REGULATORY IMPACT STATEMENT

REGULATIONS FOR NON-BANK DEPOSIT TAKERS - DEBT SECURITIES AND SUITABILITY CONCERNS

EXECUTIVE SUMMARY

1 The Non-bank Deposit Takers Bill ('the Bill) represents a stand-alone framework for the prudential regulation of NBDTs (including finance companies, building societies and credit unions). It brings across the existing prudential requirements that were in Part 5D of the Reserve Bank of New Zealand Act 1989 ('Part 5D') and it introduces some new requirements.

2 The requirements that have been brought over from Part 5D have been in place since 1 December 2010, and relate to capital, related party exposures, credit ratings, corporate governance, liquidity, and risk management. The Bill introduces licensing, suitability assessments of directors and senior officers, change of ownership requirements, and enhanced investigation and enforcement powers for the Reserve Bank of New Zealand ('Reserve Bank').

3 This paper sets out the Regulatory Impact Statement ('RIS') for two sets of regulations proposed to be made under the Bill - one relating to the definition of debt security, and the other prescribing suitability concerns. It should be read in conjunction with the associated paper to the Cabinet Economic Growth and Infrastructure Committee.

AGENCY DISCLOSURE STATEMENT

4 This RIS has been prepared by the Reserve Bank. It provides an analysis of options relating to two sets of regulations proposed to be made under the Non-bank Deposit Takers Bill.

5 The analysis builds on work undertaken by the Reserve Bank identifying problems in the industry and possible solutions to those problems. That work, and various other changes that are currently underway in the NBDT regulatory environment, provides the framework for problem definition and the development of options in this RIS.

6 The proposals in this RIS have been subject to public consultation. No quantitative estimates of costs of compliance were provided by submitters.

Toby Fiennes

Head of Prudential Supervision Department

Reserve Bank of New Zealand **14 June 2012**

STATUS QUO AND PROBLEM DEFINITION

Building societies

7 As noted in the associated Cabinet paper to the Cabinet Economic Growth and Infrastructure Committee, the treatment of building societies under the Bill differs from how they were treated under Part 5D. Part 5D explicitly included building societies in the definition of deposit taker if they were incorporated under the Building Societies Act 1965.[1] This is not the case under the Bill, as there is no longer any explicit inclusion of building societies in the definition.

8 Consequently, a building society will no longer be automatically treated as an NBDT under the Bill, and therefore will not be subject to prudential regulation, unless it satisfies the core definition. The Reserve Bank is therefore seeking a way to treat similar institutions consistently, regardless of their corporate form.

Suitability concerns

9 The Bill takes a risk-based approach to the suitability of directors and senior officers of NBDTs, allowing the industry to self-certify where there is low risk, while bringing persons of potential risk to the attention of the Reserve Bank. The Reserve Bank must be notified whether or not a person who is, or is proposed to be, a director or senior officer of an NBDT raises a suitability concern.

10 If a suitability notice states that a person does not raise any suitability concerns, the Reserve Bank is entitled to rely on that and may grant a licence to the NBDT or allow the appointment. Otherwise the Reserve Bank can, after inquiry, either issue a notice of non-objection or refuse to issue such a notice where it is satisfied that the person is unsuitable.

11 The Bill does not itself prescribe the suitability concerns. These are to be prescribed in regulations made under the Bill. These concerns need to be prescribed in order for NBDTs' directors to be able to (self-) certify whether they or any senior officer raises any suitability concerns.

OBJECTIVES

12 The Bill seeks to promote a sound and efficient financial system, and avoid significant damage to the financial system that could result from the failure of an NBDT (per clause 3 of the Bill).

13 When recommending regulations for the NBDT sector, the Reserve Bank is required to do so in a manner that is consistent with the broader objectives in the Bill. In addition,

[1] Certain building societies that did not issue debt securities to the public in New Zealand were subsequently declared not to be deposit takers under Part 5D, per the Deposit Takers (Persons Declared Not to be Deposit Takers) Regulations 2011.

clause 8 of the Bill requires the Reserve Bank to take into account certain principles when carrying out its functions under the Bill.

REGULATORY IMPACT ANALYSIS

14 As noted above, the Reserve Bank is proposing the making of two sets of regulations under the Bill - one relating to the definition of debt security, and the other prescribing suitability concerns. The options considered by the Reserve Bank in relation to each of these sets of regulations are outlined below. The first section discusses the options regarding building societies, and the second section the options for prescribing suitability concerns.

Building society shares

15 The 'core' definition of NBDT in the Bill is found in clause 5(1)(a), and is as follows:

> (a) a person that—
>
> (i) offers debt securities to the public in New Zealand; and
>
> (ii) carries on the business of borrowing and lending money, or providing financial services, or both

16 This differs from the definition of deposit taker under Part 5D, as it does not explicitly include building societies as defined in the Building Societies Act 1965. Therefore, a building society is no longer automatically subject to prudential regulation unless it satisfies the core definition of NBDT. This definition relies on the person offering debt securities to the public in New Zealand. Debt security is defined in clause 4 as follows:

> **debt security** means—
>
> (a) a debt security within the meaning given in section 2(1) of the Securities Act 1978; or
>
> (b) any other security declared by regulations to be a debt security for the purposes of this Act

17 The shares that a building society issues do not meet the Securities Act definition of debt security, rather they issue participatory securities, and therefore similar institutions are not subject to similar prudential regulation. The Reserve Bank considered three alternatives for bringing building societies back into the prudential framework:

- *Option 1* - declaring all building societies to be NBDTs;
- *Option 2* – declaring certain building societies to be NBDTs;
- *Option 3* – declaring building society shares to be debt securities.

Option 1: Declaring all building societies to be NBDTs

18 Clause 5(1)(b) of the Bill extends the definition of NBDT to a person, or a member of a class of persons, that is declared by regulations to be an NBDT. Clause 72(1)(c) provides the corresponding regulation-making power. When making such regulations, clause 72(2) requires the Bank to have regard to the nature of the business activities carried out and the extent to which those activities are in substance similar to the activities of an NBDT, or involve activities as an NBDT.

19 One option is to make regulations declaring building societies (as defined in the Building Societies Act 1965) to be NBDTs. This would ensure that building societies continue to be subject to prudential regulation, and is probably the simplest option.

20 However, the Reserve Bank considers this option would result in more entities being captured in the NBDT regime than is necessary or appropriate.

21 If the prudential regime is too wide, it may capture offshore building societies that are shell entities registered in New Zealand and which receive deposits and conduct financial services exclusively offshore. This gives such entities a degree of legitimacy and credibility as they can present themselves as being regulated by the Reserve Bank. This has the potential to damage New Zealand's reputation as a well-regulated jurisdiction, and may damage investor confidence in respect of legitimate building societies, and with that the soundness and efficiency of parts of the financial system.

22 It would have the effect of capturing building societies even though they –

(a) do not issue debt or participatory securities to the public in New Zealand;

(b) issue debt or participatory securities in New Zealand but not "to the public";

(c) are registered in New Zealand but do not conduct any business in New Zealand and operate completely offshore; or

(d) have stopped trading altogether and have repaid all deposits.

23 Some such entities (mainly building societies) were carved out of the prudential regime under Part 5D, by way of regulations declaring them not to be deposit takers for the purposes of Part 5D.[2] Option 1 would re-capture those persons for the purposes of the Bill, and therefore the Reserve Bank does not consider it an appropriate mechanism for ensuring consistent treatment of similar institutions.

Option 2: Declaring certain building societies to be NBDTs

24 A second option is to make regulations declaring only certain building societies to be NBDTs. This is somewhat similar to the approach under Part 5D, whereby certain building societies and credit unions were declared not to be deposit takers for the purposes of Part 5D.

[2] The Deposit Takers (Persons Declared Not to be Deposit Takers) Regulations 2011

25 Option 2 would mean that existing, legitimate building societies would be named in the regulations, and would be subject to the regime. This would avoid extending the prudential regime too far, and potentially legitimising the activities of illegitimate or doubtful shell building societies.

26 However, this approach does not deal well with new start ups or changes to an entity's activities. Regulations would be required to declare new building societies to be NBDTs for the purposes of the Bill. Likewise, a building society that had offered participatory securities, and did not currently carry on the business of borrowing or lending money, would have to be added if it started carrying on such business. Further regulations may also be required following mergers or acquisitions within the industry (which we are starting to see happen). This approach would increase the monitoring required by the Reserve Bank, and would lead to persons being captured by the regulatory regime that should not be captured, and *vice versa*.

Option 3: Declaring building society shares to be debt securities

27 A third option is to extend the definition of debt securities in clause 4 to include those building society shares that are similar in substance to debt securities. Clause 72(1)(d) of the Bill authorises the making of regulations for the purposes of declaring certain securities to be debt securities for the purposes of the Bill. Clause 72(3) imposes some restrictions on when such regulations can be made.

28 This option is less straightforward than option 1. In particular, clause 72(3) requires that the securities that are declared to be debt securities must be similar in substance to debt securities. Therefore, the regulations could only relate to the shares of building societies that are debt-like participatory securities.

29 However, option 3 results in better alignment with the securities regime. The Securities Act (Building Societies) Exemption Notice 2002 was granted because most building society shares are participatory securities for the purposes of securities law, but have the characteristics of debt securities. Based on an in-substance view of the securities involved, this exemption effectively substitutes the participatory securities regime with a debt securities regime. In short, the normal requirements of a statutory supervisor and deed of participation (as pertaining to participatory securities) are replaced by a trustee and trust deed (as pertaining to debt securities).

Preferred approach

30 Each of these options will impose costs on building societies, as under each option building societies will become subject to the prudential regime. However, this is a continuation of the *status quo*, i.e. they are currently subject to prudential regulation under Part 5D, and as such the Reserve Bank has looked at the cost of *how* this is achieved.

31 Although option 1 is most straightforward in that all building societies are automatically 'caught' by the regime, option 1 would capture more entities than necessary. Both option 2 and option 3 are more selective, avoiding capturing too many

entities, but option 2 would involve increased costs of monitoring who should and should not be on the list of those declared to be NBDTs.

32 Option 3, declaring building society shares to be debt securities, is the preferred approach to dealing with the current inconsistent treatment of building societies. It aligns with the approach taken in the securities regime and it should avoid legitimising the activities of shell building societies (which is a risk of option 1). It also avoids the additional monitoring that would be associated with declaring certain named persons to be NBDTs (option 2).

Suitability concerns

33 The Bill takes a risk-based approach to the suitability of directors and senior officers of NBDTs, allowing the industry to self-certify where there is low risk, while bringing persons of potential risk to the attention of the Reserve Bank. The Reserve Bank must be notified whether or not a person who is, or is proposed to be, a director or senior officer of an NBDT raises a suitability concern. If a suitability concern is raised, the Reserve Bank can, after inquiry, either issue a notice of non-objection or refuse to issue such a notice where it is satisfied that the person is unsuitable.

34 Clause 4 of the Bill defines suitability concerns as matters, circumstances or conditions that must be drawn to the attention of the Reserve Bank if they apply to a person who is, or is proposed to be, a director or senior officer of an NBDT. Clause 72(1)(e) provides for regulations prescribing such suitability concerns.

35 The Reserve Bank considered both two alternative types of criteria to be prescribed as suitability concerns:

- *Option 1* – narrow criteria;
- *Option 2* – wide criteria.

Option 1 – narrow criteria

36 One option is to prescribe a narrow set of circumstances where the appointment must be drawn to the Reserve Bank's attention. These could be targeted in terms of scope or time, for example, in relation to criminal offending, limiting the suitability concerns to dishonesty offences, or offending under certain legislation (such as the Companies Act or the Securities Act), or offending within the last 5 years. The suitability concerns could also be subject to a threshold, for example, offending that has led to a term of imprisonment, or a materiality requirement.

37 Prescribing narrow suitability concerns would have the benefit of limiting the number of appointments of directors or senior officers that must be referred to the Reserve Bank. This would minimise costs for the Reserve Bank. It may also keep down costs for NBDTs, as a narrower scope for referrals would increase the certainty of NBDTs' shareholders and governing bodies that their proposed appointee would be able to take up their position.

38 However, there are downsides to narrow suitability concerns. A more targeted approach may end up creating uncertainty as to whether an appointment needs to be referred to the Bank. For example, if a suitability concern has a materiality aspect, this raises questions as to what is 'material'. A narrow approach also increases the likelihood that situations of risk are not notified to the Reserve Bank. Cabinet agreed to a risk-based approach to suitability (EGI Min (11) 12/1 confirmed by CAB Min (11) 23/7 refers), which identifies situations where there is a risk that the person may be unsuitable. Targeting the concerns raises the possibility that situations of risk are not identified, and the suitability regime is undermined. For example, a time limit on the suitability concerns may risk excluding a significant, relevant event, when historical criminal offending will still be relevant to a person's suitability. This is particularly so in the finance company sector.

Option 2 – wide criteria

39 Alternatively, regulations could prescribe wider, more open-ended suitability concerns, creating a broader scope for the Reserve Bank's consideration of appointments. Such criteria would not be restricted in terms of time, scope, or materiality, for example, *any* criminal offending might be captured.

40 Such a wide ambit would mean that any situation where there is a risk that the proposed appointee would be unsuitable for their position is brought to the attention of the Reserve Bank. This aligns with the risk-based approach agreed to by Cabinet. Wide suitability concerns will also deter unsuitable candidates, and increase the chances that they are prevented from becoming persons of influence within an NBDT.

41 However, wide suitability concerns may increase costs for the NBDTs, as they will increase the number of appointments that need to be referred to the Reserve Bank. Needing to refer more appointments may increase the time that would otherwise be required for the appointment of directors or senior officers. It would also mean more situations in which the NBDT would have to provide the Reserve Bank with information about a proposed appointee.

Preferred approach

42 As noted above, the approach to suitability under the Bill is risk-based, whereby the industry will self-certify where there is low risk, and persons of potential risk will be brought to the attention of the Reserve Bank.

43 This risk-based approach to suitability lends itself to having wider suitability criteria, i.e. option 2. This is because with wider criteria there is less of a chance of situations where there is risk that a person may be unsuitable for their position being overlooked. Introducing limits such as scope, time, and materiality, may mean directors and senior officers are not subject to broad enough scrutiny. This would not be appropriate given what has occurred with finance companies.

44 Option 2 is likely to be the more costly of the two options for industry, due to more appointments being referred to the Reserve Bank. However, this is not likely to impose substantial economic cost. The Reserve Bank considers that any additional cost is

justified in that wider suitability concerns will mean a more effective suitability regime that benefits society. Any costs associated with uncertainty will also be reduced through guidance to be issued by the Reserve Bank, which will set out the approach the Reserve Bank will take to determining whether or not to issue a notice of non-objection. This will make the decision more transparent, reducing uncertainty for shareholders and governing bodies as to whether their appointee may be considered unsuitable.

45 The Reserve Bank also considers that the narrow suitability concerns would be unlikely to represent major cost savings as, in practice, those proposed to be directors or senior officers are unlikely to raise any of the suitability concerns, whether on a wide or narrow basis. Factors such as the Criminal Records (Clean Slate) Act 2004 will also limit the number of referrals to the Reserve Bank in either case (with potential expungement of certain corrections after 7 years).

CONSULTATION

46 The Reserve Bank undertook a broad consultation with industry regarding the appropriate approach to licensing and suitability requirements prior to submitting the initial proposals to Cabinet in 2007. Further consultation on the prudential framework was undertaken in October 2010.

47 In April 2012, the Reserve Bank released a further consultation document, setting out detailed proposals relating to these two sets of regulations. The submissions received in response to that consultation paper were considered when developing the proposals set out in this paper. Seven responses were received, and the overall response to the consultation paper was supportive in principle.

48 In relation to the proposal to declare building society shares to be debt securities, all respondents who commented on the proposed regulations supported the making of the regulations.

49 In relation to the proposed suitability concerns, a number of respondents perceived the proposed suitability concerns as hard-line tests rather than triggers for discussion with the Reserve Bank. This caused some respondents to be concerned about the width of the suitability concerns.

50 It has always been the Reserve Bank's intention to issue guidance on how the suitability concerns will be applied in practice and to give the NBDT sector as much assistance as possible when it came to this. That remains the intention.

51 It is the Reserve Bank's strong preference not to build in constraints in the regulations such as ruling out matters that may have occurred as far back as the 1980's, in particular, when we see what has happened with the recent collapse of the finance companies. It is important that the Reserve Bank should have the ability to look at a person's full history to determine their suitability to be a director or senior officer of an NBDT. A person's attitude to compliance with the law generally is also something that

is considered relevant as was emphasised in a recent District Court decision involving the declining of an authorisation by the Financial Markets Authority.

52 The Reserve Bank has adjusted the suitability concern about involvement with a failed entity to limit this to an involvement in the period of 5 years before the failure. The nature of a person's involvement will also be relevant and will be subject to elaboration in the Reserve Bank's subsequent guideline. It is not intended to remove the conflict of interest concern. While there are provisions in the Companies Act 1993 on the managing of conflicts of interest these have a narrow compass and in any case would not apply to the bulk of NBDTs who comprise building societies and credit unions. Following the release of the Consultation Paper, the Reserve Bank met with, or obtained feedback from, the Treasury, the Ministry of Economic Development, the FMA, the Ministry of Justice, Parliamentary Counsel Office, and the Department of the Prime Minister and Cabinet.

CONCLUSIONS AND RECOMMENDATIONS

53 The Reserve Bank's analysis of the options outlined above has resulted in the following conclusions:

(a) the Reserve Bank will recommend the making of regulations under clause 72(1)(d) declaring debt-like participatory securities issued by building societies to be debt securities for the purposes of the Bill (option 3);

(b) the Reserve Bank will recommend the making of regulations under clause 72(1)(e) prescribing matters, circumstances or conditions relating to the character of the person concerned to be suitability concerns (option 2).

IMPLEMENTATION

54 It is desirable that both sets of regulations discussed in this paper – declaring building society shares to be debt securities for the purposes of the Bill, and prescribing suitability concerns – come into force on the same date as the Bill.

55 In relation to the debt security regulations, this is desirable so there is a smooth transition between Part 5D and the Bill in respect of the treatment of building societies. In relation to the suitability concerns, this is desirable so that persons that apply for a licence are able to provide the suitability notices required as part of their licence applications under the Bill.

56 A transition period is not necessary in relation to either set of regulations.

MONITORING, EVALUATION AND REVIEW

57 The Reserve Bank will monitor the operation of these provisions, and their impact on the NBDT sector, on an ongoing basis.

58 Under clause 86 of the Bill, the Reserve Bank is required to review and report on the operation of the Bill no later than 9 September 2013. The review is intended to be a fundamental review of all aspects of the regime, and will include the new aspects introduced by the Bill, including regulations made under the Bill. Upon completion of the review, the Reserve Bank will prepare a report for the Minister of Finance, who will table the report in the House of Representatives.