

# New regulations for finance companies and other non-bank deposit takers

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**In this article, associate Ben Johnston gives an in-depth review of the new regulations governing finance companies.**

The recent spate of finance company failures has left many investors out-of-pocket and dented public confidence in investing in finance companies or other non-bank deposit takers.

The government moved recently to put in place further regulations for finance companies and certain other non-bank deposit takers to help ensure that they provide more information to the trustees which supervise and monitor them on behalf of investors. The new regulations, the Securities Amendment Regulations 2007 (“the Regulations”) which amend the existing Securities Regulations 1983, came into force on 21 September 2007.

## **Supporting the role of the trustee**

In New Zealand, the Securities Act 1978 (“the Act”) regulates the offers of securities to the public. One of the Act’s requirements is that offers of “debt securities” to the public must be monitored on behalf of investors by an independent trustee. “Debt securities” include secured and unsecured deposits (including at call and term deposits) and debenture stock typically offered by the issuers of such securities, including finance companies and other non-bank deposit takers (which, in this article, we refer to as “issuers”).

The function of the trustee is to monitor the compliance of the issuer of the securities with

its legal obligations (principally contained in the trust deed between the trustee and the issuer) with a view to ensuring that the interests of investors are protected.

Typically trust deeds include the information and reporting requirements of the issuer to the trustee, permitted investments, remuneration of the issuer, and financial covenants such as liquidity requirements and any financial ratios (such as the ratio of debt to total tangible assets) which must be maintained. Effectively, the trust deed sets out the “legal and other agreed obligations” under which the issuer must operate.

The trustee’s role is therefore an important one in terms of ensuring, on behalf of investors, that an issuer is operating within the trust deed, and within any other requirements agreed with the trustee. The new Regulations are designed to ensure that trustees receive greater and more timely information on the business, and in particular the financial position of the issuer, in order that they can fulfil this role more effectively.

## **What do the new Regulations require?**

The Regulations apply to issuers that in the ordinary course of their business continuously raise money from the public, and carry on the business of lending money or providing financial services. The Regulations are clearly

directed at and include issuers such as finance companies and other similar non-bank deposit takers, but do not apply to building societies, credit unions or co-operative companies, which operate under their own special Acts of Parliament.

The Regulations have the effect of amending the existing Securities Regulations 1983 by adding to the requirements which are deemed to be contained in trust deeds between issuers and their trustees.

The new requirements included under the Regulations are discussed below.

### **Obligation to provide regular reports and certificates**

Each issuer is now obliged to provide to the trustee, within 30 days of the end of each month:

- the issuer's monthly management report prepared for the directors of the issuer; and
- a monthly report reporting on the liquidity of the issuer, the asset quality of the issuer, the reinvestment rates for investment in the issuer, and any breach by members of the issuer's borrowing group of financial covenants and financial arrangements with third parties.

Issuers are also now required to provide the trustee at least once in every three months a report certifying that at all times during the period covered by the report the issuer's current prospectus has been up to date and has not been false or misleading in a material particular and that the issuer has complied with all the provisions of the trust deed.

These new obligations are clearly aimed at providing a trustee with more "early warning" information about issuers. They may also increase awareness amongst issuers of any problems or potential problems that they themselves may identify as a result of preparing these reports for the trustee.

### **Obligation to keep the trustee informed**

Issuers are now obliged to tell the trustee about a number of events that may have a material effect on their business, including:

- advising the trustee in advance or as soon as known, of every change in ownership

that results in a change to the shareholders having effective control of the issuer, every change of directors of the issuer and significant changes in senior management of the issuer;

- advising the trustee in advance of any major transaction (as defined under the Companies Act 1993, such as selling a major asset) to be entered into by the issuer; and
- providing the trustee with any other reports that the trustee may require within the time the trustee specifies (which must be reasonable in the circumstances). The trustee may require any report to be prepared in this regard which is relevant to the performance of the trustee's duties.

These new requirements recognise these changes are potentially significant to investors and may have an impact on the performance of the issuer.

### **Obligation to audit or review half-yearly financial statements**

Half-yearly financial statements of an issuer's borrowing group now must be audited unless the trustee expressly waives that requirement. Even if the trustee does waive the audit requirement, the issuer is still obliged to have the borrowing group's half-yearly financial statements reviewed by the auditor.

It is reasonably common practice for the financial statements of debt security issuers to be audited under the terms of existing debt security trust deeds. However, the Regulations make this practice mandatory, and not simply a prudent option.

### **Obligation to provide financial statements to the trustee**

Copies of the annual financial statements and half-yearly financial statements of the borrowing group of the issuer now must be provided to the trustee within three months of the end of the relevant financial year or half year. These statements need to be signed by at least two directors of the issuer on behalf of the board.

Again, this type of provision is common in many existing debt security trust deeds. However, again the Regulations now confirm that this is mandatory.

### **Obligation concerning the appointment or re-appointment of auditors**

An issuer must now consult the trustee before the re-appointment of an auditor. Any comments of the trustee concerning the proposed auditor must be brought to the attention of persons appointing or re-appointing the auditor (generally shareholders of the issuer or fund).

If an auditor resigns or declines to accept appointment or re-appointment, the trustee must be notified and the issuer must pass on to the trustee any explanation provided by the auditor for resigning or declining to accept appointment or re-appointment. The issuer must not prevent an explanation being offered by the relevant auditor or disclosing the reasons to the trustee.

The role of an auditor is critical to a trustee receiving accurate and independent financial information on an issuer. These new requirements reflect the importance of the relationship between trustee and auditor and the auditor's role, and that it is both appropriate and desirable that trustees are consulted regarding auditor appointments so that they can have trust and confidence in the auditor appointed. It will also be highly relevant to a trustee if an auditor declines an appointment of the issuer for any reason.

### **Terms of appointment of auditor**

The terms of appointment of an auditor for an issuer, whether the auditor is conducting an audit or a review of the issuer, must now include that the auditor will:

- report separately to the trustee on any matter immediately upon becoming aware of it, that is (in the opinion of the auditor) relevant to the exercise of the powers of performance of the duties of the trustee, or likely to call for further investigation by the trustee in the interest of security holders;
- report separately to the trustee on whether, during the period covered by the audit or review, all reports or certificates given by the issuer to the trustee give a true and fair view of the matters to which they relate, and any directors' opinions expressed to the trustee are reasonable;
- confirm its audit opinion for the benefit of the trustee;

- provide the trustee with a copy of the management letter, setting out the material findings of the audit or review, that is provided to the board or the issuer; and
- meet with the trustee without any representative of the issuer being present to discuss matters arising in the performance of the audit or review, and to answer any questions the trustee may have concerning the audit or review.

The new requirements spell out certain direct obligations of the auditor to the trustee, again to reflect that the auditor is an important ally of the trustee in monitoring the interests of investors.

### **Right of trustee to appoint independent auditor**

The trustee is now also entitled (at the issuer's cost) to appoint an independent auditor to audit the financial statements of the borrowing group where:

- the relevant firm appointed by the issuer is not a firm having at least five partners and receiving at least 20% of their revenue from audit or audit-related work; or
- in the opinion of the trustee the auditor appointed does not have sufficient experience or capacity to undertake the audit of the issuer.

If an independent auditor is appointed, the issuer is obliged to co-operate in permitting the auditor to carry out the audit and the trustee must ensure that the terms of the audit include the matters specified above.

This provides a further option for a trustee where it has any concerns about the quality of audit information with which it has been provided.

### **Right of trustee to engage expert**

The trustee is now also entitled (at the issuer's cost) to engage an expert to assist the trustee in determining the true financial position of the issuer if the trustee considers it requires the assistance of such an expert.

## Conclusion

The Regulations oblige certain debt security issuers (such as finance companies) to provide their trustees with more information and additional tools with which the trustee can use to monitor and supervise the issuer on behalf of investors.

Many of the new requirements are already being met by a number of issuers, either under the terms of their trust deeds or as best practice. While the Regulations will not guarantee that there will be no further finance company collapses, they do give trustees greater powers to make their own investigations and should also provide trustees with more “early warning” of any danger signs, affording them the opportunity to increase monitoring or take action to remedy any breaches of the trust deed.

Prior to these latest Regulations being passed, the government had also previously announced proposals to further regulate non-bank deposit takers as part of an ongoing review of financial services regulation being undertaken by the Ministry of Economic Development and the Reserve Bank. Those proposals provide that non-bank deposit takers such as finance companies would continue to be supervised by trustees, but additional requirements would be imposed including that such issuers:

- be required to be licensed by the Reserve Bank and therefore subject to more rigorous prudential governance and regulatory requirements;
- be subject to enhanced public disclosure requirements under the Securities Act; and
- be required to obtain and disclose a credit rating from an approved rating agency (with the credit ratings regime to be administered by the Reserve Bank).

At the date of writing, indications from the Reserve Bank are that legislation may be introduced to implement these proposals later in the year as regards the credit rating and prudential requirements, and later in 2008 in respect of licensing with the Reserve Bank. However, in the meantime the Regulations provide trustees with some further tools to protect investor interests, with a view to helping restore investor confidence in the industry.



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