the register, suspend registration and to deregister a mutual.
- 7.6 An obligation on mutuals to file annual returns, and to notify the registrar of changes to material information;

- 7.7 An inspection power for the registrar, to ensure compliance with the registration requirements.
- 8 **Agree** that the legislation shall include regulation-making powers to provide for:
- 8.1 Prescription of any necessary forms, information required for an application for registration or for periodic updating of information, method of delivery of documents and other matters to enable the administration of the registration system;
- 8.2 Prescription of any fees and charges in relation to registration;
- 8.3 The manner and form of public notice; and
- 8.4 Any other regulations necessary for the administration of the register.

*Friendly Societies and Credit Unions Act*

- 9 **Note** that, as previously agreed, the Friendly Societies and Credit Unions Act 1982 (FSCU Act) will be amended so that all credit unions registered under the Act will be entities with full legal personality [EDC Min (05) 9/7] .
- 10 **Agree** that the FSCU Act be amended to allow societies registered under the Act to convert to an entity with full legal personality, if they wish.
- 11 **Agree** that the maximum gross sum of assurances that can be paid by a society under section 42 of the FSCU Act be increased from \$60,000 to \$100,000.
- 12 **Note** that in September 2007, Cabinet agreed that the FSCU Act would be amended to remove existing prudential and operational constraints on credit unions as previously agreed [EDC Min (07) 19/1];
- 13 **Agree** that the FSCU Act be amended to remove the following powers of the Registrar of Friendly Societies and Credit Unions, which will become redundant when credit unions are subject to the deposit takers regulatory framework (and relevant regulations). The powers to:
- 13.1 approve bank overdrafts for a period greater than 6 months at a time;
- 13.2 approve borrowings from other credit unions or associations greater than one year;
- 13.3 approve term loans to members of a union in excess of 10 years for secured loans and 5 years for unsecured loans;
- 13.4 approve the use of security instruments which is currently limited to mortgages, guarantees or promissory notes;

- 13.5 approve the holding of land for longer than six months, if acquired through the exercise of a security interest;
  - 13.6 approve the amount and form of security to be provided by officers of the credit union;
  - 13.7 approve the utilisation of the union's general reserve, apart from being used to offset realised losses; and
  - 13.8 approve arrangements for credit unions to contribute to guarantee funds and arrangements for the support of credit unions in financial difficulty.
- 14 **Agree** that the power of the Minister of Commerce to fix the maximum amount of any loan that a credit union may make to a member be removed from the FSCU Act.
  - 15 **Agree** that the provision setting a limit on the amount a member may have as a deposit with a credit union be removed from the FSCU Act.
  - 16 **Agree** that the decision on the credit unions capital raising mechanisms [Cab Min (07) 21/10] be amended to allow a credit union to issue withdrawable and non-withdrawable shares, to the extent that its rules allow.
  - 17 **Agree** that the trustee supervisor of a credit union be required to certify to the Reserve Bank that it is satisfied that any amendments to trust deeds (where credit unions depart from the default provisions on borrowing and investment) comply with the new provisions in the FSCU Act.

#### *Building Societies Act 1965*

- 18 **Agree** that the provisions in the Building Societies Act allowing the issue of bonus balloting shares and the distribution of prizes by ballot be removed, with a grandparenting provision allowing existing schemes to continue.

#### **Repeal of Mutual Insurance Act 1955**

- 19 **Note** that there are no entities incorporated under the Mutual Insurance Act 1955.
- 20 **Agree** that the Mutual Insurance Act 1955 shall be repealed.

#### **Next Steps**

- 21 **Agree** that this paper may be made public on the Ministry of Economic Development's website.
- 22 **Direct** officials to provide drafting instructions to Parliamentary Counsel Office.

- 23 **Agree** to delegate to the Minister of Commerce the power to make decisions on minor issues that arise during the drafting process.

Hon Lianne Dalziel  
**Minister of Commerce**

Date signed: \_\_\_\_\_

## **Regulatory Impact Statement**

### **EXECUTIVE SUMMARY**

Current governance requirements for mutual financial institutions are inconsistent and do not comply with best practice international benchmarks. The preferred option is to consolidate base level corporate governance requirements for mutual financial institutions in a new Act. Mutual financial institutions will then be required to meet unified requirements that they be managed by a board, with directors meeting the same qualifications and having the same duties as in the Companies Act 1993, and equivalent disclosure and transparency requirements. Members of mutuals will have access to consistent processes for holding management of the mutual to account, appropriate voting rights and equitable meeting procedures. Mutuals will meet standardised and modernised registration procedures, enabling streamlining of registration and filing processes and providing consistency of the relevant registrars' functions. It is proposed that the Mutual Insurance Act 1955 be repealed as there are no longer any entities incorporated under it.

### **ADEQUACY STATEMENT**

Aspects of the paper apart from the proposals for a unified governance framework for mutual financial institutions and the standardising and updating of the registration provisions, are implementing decisions that Cabinet has already made in relation to the credit union provisions of the Friendly Societies and Credit Unions Act 1982 (FSCU Act) and the regulatory framework for deposit takers. The regulatory impacts of those proposals were considered in the relevant Cabinet papers and the associated Regulatory Impact Statements and are not repeated here.

The Ministry of Economic Development (MED) 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.

### **STATUS QUO AND PROBLEM**

Corporate governance refers to the structures and processes by which companies and other entities are directed and controlled. Current governance requirements for mutual organisations providing financial services are inconsistent and do not comply with best practice as expressed in international benchmarks such as the OECD 2004 Principles of Corporate Governance. The New Zealand Companies Act 1993 incorporates a large number of the OECD principles.

Issues that were identified with the current governance provisions when compared with the OECD principles and the Companies Act include:

- an absence of a specific requirement that a mutual financial institution is to be managed by a board/committee;
- weaker statutory rules for qualifications of directors of mutual financial institutions than for directors of other financial institutions;
- a lack of provisions enabling members of mutual financial institutions to monitor management;
- a lack of specific powers for members to hold management to account;
- a lack of provisions ensuring the equitable conduct of member meetings; and
- inconsistent requirements for the appointment and role of auditors.

One of the objectives of the review of financial products and providers is to develop an effective and consistent framework for the regulation of non-bank financial institutions. Retaining the status quo would not give consistency of the regulatory framework between the various types of mutual financial institutions nor would it give consistency between mutual financial institutions and companies that are financial institutions. Earlier decisions were made by Cabinet that the governance of credit unions should be strengthened.

#### *Registration provisions*

The Building Societies Act 1965, Industrial and Provident Societies Act 1908 and FSCU Act all include requirements for the entities established under the Act to register and for the Registrar to operate a public register. The different registration provisions currently have some of the attributes of a modern registration system, but they are inconsistent, contain gaps, and in many cases contain outdated language and concepts.

## **OBJECTIVES**

Good corporate governance should provide proper incentives to the Board of Management to pursue objectives that are in the interests of the body corporate and its shareholders and should facilitate effective monitoring. Hence for mutuals the objectives are:

- to establish the appropriate relationships (in terms of the delegation and retention of powers and the rights to control) between members, the board and the executive;
- to ensure effective internal monitoring and control of the mutual and management by the board;
- to ensure effective external monitoring by members, requiring adequate and timely information to be disclosed by the mutual; and
- to provide appropriate powers for members to hold management to account.

### *Registration provisions*

The objective is to have a consistent streamlined registration system for all mutuals, which will improve the availability of information on the register for members of the public, and provide for appropriate privacy provisions.

## **ALTERNATIVE OPTIONS**

The discussion document canvassed the option of the base level corporate governance requirements for mutual financial institutions being set as principles rather than legal requirements. Under this approach, mutuals would disclose annually the extent to which the base level requirements have been adopted in their governing rules. However, as compliance with the principles would not be compulsory, it was considered that this would not lead to a consistent level of protection for members of mutuals and would also be likely to be confusing for members.

Under the option of the corporate governance requirements being made legal requirements, several ways for implementing this were considered:

- amending each of the existing mutuals Acts to include the corporate governance provisions for mutual financial institutions. This was not preferred as if all mutual financial institutions have to meet the base-level corporate governance requirements it is simpler not to duplicate those requirements in several pieces of legislation.
- setting out all the base level requirements in a single piece of legislation leaving the existing requirements in each of the existing Acts, but providing in the existing Acts that where the relevant provision in the Act is inconsistent with the base level requirement the stricter provision will apply. This was not preferred as it would require a decision to be made in each case on whether the base level requirement or the existing requirement was stricter. This would create uncertainty for directors, management and members.

## **PREFERRED OPTION**

The preferred option is to consolidate all the base level corporate governance requirements for mutual financial institutions in a new Act. In the case of credit unions and building societies (which all provide financial services), the existing legislation would no longer contain any corporate governance requirements. In the case of friendly societies and industrial and provident societies, the governance requirements would remain in the existing legislation but would be expressly excluded from applying to organisations that provide financial services.

The consolidated base-level provisions for mutual financial institutions cover:

- the role and responsibilities of the board;

- directors' duties and remedies for breaches of them;
- qualifications of directors;
- election and removal of directors;
- disclosure of directors' and executives' remuneration;
- members' participation and voting at general meetings;
- members' participation in major changes;
- requirements for conduct of member meetings;
- the content and distribution of annual reports;
- directors' disclosure of interests; and
- appointment, rights and duties of auditors.

Setting base level requirements in legislation, and allowing mutuals the flexibility to adopt stricter requirements assists in minimising compliance costs. This option means that there may be different governance requirements for mutuals which provide financial services and those which do not. This is preferable to imposing the legal requirements appropriate for mutual financial institutions on the remaining mutuals which are not part of the financial sector, for example, the societies registered under the FSCU Act which are established for charitable or social purposes (such as working men's clubs).

This option provides mechanisms to enable members of mutual financial institutions to hold management accountable and have effective redress. The preferred option will meet the public policy objectives set out above.

Many mutual financial institutions commented that they already meet most of the base level requirements voluntarily. Hence the compliance cost of the base level requirements is not expected to be high.

The preferred option will mean that mutual financial institutions will be regulated under two separate pieces of legislation, compared with one piece of legislation under the current situation. The Mutual Insurance Act will be repealed as there is now no insurer incorporated under this Act.

#### *Registration provisions*

The preferred option will not result in any increase in costs for mutuals, and should streamline the way in which they can provide information. Mutuals already have obligations to file annual returns, changes of details, etc.

## **IMPLEMENTATION AND REVIEW**

To implement the proposal, legislation will be required. The necessary provisions will be part of the Mutuals Governance Bill intended to be passed in 2009. Amendments will also be required to the existing mutuals legislation, i.e. the Friendly Societies and Credit Unions Act 1982, the Building Societies Act 1965 and the Industrial and Provident Societies Act 1908.

It is intended that there will be a transitional period, intended to be at least eighteen months, to allow those affected time to ensure compliance. This would provide sufficient time for mutual financial institutions to put processes in place to make any necessary changes to their rules and reporting processes, and to ensure that directors meet the qualification criteria and understand their role and duties. It is also intended to coordinate the coming into effect of the governance framework with the other related reforms, that is, the registration regime for financial service providers and the regulatory framework for deposit takers.

## **CONSULTATION**

The proposals were the subject of a public discussion paper which was released in August 2006, along with other discussion papers in the Review of Financial Products and Providers (RFPP). 139 submissions were received on the RFPP discussion papers, of which around 40 contained comments on mutuals' governance. The submitters included associations representing various parts of the financial sector including mutuals, and individual businesses and mutuals operating in the sector.

Concerns were raised in submissions about costs of providing annual reports and other material to members. This has been addressed by providing that a notice (which can be sent electronically) advising of the availability of the annual report is required, and members who wish to receive a hard copy can request one.

The following government agencies have been consulted on the proposals in this paper: the Treasury, the Reserve Bank, the Office of the Privacy Commissioner, and the Securities Commission. The Department of the Prime Minister and Cabinet was informed. No significant concerns were raised.