Serving investors
Taking a comprehensive approach

In the past decade over 40 non-bank institutions collapsed. Public concern led to a comprehensive legislative programme that has put new powers in the hands of government agencies and frontline supervisors.

This note is not intended as a manual for operating a non-bank institution, (hereafter “institution”). Rather, it sets out to summarise the legislative change that has taken place and the supervision framework we now work within.

Repeating principles established by the Basel Committee on Banking Supervision¹ this note then sets out key items of interest to supervisors. It is for general guidance. Institutions should seek specialist advice in the governance and management of their organisation that takes into consideration its unique characteristics and operating environment.

New Zealand’s only full service, stand alone, corporate trustee

There has been a great deal of change in our industry - new rules which today provide us with a bigger toolkit to empower us to ask the right questions, to look deeper.

We take a proactive approach to safer investment, working closely with issuers to help them to be more accountable and enabling their investors to have better trust and security in their investment.
**Legislative framework**

The regulatory regime has been in transition. Key pieces of legislation include:

- Reserve Bank of New Zealand Act
- Non-bank Deposit Takers Act
- Securities Act
- Financial Markets Conduct Act
- Securities Trustees and Statutory Supervisors Act

and their associated regulations, including deposit taker regulations.

Rob Everett, Chief Executive of the FMA recently commented to the Governance, Risk and Compliance Institute on the changes that have been made to the regulatory regime:

> “The financial services regulatory framework that’s in place in New Zealand – that’s the one that’s applied for the most part by FMA and the Reserve Bank – has three overall goals:

- Providing quality governance – especially for Boards and senior management teams that have oversight of balance sheets and oversight of culture.
- Managing risk comprehensively and coherently, both at the systems level, and also for individual firms and groups of professionals dealing with recognising regulatory risk, quantifying it, and ensuring mitigation is in place.
- Ensuring sustained good conduct – in retail and wholesale markets – among firms and professionals.

Let me back-up briefly and explain how we have arrived at this point in New Zealand, because it reveals why those three goals – among others – have emerged.

The Global Financial Crisis (GFC) and its aftermath brought some major lessons in New Zealand regarding regulation in financial services and capital markets.

But even without the GFC in 2008, there was a growing recognition – at least among regulators in New Zealand – of the need to modernise and reform securities and markets law.

The existing statutory regime dated back to the 1960s and 1970s. It had been amended – over the years – piece-by-piece.

There were several shortcomings in it.

It provided an inconsistent set of investors’ rights, which varied depending on the legal form of investment or savings vehicles.

That meant, for example, that investors in unit trusts enjoyed a different set of rights to those in other managed investment schemes, even though those were virtually the same thing, at least for an investor.

The regime employed a few regulatory tools – notably extensive requirements for disclosure on the part of firms and providers – but some other good regulatory systems – like licensing and control over authorisations – were barely used.

The regulators had relatively few powers (and seemed to be discouraged from) intervention.

Modern developments also meant the regime was steadily overtaken by practice.

Ambiguities and gaps appeared.

An example is the so-called finance companies, which largely fell outside the previous framework.

New products had appeared – in retail and wholesale markets – and new distribution channels...
were being used. But regulation hadn’t kept pace with that.

The major changes we have seen – since 2008 – are:

- The Reserve Bank has taken on responsibility for prudential regulation of the insurers, the non-bank deposit-takers, and prudential regulation has been deepened for all the intermediaries that the RB regulates.
- The FMA has been established, with a substantial mandate that covers retail and wholesale markets, and which includes both infrastructure regulation – so, for example, where we have oversight of the public capital market in the form of the NZX – as well as regulation of specific providers and professions – say the financial advisers.
- Extensive use of licensing and supervision – of firms, markets, and professionals – as a means to set and maintain standards.
- Regulatory arrangements that cover emerging new services, such as peer-to-peer lending services and crowd funding services.
- Regulation specifically aimed at making capital-raising easier, provided issuers meet certain requirements. This is in line with the Government’s commitment of services and crowd funding $200 billion to New Zealand’s public capital stock over the next decade.
- The fair-dealing provision, which is new to the FMA and is in the Financial Markets Conduct Act that’s just taking effect – although this ‘conduct’ is focused on mis-selling and misrepresentation – it is nonetheless very broadly based.

There are other new regulations – either proposed or before Parliament now – which have an impact on financial services law in New Zealand.”

In addition to the main body of legislation institutions will need to be aware of the following statutes as they develop their operating style:

- Credit Contracts and Consumer Finance Act
- Fair Trading Act

- Consumer Guarantees Act
- Privacy Act
- Financial Markets Conduct Act
- Financial Transactions Reporting Act
- Anti-Money Laundering and Countering Financing of Terrorism Act
- Crimes Act
- Proceeds of Crime Act

And whatever legislation governs the form of entity being used:

- Building Societies Act
- Friendly Societies and Credit Unions Act
- Companies Act
- Incorporated Societies Act

Regulators

As set out above non-bank deposit takers are overseen by the Reserve Bank of New Zealand and the Financial Markets Authority.

The Reserve Bank promotes the maintenance of a sound and efficient financial system, and avoiding significant damage to the financial system if a deposit taker fails. Unlike the banking regime, where the Reserve Bank is both the regulator and supervisor of registered banks, for the non-bank deposit taker the Reserve Bank is regulator and licenses individual institutions.
The Financial Markets Authority regulates New Zealand’s financial markets. It oversees securities, financial reporting, and company laws as they apply to financial services and markets. It licenses supervisors.

**Supervisors**

Non-bank deposit takers must have:

- a trust deed setting out what the organisation can do with investors' money and establishing a supervisor, whose job is to look after investors' interests
- an investment statement (for most investments) and prospectus that explain the investment.

These should tell you about the people the organisation is lending your money to, and help you assess whether the interest rate offered reflects the risk of the investment.

Supervision is conducted by a licenced Supervisor. The institution’s performance of obligations is reviewed. The Supervisor must satisfy itself that the institution’s assets are sufficient to discharge the amounts of debt securities as they become due. This is overlaid with the responsibility to act on behalf of the debt security holders in relation to the issuer and the trust deed.

The Supervisor is the front line supervisor. This means that it holds the core supervisory and compliance monitoring role. The Reserve Bank and Financial Markets Authority work through the Supervisor to build investor trust and achieve greater regulatory efficiencies, improved compliance standards and consistency across the industry.

**Governance and management**

Corporate governance policies and processes should ensure there is effective control over the institution’s entire business. These policies and procedures should cover, for example, strategic direction, group and organisational structure, control environment, responsibilities of the institution’s board and senior management, and compensation.

It is prudent to have a documented process for nominating and appointing Board members to ensure that membership includes experienced non-executive members, where appropriate. Commensurate with the risk profile of the institution audit, risk oversight and remuneration committees with experienced non-executive members should be considered. Board members should be suitably qualified, effective and exercise their “duty of care” and “duty of loyalty”. Board members establish and communicate corporate culture and values (eg through a code of conduct). Board members should operate to strict conflicts of interest policies and encourage a strong control environment.

The Board should maintain plans for succession, and actively and critically oversee senior management’s execution of Board strategies, including monitoring senior management’s performance against standards established for them. Compensation systems, need to
be consistent with long-term objectives and financial 
soundness.

The Board should notify the supervisor as soon as it 
becomes aware of any material and bona fide 
information that may negatively affect the fitness and 
propriety of an institution’s board member or a member 
of the senior management. Board changes and changes 
to any officer’s status as a suitable person should also be 
advised.

Roger Drummond, Barrister and Solicitor, has considerable 
experience in providing advice in this area. His comments on the 
need for strong governance and senior management teams are as 
follows:

“Strong, competent, ethical, and experienced 
governance and senior management are essential for 
participants in the financial services sector to ensure 
the participants are able to discharge their duties to 
their various stakeholders and to ensure compliance 
with the recent legislative and regulatory changes 
affecting the financial services sector.

It is important that there is a breadth of experience 
covering the risk profile of the institution. Conflicts of 
interest should be recognised and dealt with as soon 
as they arise. The board should include independent 
directors not involved in the day to day operations of 
the institution.”

The risk management process should identify, measure, 
evaluate, monitor, report and control or mitigate all 
material risks on a timely basis and assess the adequacy 
of capital and liquidity in relation to risk profile and 
market and macroeconomic conditions. This extends to 
development and review of contingency arrangements 
(including robust and credible recovery plans where 
warranted) that take into account the specific 
circumstances of the institution.

Risk management strategies need to be approved by the 
institution’s board. The board needs to set a suitable 
risk appetite to define the level of risk the institution is 
willing to assume or tolerate.

A sound risk management culture, policies and 
processes should be developed for risk-taking that:

- are consistent with the risk management 
  strategy
- establish risk appetite
- recognise uncertainties attached to risk 
  measurement
- set appropriate limits consistent with the 
  institution’s risk appetite, risk profile and capital 
  strength, and that are understood by, and 
  regularly communicated to, relevant staff
- ensure senior management take the steps 
  necessary to monitor and control all material 
  risks consistent with the approved strategies 
  and risk appetite
- provide for risk management strategies, 
  policies, processes and limits to be properly 
  documented; regularly reviewed and 
  appropriately adjusted to reflect changing risk 
  appetites, risk profiles and market and 
  macroeconomic conditions
- are in a form suitable for communication 
  throughout the institution.
Full and timely information flows are critical to risk monitoring. The institution’s board and senior management should obtain sufficient information on, and understand, the nature and level of risk being taken by the institution and how this risk relates to adequate levels of capital and liquidity. Information systems must be adequate (both under normal circumstances and in periods of stress) for measuring, assessing and reporting on the size, composition and quality of exposures on an institution-wide basis across all risk types, products and counterparties.

Board and senior management need to understand the risks inherent in new products, material modifications to existing products, and major management initiatives (such as changes in systems, processes, business model and major acquisitions). Major activities of this nature should be approved by the board.

It is preferable that risk management functions are conducted by a standalone risk function within the institution. The function should have sufficient resources, independence, authority and access to the institution’s board to perform its duties effectively. The risk management function needs to be subject to regular review by the internal audit function.

The supervisor requires institutions to look into the future. Risk programmes need to be stress tested. Stress testing focuses on material sources of risk and adopts plausible adverse scenarios. Results of stressing should be integrated into decision-making, risk management processes and the assessment of capital and liquidity levels.

Disaster recovery and business continuity plans need to be in place. In severe business disruption, the institution should be able to continue to operate as a going concern and minimise losses, including those that may arise from disturbances to payment and settlement systems. Supporting information technology policies and processes should identify, assess, monitor and manage technology risks. Policies need to ensure data and system integrity, security and availability, with the ability to manage and monitor outsourced activities. Due diligence for selecting potential service providers; structuring the outsourcing arrangement; ensuring an effective control environment; and establishing viable contingency planning require advanced skills that may need to be specifically recruited.

Credit management

The full credit lifecycle needs to be covered in credit policy. The policy should cover credit underwriting, credit evaluation and the ongoing management of the institution’s loan and investment portfolios. It should include prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk (including counterparty credit risk) on a timely basis.
Processes for assuming credit risk are core processes and should:

- operate without undue reliance on external credit assessments
- ensure prudent and appropriate credit limits, consistent with the institution’s risk appetite, risk profile and capital strength, which are understood by, and regularly communicated to, relevant staff
- provide appropriate discipline on approval of new exposures as well as for renewal and refinance of existing exposures
- identify the appropriate approval authority for the size and complexity of the exposures

Credit policy prescribes that major credit risk exposures exceeding a certain amount or percentage of the institution’s capital are to be decided by the institution’s board or senior management. The same applies to credit risk exposures that are especially risky or otherwise not in line with the mainstream of the institution’s activities.

In the event that assets, including off-balance sheet assets, become stressed appropriate policies and processes need to be in place to ensure that provisions...
and write-offs are timely and reflect realistic repayment and recovery expectations, taking into account market and macroeconomic conditions. Early identification of deteriorating assets is essential and should lead to ongoing oversight of problem assets and assessment of the value of risk mitigants, including guarantees, credit derivatives and collateral. The valuation of collateral needs to reflect the net realisable value, taking into account prevailing market conditions. A loan is only considered to be rehabilitated when payments return to the contractual terms of the loan agreement and all arrears have been cleared and the loan has been brought fully current.

The supervisor should be provided with summary results of the latest asset review process, comparative trends in the overall quality of problem assets, and measurements of existing or anticipated deterioration in asset quality and losses expected to be incurred. Information should be provided on an individual item basis.

Concentration risk and large exposure limits need to be set with care and regularly reviewed. Off-balance sheet as well as on-balance sheet items need to be considered in the process. Acceptable concentrations of risk, reflecting the institution’s risk appetite, risk profile and capital strength should be regularly reviewed looking for concentrations within an institution’s portfolio, including sectoral, geographical and currency exposures. Management should monitor the impact of significant risk concentrations by including them in stress testing programmes for risk management purposes.

Related party transactions should not be actively sought. Where they are accepted they should be in accordance with legislation. “Conflicts of interest” and “related parties” are terms that need to be fully defined. Should related party transactions take place on more favourable terms (eg in credit assessment, tenor, interest rates, fees, amortisation schedules, requirement for collateral) than would normally be the case, they should be subject to prior approval by the institution’s board.

**Capital and liquidity management**

Capital adequacy is quite simply the ability to absorb losses. Whereas liquidity adequacy is the ability to meet commitments as they become due. A forward-looking approach should be taken to capital and liquidity management, including appropriate stress testing in anticipation of possible events or changes in market conditions that could have an adverse effect. Capital calculations should have broad risk coverage. The method of calculation and thresholds arrived at should be clear and transparent. Calculations should include off-balance sheet risks.
John Fisk, who has conducted a wide range of finance company receiverships, emphasises the importance of cash flow in the day to day operations of a non-bank deposit taking institution

“When asset valuations are accelerating and investor deposits are flowing in, institutions can be lulled into false comfort. Just as asset values accelerate, they can also decelerate. As the market slows down, deposit maturities can overtake the time necessary to recover loans. It is important that institutions keep a focus on cashflow and, ultimately, the suitability of their liquidity and capital management policies.

Capitalised interest and loan fees are not cash coming in at the time of recognition, loan maturity dates on partially completed projects often mean rollovers are realistically the only option and therefore don’t represent opportunities for cash inflows. While the profit and loss statement may be showing a healthy picture, keep an eye on the cashflow statement. Net cash generated from operating activities will provide a useful parameter of an institution’s health.”

Market conditions including interest rate risks can be difficult to predict. Exception tracking and reporting processes ensure prompt action at the appropriate level of the institution’s senior management or board.

Marked-to-market positions should be revalued frequently. Transactions need to be captured on a timely basis and the valuation process needs to use consistent and prudent practices and reliable market data verified by a function independent of the relevant risk-taking business units (or, in the absence of market prices, use industry-accepted models). To the extent that the institution relies on modelling for the purposes of valuation, the institution is required to ensure that the model is validated by a function independent of the relevant risk-taking businesses units. Policies and processes should be in place for considering valuation adjustments for positions that otherwise cannot be prudently valued, including concentrated, less liquid, and stale positions. Market risk exposure will need to be incorporated into stress testing programmes.

Interest rate risk in the trading book needs to be covered by effective exception tracking and reporting processes. Appropriate scenarios should be included in stress testing programmes.

Liquidity management strategies should take into account the institution’s risk profile as well as market and macroeconomic conditions and include prudent policies and processes consistent with the institution’s risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. The institution should maintain sufficient liquidity to withstand a range of stress events. It is important that there is a clear articulation of the overall liquidity risk appetite on both an intra-day and longer term basis.

Funding strategies may include:

- funding requirements under alternative scenarios
- a cushion of high quality, unencumbered, liquid assets
- diversification in the sources (including counterparties, instruments and markets) and tenor of funding, and regular review of concentration limits
• regular efforts to establish and maintain relationships with liability holders

• regular assessment of the capacity to sell assets.

The contingency funding plan needs to be formally articulated, adequately documented and set out the institution’s strategy for addressing liquidity shortfalls in a range of stress environments. It needs to include clear lines of responsibility, clear communication plans and be regularly tested and updated to ensure it is operationally robust.

Levels of encumbered balance sheet assets need to be managed within acceptable limits to mitigate the risks posed by excessive levels of encumbrance in terms of the impact on the institution’s cost of funding and the implications for the sustainability of its long-term liquidity position.

Ming Lim-Pollard, responsible for the securitisation operations of Bank of New Zealand subsidiary Titan, summarises the role securitisation can play in liquidity management

“For thinly capitalised organisations, borrowing short to lend long is particularly high risk. Through securitisation, institutions funded in the past by a predominance of short term deposits, can more safely consider offering longer term lending products such as mortgages. Securitisation can be arranged so that it is on the institution’s balance sheet or off-balance sheet.

Consider the following residential mortgage-backed securitisation.

Mortgage assets are channeled into a special purpose vehicle (SPV) such as a trust which is within or outside the institution’s accounting group. The SPV exists solely to acquire mortgages and to issue debt securities to fund them.

The mortgages would have to conform to strict rules designed to diversify the aggregate risk of the mortgage portfolio. This would allow the SPV to gain an investment grade credit rating of its debt from an independent rating agency such as Standard & Poors. Some form of equity, subordinated debt or other ‘credit support’ is invariably part of the mix, usually less than the equity that would be required if the assets were funded in the normal course of business.

Capital Market investors purchase and hold securities issued by the SPV in large denominations. The result for the originator is wholesale funding for the retail assets it originates. Longer tenor of funding can be achieved along with cheaper funding and less capital required in the business. The institution gets to diversify its funding sources and hence funding risk.”
**Internal controls and reporting**

In delegating authority and responsibility there should be separation of the functions that involve committing the institution, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes and safeguarding the institution’s assets. Internal audit and compliance functions are to test adherence to these controls as well as applicable laws and regulations. They should be independent of business units to avoid conflicts of interest in the performance measurement of staff.

Organisational structure, accounting policies and processes, checks and balances are important for safeguarding of assets and investments (including measures for the prevention and early detection and reporting of misuse such as fraud, embezzlement, unauthorised trading and computer intrusion). Organisation structure should ensure that duties and responsibilities are well defined, including clear delegation of authority (eg clear loan approval limits), decision-making policies and processes and separation of critical functions (eg business origination, payments, reconciliation, risk management, accounting, audit and compliance).

The ‘four eyes principle’ or segregation of duties, cross-checking, dual control of assets and double signatures is a useful rule of thumb in establishing controls. Safeguards need to include physical and computer controls.

Financial statements are to be prepared in accordance with accounting policies and practices that are widely accepted internationally. The institution must annually publish information that fairly reflects its financial condition and performance and bears an independent external auditor’s opinion. Accounts should be consolidated and, where appropriate, provided on a solo basis that is easily accessible and fairly reflects financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes. Accounts should provide both qualitative and quantitative information, disclosing all material entities in the group structure. The institution should disclose all information that will help in understanding an institution’s risk exposures during a financial reporting period, for example on average exposures or turnover during the reporting period.

The board is responsible for adequate governance and oversight of the external audit function. A risk and materiality based approach should be taken in planning and performing the external audit. The external audit cover areas such as the loan portfolio, loan loss provisions, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitisations, consolidation of and other involvement with off-balance sheet vehicles and the adequacy of internal controls over financial reporting. Inadequate expertise or independence must be actively avoided. The auditor must adhere to established professional standards. It is prudent for the external auditors to be changed from time to time.

Where valuations are relied upon valuation practices must be consistent with accounting standards widely accepted internationally. The framework, structure and processes for fair value estimation must be subject to
independent verification and validation, and the institution must document any significant differences between the valuations used for financial reporting purposes and for regulatory purposes. Valuers should be regularly rotated where it is feasible to do so. It is important that there is a clear understanding of the assumptions that the valuer is using and whether these are acceptable.

In the drive to develop the business, back office functions can be neglected. There should be an appropriate balance in the skills and resources of the back office, control functions and operational management relative to the business origination units. Staff of the back office and control functions must have sufficient expertise and authority within the organisation (and, where appropriate, in the case of control functions, sufficient access to the institution’s board) to be an effective check and balance to the business origination units. The board should exercise oversight of the management of the compliance function.

An independent, permanent and effective internal audit function is essential. It should assess whether existing policies, processes and internal controls (including risk management, compliance and corporate governance processes) are effective, appropriate and remain sufficient for the institution’s business; and ensuring that policies and processes are complied with. It requires full access to and communication with any member of staff, access to records, files or data of the institution and its affiliates, whenever relevant to the performance of its duties. The internal audit function must employ a methodology that identifies the material risks run by the institution; prepare an audit plan, which is reviewed regularly, based on its own risk assessment and allocates its resources accordingly. It must have the authority to assess any outsourced functions.

Abuse of financial services can and does happen. Ensure strict customer due diligence (CDD) rules to promote high ethical and professional standards in the financial sector and prevent the institution from being used, intentionally or unintentionally, for criminal activities.

The Board should advise the Supervisor of matters of material significance, for example failure to comply with the licensing criteria or breaches of law, significant deficiencies and control weaknesses in the institution’s financial reporting process or other matters that it believes are likely to be of material significance to the functions of the supervisor.

**Active supervision**

These days the supervision role is more proactive. The supervisor is expected to take an active interest in its client institutions.

Questions that can be expected include:

- **Corporate governance**
  - How is the risk function separate from the rest of the business?
  - What are the channels for risk reporting to the board?
  - Who are the independent board members and what are their qualifications?

- **Risk management process**
How does the business identify risks across the business and changes to them overtime?

What is the system of controls in place and how are controls reviewed?

Operational risk
- What systems are in place to detect human error, system failures and inadequate procedures and controls?
- How are breaches recorded, compliance monitored and non-compliance dealt with?
- How are operational failures shared with the organisation so that they are learnt from?

Credit risk
- What are the main credit risks for the products provided?
- What lending policies are in place based on these risks?
- By what process is the level of credit risk established for each exposure?
- Is there a band of risk that is seen as unacceptable?
- What special management procedures are in place for exposures in the unacceptable risk band?

Problem assets, provisions and reserves
- How are problem assets and collections efforts reported to management and governance?
- How are problem assets identified?
- What escalation processes are in place for assets that become identified as problematic?
- Who is responsible for raising provisions and how are they raised?

Concentration risk and large exposure limits
- Are there individual interests that are above 5 percent when aggregated?
- If there are what is the procedure for reducing concentration?

Transactions with related parties
- What constitutes a related party transaction?
- Are related party transactions accepted and if so how?
- How are any related party transactions monitored?

Market risk
- How does the organisation quantify its interest rate and exchange risks?
- How does the organisation hedge interest rate and exchange risks?
- What is the framework of the organisation’s treasury policy?

Capital adequacy
- How is the prudential level of capital established given statutory requirements and for what reasons is the requirement reviewed?
- What will happen if there is insufficient capital at any point in time?

Liquidity risk
- What is an acceptable liquidity profile?
- How is the liquidity profile monitored?
- What happens if the acceptable liquidity profile is breached?

Internal control and audit
- How is the internal audit function separate from the rest of the business?
- What are the channels for internal audit reporting to the board?
• Financial reporting and external audit
  o Is the external auditor position regularly tendered?
  o What have recent audit management letters noted are issues for the business?

• Disclosure
  o What is the system of internal and external performance measures that the business uses?
  o Are performance measures circulated to staff and the board, are they published to members?

• Abuse of financial services
  o What anti-money laundering procedures are in place?
  o How does customer due diligence take place?

• Being ready to answer supervisor questions
  o Are points of authority for working with supervisors well established?
  o To what extent do internal audits cover information provided?
  o What are the protocols for up-dating the supervisor where information provided is later found to be materially incorrect?

We welcome your thoughts. The strongest solutions will be those thought through carefully across all participants

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i Calculated from KPMG Financial Institutions Performance Survey   ii http://www.bis.org/bcbs/