New Zealand

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REGULATION OF NEW ZEALAND'S NON-BANK DEPOSIT TAKERS: THE NEW REGIME UNFOLDS

In the last three years, a large number of New Zealand's finance companies have effectively collapsed and there has been little activity amongst those left standing. As a result, depositors have suffered large losses and investor confidence in the sector has become practically non-existent. In response, the New Zealand government has undertaken substantial reform to the regulatory framework applying to New Zealand's remaining and future non-bank deposit takers. These reforms impose considerably more onerous obligations on deposit takers and their corporate trustees with a view to achieving a stated purpose – the maintenance of a sound and efficient financial system. This note seeks to provide a summary of the reforms.

INTRODUCTION

The *Reserve Bank of New Zealand Amendment Act 2008* (NZ) introduced into the *Reserve Bank of New Zealand Act 1989* (NZ) (the Act) a new Pt 5D and established the Reserve Bank of New Zealand as the primary regulator of New Zealand's non-bank deposit takers.

Part 5D will be and has been incrementally introduced and contemplates in several places that further regulations (imposing, for example, minimum capital requirements, restrictions on related party exposures and liquidity requirements) will be introduced as necessary. Except to the extent that ban exemption applies to an entity, each deposit taker must comply with the remaining provisions of Pt 5D as follows:

- Much of Pt 5D came into effect when the Act received Royal Assent in September 2008, including the provisions enabling the Reserve Bank to introduce further regulations.
- From 1 September 2009, deposit takers have been required to have a risk management program in place.[1]
- From 1 March 2010, deposit takers have been required to have a current credit rating.[2]
- Various governance requirements will apply to deposit takers on a date to be appointed, which is likely to be in late 2010.[3]

WHO WILL BE AFFECTED BY THE REFORMS?

Deposit takers are defined in Pt 5D as persons who issue debt securities[4] and carry on the business of borrowing and lending money, and/or providing financial services to the New Zealand public. The definition includes building societies and credit unions, but expressly excludes registered banks, issuers of collective investment schemes, local authorities and the Crown.[5]

FAILED FINANCE COMPANIES PARTLY EXCLUDED

Initially, there was much focus on the extent to which insolvent deposit takers would be required to comply with Pt 5D. In the last three years, approximately 30 deposit takers have entered into receivership, liquidation, moratoria, or frozen repayments to depositors.[6] In August 2009, there were

[1] *Reserve Bank of New Zealand Act 1989* (NZ), ss 157M-157O.

[2] *Reserve Bank of New Zealand Act 1989* (NZ), s 157I.

[3] *Reserve Bank of New Zealand Act 1989* (NZ), s 157L.

[4] The term "debt securities" is defined in the *Securities Act 1978* (NZ).

[5] *Reserve Bank of New Zealand Act 1989* (NZ), s 157C.

[6] See NZ Commerce Committee, *Inquiry into Finance Company Failures*, Media Release (20 August 2009), http://www.parliament.nz/en-NZ/PB/SC/About/Media/5/2/3/00SCCO_MediaRelease20090820_1-Inquiry-into-finance-company-failures.htm viewed 29 April 2010.

12 companies in moratoria, with a combined debt to depositors of approximately NZ$2 billion[7] and the question of how these entities should be treated was therefore of significant importance.

In October 2009, the Reserve Bank issued an exemption notice in relation to deposit takers in receivership and liquidation[8] which applies where the relevant deposit taker has ceased issuing further debt securities. Under the relevant exemption, such entities are exempted from complying with the requirement to have a risk management program and a credit rating in place.

Attention then shifted to the question of whether Pt 5D was intended to apply to deposit takers that have successfully entered into wind-down moratoria with their depositors. The Reserve Bank initially advised that, although it would provide general guidance on this issue, individual deposit takers should seek legal advice as to the operation of the law in their particular circumstances. In December 2009, the Reserve Bank issued a further exemption notice in relation to specific entities in moratoria,[9] but only in relation to the credit rating requirement. The exemption notice imposes conditions around disclosure to investors and requires that such entities display a notice on their websites and write to each depositor informing them of the credit rating exemption.

Insolvent deposit takers are therefore subject to the new regime, but have been and may continue to be partially exempted from certain requirements under the Act. It is unclear, at present, exactly which obligations may still be imposed on insolvent deposit takers but the Reserve Bank has indicated that further exemptions will be considered at the time new regulations are brought into effect. Failed companies should logically be excluded from future regulations prescribing minimum capital requirements and such other regulations which are not readily applicable to their circumstances. It is difficult to see the value in requiring companies in wind-down mode to comply with measures aimed at maintaining financial health.

The Act prescribes principles which must be taken into account by the Reserve Bank when carrying out its functions under Pt 5D, including the need to avoid unnecessary compliance costs.[10] Compliance is likely to be onerous and expensive (given the likely need for expert legal and/or accountancy advice) and will therefore reduce the payouts available to depositors of insolvent finance companies. Imposing compliance costs on insolvent deposit takers who are not taking new deposits seems unnecessary and detrimental to existing depositors.

EXEMPTIONS

In addition to those mentioned above, the Reserve Bank has issued several other exemption notices which apply to certain limited categories of deposit takers.[11] Deposit takers are entitled to apply to the Reserve Bank for an exemption from all or some of the provisions of Pt 5D.[12] The Reserve Bank must not grant an exemption unless it is satisfied that the exemption will be "consistent with the maintenance of a sound and efficient financial system" in circumstances where compliance with the relevant provisions would be "unduly onerous or burdensome" on the deposit taker or its trustee. The extent of the exemption must not be broader than is necessary to address the matters giving rise to the exemption.

[7] See Power S, *Government Moves on Finance Company Moratoria*, Media Release (26 August 2009), http://www.beehive.govt.nz/release/government+moves+finance+company+moratoria viewed 29 April 2010.

[8] See the *Deposit Takers (In Receivership or Liquidation) Exemption Notice 2009* (NZ).

[9] See the *Deposit Takers (Moratorium) Exemption Notice 2009* (NZ).

[10] *Reserve Bank of New Zealand Act 1989* (NZ), s 157F.

[11] See, in addition to the exemption notices mentioned above, the *Deposit Takers (Non-trustee Entities Risk Management) Exemption Notice 2009* (NZ), which relates to entities that are not required by the *Securities Act 1978* (NZ) to have a trustee and a trust deed, the *Deposit Takers (Payment Facility Providers) Exemption Notice 2009* (NZ) in relation to a specific English entity, and the *Deposit Takers (Credit Ratings Minimum Threshold) Exemption Notice 2009* (NZ), which applies to entities with consolidated liabilities of less than NZ$20 million.

[12] *Reserve Bank of New Zealand Act 1989* (NZ), s 157G.

REQUIREMENTS FOR CREDIT RATING

The *Deposit Takers (Credit Ratings) Regulations 2009* (NZ) were promulgated pursuant to Pt 5D and came into force in December 2009. The Regulations state the requirement for credit ratings to be a current rating of a deposit taker's creditworthiness which is "a local currency (New Zealand dollar), long term, issuer rating".[13] Requiring a rating is intended to provide a clearer basis for depositors to distinguish between high and low risk investments. Although this requirement is, in theory, a commendable strategy, the recent credit crisis has demonstrated limitations on the ability of rating agencies to predict financial stability.

RISK MANAGEMENT PROGRAM

Part 5D defines, in relatively broad terms, the information to be included in a risk management program. Essentially, the Act requires that each deposit taker identifies and manages four key types of risk, namely credit risk, liquidity risk, market risk and operational risk.[14] Deposit takers are also required to provide details of record-keeping processes and steps to be taken to ensure that the program remains current and is capable of identifying and addressing deficiencies.

Each deposit taker is required to submit its risk management program to its trustee who is, in turn, required to inform the deposit taker whether it is satisfied that the program meets the requirements of the Act.[15] The trustee may require the deposit taker to amend the program and/or require that the deposit taker has the program audited.[16]

MINIMUM CAPITAL, CAPITAL RATIO, RELATED PARTY EXPOSURE AND LIQUIDITY REQUIREMENTS

Part 5D contains further provisions[17] which permit regulations to be made requiring deposit takers and trustees to ensure that the relevant trust deed:

- sets out the minimum capital that a deposit taker is required to maintain;[18]
- includes a capital ratio, a minimum level of which can be prescribed by the regulations, to be calculated in accordance with a prescribed framework in relation to a deposit taker or a borrowing group;[19]
- includes a maximum limit on exposures to related parties relative to the deposit taker or its borrowing group;[20] and/or
- includes liquidity requirements. Such regulations may specify assets that qualify as liquid assets.[21]

Any requisite amendments to trust deeds must be made and will be deemed to be effective notwithstanding any restrictions in an existing trust deed.[22] Trustees are required to negotiate with deposit takers to agree the form of amendment to the relevant trust deed but, where agreement cannot be reached, the trustee shall be entitled to execute an amending deed in place of the deposit taker.[23]

No regulations have yet been published pursuant to these provisions. However, the Reserve Bank has released the following documentation:

[13] *Deposit Takers (Credit Ratings) Regulations 2009* (NZ), reg 3.

[14] *Reserve Bank of New Zealand Act 1989* (NZ), s 157M.

[15] *Reserve Bank of New Zealand Act 1989* (NZ), s 157N.

[16] *Reserve Bank of New Zealand Act 1989* (NZ), s 157O.

[17] *Reserve Bank of New Zealand Act 1989* (NZ), ss 157P-157ZD.

[18] *Reserve Bank of New Zealand Act 1989* (NZ), s 157P.

[19] *Reserve Bank of New Zealand Act 1989* (NZ), s 157S.

[20] *Reserve Bank of New Zealand Act 1989* (NZ), s 157V.

[21] *Reserve Bank of New Zealand Act 1989* (NZ), s 157Z.

[22] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZC.

[23] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZD.

- A Capital Policy Paper[24] was released in late 2009 which sought to explain the basis for the risk weighting structure applying to minimum capital requirements with enactment of the final regulations being expected imminently.
- In February 2010, a consultation paper on liquidity policy[25] was released, pursuant to which the Reserve Bank proposes a series of options for regulating liquidity risk and sought submissions as to the appropriate level of regulation regarding liquidity requirements. In particular, the Reserve Bank has sought and obtained submissions as to whether the status quo should be maintained (so that further regulation will not eventuate except to require liquidity requirements to be set out in trust deeds), or whether a measurement framework or precise quantitative requirements should be introduced.
- A consultation document[26] and draft regulations[27] regarding proposed capital ratios and related party exposures regulations were released in February 2010 with the expectation that final regulations will be promulgated in September 2010. The regulations deal comprehensively with the definition and treatment of related parties and require that related party exposure be not more than 15% of the deposit taker's capital. The regulations also specify minimum capital ratios to be maintained and specified in the trust deed – the proposed ratios are 8% for deposit takers with a credit rating and 10% for deposit takers who do not have credit ratings (ie where they are exempt from compliance with that requirement).

The recommendations contained in the Capital Policy Paper are based on the standardised Basel II risk weights applying to registered banks, with allowances supposedly having been made so that the standards are somewhat lower for deposit takers. However, assuming the recommendations in the paper form the basis for the final regulations, very few of the existing remaining deposit takers are likely to meet the requisite standards on the basis of their existing models.

The effects of the resulting market gap will be interesting to monitor. It may well be that, as a result of the standards imposed, deposit takers will need to make major adjustments to the asset classes they are willing to fund. If so, it is likely that there will be a significant market gap in relation to development funding, which is subject to particularly onerous risk weighting. Sourcing alternative funding for such projects is unlikely to be a straightforward task for property developers, who have relied heavily on deposit takers in recent years.

OFFENCES BY DEPOSIT TAKERS

Failure to comply with the requirements of the Act, including the requirements to have a risk management program and credit rating in place and the requirements around the provision of information, is an offence.[28] Deposit takers will have a valid defence where they can demonstrate that the failure to comply was due to the act or omission of another person or beyond their control and that they took reasonable precautions and exercised due diligence to avoid the contravention.[29] The court is entitled to discharge and acquit the deposit taker where it considers that the contravention relates to immaterial matters.[30]

Where a deposit taker is convicted of an offence, each of its directors will also be guilty of an offence where the offence took place with that person's authority or permission, in circumstances

[24] Harrison I, *Non-Bank Deposit Taker (NBDT) Capital Policy Paper* (2009), http://www.rbnz.govt.nz/finstab/nbdt/regulation/3799546.pdf viewed 29 April 2010.

[25] Reserve Bank of New Zealand, *NBDT Consultation Document: Liquidity Policy* (February 2010), http://www.rbnz.govt.nz/finstab/nbdt/regulation/3890317.pdf viewed 29 April 2010.

[26] Reserve Bank of New Zealand, *NBDT Consultation Document: Proposed Capital Ratios and Related Party Exposures Regulations* (February 2010), http://www.rbnz.govt.nz/finstab/nbdt/regulation/3896874.pdf viewed 29 April 2010.

[27] Reserve Bank of New Zealand, *Draft for Consultation: Deposit Takers (Credit Ratings, Capital Ratios and Related Party Exposures) Regulations 2010* (February 2010), http://www.rbnz.govt.nz/finstab/nbdt/regulation/3896730.pdf viewed 29 April 2010.

[28] *Reserve Bank of New Zealand Act 1989* (NZ), ss 157ZR, 157ZS.

[29] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZT.

[30] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZU.

where the director knew or ought to have known that the offence would be committed and where the director failed to take reasonable steps to prevent the offence from occurring.[31]

On summary conviction, corporate deposit takers are liable to a fine of up to NZ$2 million depending on the offence. Directors are liable to a fine not exceeding NZ$100,000 or a term of imprisonment not exceeding 12 months or both.[32]

The *Securities Act 1978* (NZ) also imposes criminal sanctions on deposit takers for misstatements contained in advertisements and prospectuses, for offering securities in contravention of that Act and for various acts relating to obstructing the powers of the Securities Commission. The offences enacted under Pt 5D are very broad and can occur in relation to a breach of most of the main provisions of the Part. Criminal proceedings under the *Securities Act* have been relatively rare and it will be interesting to see whether these new offences are more frequently invoked against deposit takers and their directors.

TRUSTEES: OBLIGATIONS AND OFFENCES

Trustees will continue to be responsible for monitoring deposit takers pursuant to the terms of the relevant trust deed and pursuant to the requirements of the *Securities Act*. However, Pt 5D extends the role of trustees as supervisors of deposit takers by imposing some new and potentially onerous obligations on trustees:

- Trustees will be required to ensure that trust deeds comply with the various requirements of Pt 5D and any regulations requiring trust deeds to contain specific financial covenants, information and undertakings (for example, a capital ratio or maximum exposures to related parties).
- The Reserve Bank may require a trustee to attest that a deposit taker is complying with Pt 5D and the trustee must either provide such an attestation or, if unable to do so, report the reason, specifying the details of non-compliance.[33]
- Trustees are under a separate duty to report non-compliance or likely non-compliance to the Reserve Bank where they have reasonable grounds to believe that a material failure to comply with Pt 5D has occurred, or is likely to occur.[34]
- Where a trustee forms a reasonable opinion that a deposit taker is cash flow or balance sheet insolvent, or has breached or is likely to breach materially the terms of its trust deed or the terms of any offer of debt securities, the trustee must disclose all relevant details to the Reserve Bank.[35]

Part 5D precludes proceedings from being commenced against trustees arising from a disclosure in relation to the above provisions.[36]

Trustees who do not comply with their obligations to ensure that the trust deed contains clauses meeting the new requirements, or with their various reporting obligations, will commit an offence[37] and, on summary conviction, a fine of up to NZ$200,000 may be imposed.[38]

The new legislation is likely to mean that trustees have a significantly different and more onerous role than that which they originally contracted with deposit takers to assume. The introduction of criminal sanctions to trustees is a radical addition to the previous law. It is questionable whether the Reserve Bank has given trustees sufficient direction or support to enable them to effectively discharge their increased responsibilities. There is a real danger that, without such support, trustees will lack proper resources and expertise to be able to comply with their responsibilities.

[31] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZV.

[32] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZX. Individual deposit takers are liable to lesser fines, but may face a term of imprisonment not exceeding 18 months, depending on the offence.

[33] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZE.

[34] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZF.

[35] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZG.

[36] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZH.

[37] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZW.

[38] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZX.

RESERVE BANK ACCOUNTABILITY

The Reserve Bank has acquired some broad and extensive investigatory powers and powers of enforcement.[39] Where the Reserve Bank decides to investigate a deposit taker's compliance with Pt 5D, deposit takers are required to provide the Reserve Bank, at the deposit taker's cost, with, seemingly, almost any information requested in relation to the deposit taker's business, operation or management.[40] The only exceptions apply where disclosure would breach an obligation of secrecy or non-disclosure imposed by another enactment[41] or where privilege can be asserted.[42] Where an offence is suspected, the Act provides for the Reserve Bank to search premises and gather papers and documents pursuant to a search warrant.[43]

OTHER SECURITIES LAW DEVELOPMENTS RELATING TO DEPOSIT TAKERS

The introduction of Pt 5D is only part of the picture for legislative reform of the financial sector that affects deposit takers. In addition, there have been a number of recent reforms in the securities law arena.

- On 28 April 2010, the Minister of Commerce confirmed that the government intends to implement a single, integrated financial regulator. The new Financial Markets Authority will assume the responsibilities of the Securities Commission as well as certain functions of the Companies Office and National Enforcement Unit. The Authority will also have some responsibility for certain functions of the New Zealand Stock Exchange and the Government Actuary (including Kiwisaver, New Zealand's public superannuation scheme).
- The *Securities Regulations 1983* (NZ) have, subject to some transitional provisions, been replaced by new 2009 Regulations, which amend the detailed rules applying to the content of prospectuses, investment statements and advertisements issued pursuant to the *Securities Act*.
- The *Securities (Moratorium) Regulations 2009* (NZ) came into force in December 2009. Their purpose is to regulate (by supplementing the requirements of the *Securities Regulations 1983* or the *Securities Regulations 2009*, whichever is relevant) the contents of prospectuses and investment statements relating to moratorium proposals. These Regulations provide detailed scheduled lists of matters requiring disclosure. In addition, the Regulations deem certain provisions (which essentially place restrictions on the ability of a deposit taker to enter into a moratorium) to be contained in trust deeds and require deposit takers in moratorium to provide their security holders with prescribed periodic information relating to the progress of the moratorium.
- The government has recently introduced the *Securities Trustees and Statutory Supervisors Bill* (NZ), which is also aimed at increasing investor confidence. The Bill, if passed, will remove the current statutory approval relating to the existing six trustee corporations and will require all trustees, statutory supervisors, and unit trustees to be licensed by the Securities Commission. It will also require those license holders to provide the Securities Commission with six-monthly compliance reports, and to report any actual or potential breaches of obligations. The new legislation (if passed in the Bill's current form) will also allow the Securities Commission to seek pecuniary penalties and compensatory penalties against trustees, statutory supervisors and unit trustees who fail to comply with their obligations under the Bill. The Parliamentary Select Committee sought public submissions by 6 May 2010. Presumably all references to the Securities Commission will be replaced by references to the new Financial Markets Authority.

CONCLUSION

The raft of new regulations, responsibilities, obligations and offences mark a significant change to what had been, in retrospect, a system fraught with shortcomings and insufficient safeguards to

[39] *Reserve Bank of New Zealand Act 1989* (NZ), ss 157ZI-157ZN.

[40] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZI.

[41] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZK.

[42] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZN.

[43] *Reserve Bank of New Zealand Act 1989* (NZ), s 157ZJ, 157ZL, 157ZM.

monitor deposit takers. Regulatory intervention was undoubtedly a necessary step to attempt to restore investor confidence. While many of the new reporting and monitoring measures are long overdue, only time will tell whether, in practice, the reforms will bring about real change in the practices of non-bank deposit takers and their trustees.

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