Office of the Minister of Finance
Office of the Minister of Commerce

13 June 2007

Chair
CABINET ECONOMIC DEVELOPMENT COMMITTEE

INSTITUTIONAL ARRANGEMENTS FOR PRUDENTIAL REGULATION

Proposal

1. This paper seeks the Committee's agreement to changes to the institutional arrangements for the Reserve Bank. These changes support the regulatory regime proposed in the Review of Financial Products and Providers (RFPP). The paper makes recommendations on institutional arrangements that will enable Cabinet to confirm its earlier in-principle decision that the Reserve Bank be the single prudential regulator. This would widen the scope of the Reserve Bank's prudential functions to include the prudential regulation of non-bank deposit takers (NBDTs) and the regulation and supervision of insurance companies.

Background Information

2. In December 2005, Cabinet agreed that prudential supervision for the financial sector be consolidated into a single regulator [CBC Min (05) 18/28 refers]. Cabinet also agreed in principle that this regulator should be the Reserve Bank, subject to officials reporting back on detailed institutional arrangements. Cabinet took decisions in principle to allow more detailed assessment of what additional arrangements would be suitable for the Reserve Bank, given its expanded prudential role, and whether the risk of undermining the independence of the Reserve Bank's monetary policy activities was sufficiently manageable through updated governance and accountability arrangements.

Executive Summary

3. This paper considers how to give effect to the proposal that the Reserve Bank be the single prudential regulator. It sets out a package of changes that:

   - preserve the independence of the Reserve Bank's monetary policy functions; and

   - support the extension of the Reserve Bank's prudential regulation functions.

4. The proposals recognise the Reserve Bank's primary focus on monetary policy and do not undermine its ability to perform this function. None of the proposals

alter the legislated separation of the Reserve Bank’s monetary policy and prudential regulation functions. The Reserve Bank cannot use its monetary policy tools for financial sector objectives or vice versa.

5. Changes to institutional arrangements are proposed to support the broader scope of the Reserve Bank’s prudential regulation activity. Changes to governance and accountability arrangements increase the Reserve Bank’s transparency and responsiveness to Government while maintaining its regulatory independence. They bolster monitoring and reporting requirements for the Reserve Bank’s activities in line with its widened prudential responsibilities. New legislative provisions are to be used to reflect the different purposes for which the Reserve Bank is expected to regulate different types of financial institutions.

6. Changes to policy advice responsibilities are also recommended. These reflect the proposed changes in agency responsibilities for regulatory activities. It is proposed that the Reserve Bank provide advice to the Minister of Finance on prudential regulation. While the Ministry of Economic Development (MED) would no longer provide lead prudential policy advice on NBDTs and insurance, Treasury and MED would continue to provide advice to their respective Ministers on the implications of prudential regulation for their areas of focus and on related areas that fall within their responsibilities. The immediate transfer of responsibility for policy advice on prudential regulation to the Reserve Bank is recommended to expedite the RFPP policy process for NBDTs and insurance.

7. New funding is needed to meet the costs of the Reserve Bank’s additional regulatory functions. On the basis of Treasury’s guidelines on setting charges in the public sector, it is proposed that the costs of Reserve Bank regulation of NBDTs be met by government, in this case through the Funding Agreement between the Minister of Finance and the Reserve Bank. However, it is proposed that the costs of Reserve Bank regulation of insurance companies be met through a levy on companies. Alternatively, the Committee could consider whether it instead wishes to meet the costs for insurance companies through the Funding Agreement, if it is concerned about overall level of costs being imposed by the reforms.

Comment

8. This paper considers the issues raised by the Reserve Bank becoming the single prudential regulator, including:

- whether current governance and accountability arrangements are sufficient;
- whether legislative changes are required (including which Acts require amendment and whether a new Act is required);
- Ministerial portfolio implications and departmental/Reserve Bank responsibilities;
- funding arrangements; and
- transitional arrangements and details of functions to be located in the Reserve Bank.

9. Each of these issues is addressed below, except transitional arrangements and details of functions to be located in the Reserve Bank. It is proposed that MED and Reserve Bank officials work together on transitional issues and report to the Ministers of Finance and Commerce on any operational issues that arise, such as the details of the operational functions to be transferred between agencies.

Governance

10. Some degree of power is delegated to a regulatory agency that acts on behalf of the government. For the delegation of power to be effective, legislation needs to be clear about the objectives the regulator is intended to pursue and clear about the functions and powers of the regulator and the Minister. Amendments are proposed to the purposes and functions of the Reserve Bank and the respective roles of the Reserve Bank and the Minister in regard to prudential regulation.

Purpose and functions of the Reserve Bank

11. Banks, NBDTs and insurance companies are to be prudentially regulated for different purposes, as follows:

- Banks: the promotion of a sound and efficient financial system and avoidance of significant damage to the financial system that could result from the failure of a bank;
- NBDTs: the promotion of a sound and efficient financial system and confidence in the financial sector that encourages participation by providers and consumers; and
- Insurance: the promotion of policyholder protection.

12. The regulatory functions the Reserve Bank would perform to achieve these purposes also differ:

- Banks: to license and undertake prudential supervision of banks;
- NBDTs: to license NBDTs, be responsible for various obligations upon NBDTs to be included in regulations (eg relating to capital and governance) with frontline supervision of NBDTs to be undertaken by trustees; and
- Insurance: to license and undertake prudential supervision of insurance companies.

13. There are key differences with NBDTs and insurance that would make it difficult to formulate functions and purposes that are broad enough to satisfactorily cover all entity/industry types within the prudential purposes and functions currently set out in the Reserve Bank Act. Therefore, it would be more effective to have separate purposes and functions for each entity type.

14. It is proposed that separate legislative provisions be developed for the purposes and functions related to the regulation of NBDTs and insurance. These would be administered by the Reserve Bank. As the single prudential regulator, the

Reserve Bank would still make judgements across the financial sector. Its prudential regulation of all entity types is relevant to its broad focus on financial system stability.

The role of the Reserve Bank and the Minister

15. Government should have the opportunity to be involved in issues that raise policy considerations, to ensure that the value judgements underpinning policy reflect those of society at large, that policy in specific areas supports the government's wider strategic objectives and that priorities and policy are coherent and consistent across government. At the same time, government involvement in regulatory functions raises a number of risks that need to be guarded against:

    - the risk of a perception of government endorsement of regulation and thereby an implied guarantee of regulated entities;

    - the risk of poorer quality regulation, if political concerns lead to inconsistency in regulatory approach over time and reduced regulatory certainty, or to regulation that is short-term in focus;

    - more opportunity for lobbying by industry, and associated political risks;

    - in the case of financial sector regulation, risks to New Zealand's international reputation, given the weight put on independence of regulation in this sector.

16. The Reserve Bank has independence in setting prudential rules and applying them to banks. It also has independence in determining the outcomes it seeks to achieve, based on the objectives set out in statute. To guard against the risks identified above, the government's engagement with the Reserve Bank should not extend to involvement in these regulatory decisions.

17. It is proposed that the government have a greater ability to engage with the Reserve Bank in its development of financial sector objectives, to ensure they are aligned with (or not inconsistent with) government's objectives for the financial sector. This would enable the government to engage with the Reserve Bank more broadly on the financial sector issues that may arise from having responsibility for prudential regulation across the sector as well as responsibility for other financial sector functions (such as the payments system). It is proposed that engagement on financial sector objectives be facilitated through giving the Minister of Finance the authority to:

    - require the Reserve Bank to provide a response through the Statement of Intent process to any comments made by the Minister on the financial sector outcomes set out in the Reserve Bank's draft Statement of Intent, demonstrating how it has taken comments into account in the formulation of its objectives and, if not, why not; and

    - direct the Reserve Bank to have regard to a statement of Government policy objectives relating to the financial sector functions and objectives of the Reserve Bank and to demonstrate in its Statement of Intent how it has done so.

18. These changes would enable the Minister to engage with the Reserve Bank on the outcomes it is seeking to achieve, but would maintain the Reserve Bank's independence in its regulatory functions. This engagement would be further supported by introducing greater specificity on the content of the Statement of Intent (as is proposed below).

Accountability

19. Accountability arrangements provide the system of oversight that supports governance arrangements, by determining how the agency can be held to account for the use of its powers. Formalisation of some reporting arrangements and a greater statutory focus on financial sector functions are recommended to enable better assessment of the Reserve Bank's performance and the performance of the new regulatory regime.

Enhanced reporting

20. The Reserve Bank's Statement of Intent and Annual Report describe the issues being faced by the Reserve Bank and the initiatives and strategies it is undertaking to address them. These documents do not currently provide much information on the Reserve Bank's financial sector regulatory functions. It is proposed that the Reserve Bank's Statement of Intent be required to contain information that is required of a Statement of Intent under the Crown Entities Act. This would mean it provides more ex ante information about the specific impacts, outcomes or objectives the Reserve Bank seeks to achieve or contribute to through financial sector regulatory functions, its intended actions and the main measures and standards by which its future performance may be judged.

21. The Annual Report contains information needed to enable an informed assessment of the effectiveness of the Reserve Bank in the exercise of its functions. It is proposed that this include an assessment against the intentions, measures, and standards set out in the Statement of Intent, as is required of an Annual Report under the Crown Entities Act. The Reserve Bank (in consultation with the Treasury) will develop measures that enable users of the report to assess the Reserve Bank's performance. Of particular interest in the next few years will be the effectiveness of the Reserve Bank's regulation of NBDTs and insurance companies.

22. It is proposed that the Reserve Bank's *Financial Stability Report* contain detailed reporting on the soundness and efficiency of the financial sector and macro-economy, and the performance of the prudential regulation regime and its implications for the financial sector. Of particular interest in the next few years will be an assessment of the impacts of the new regulatory regime on regulated entities. It is recommended the preparation of the *Financial Stability Report* become a statutory requirement on the Reserve Bank.

23. As well as improving reporting, the Reserve Bank could increase transparency around its policy making process, to give the public a greater understanding of how it determines its principles and its regulatory approach. This is important where the Reserve Bank's policies do not require government decisions and so are not subject to the same transparency requirements associated with

departmental policy processes. The Reserve Bank of New Zealand Act 1989 (RBA) requires the Reserve Bank to publish the principles on which it bases its regulatory decisions. It is proposed that the Reserve Bank also be required to produce more assessment of the expected net benefits of its policies.

Enhance monitoring

24. With the proposed increase in resources to be devoted to prudential activity within the Reserve Bank, it is proposed that those bodies responsible for monitoring the Reserve Bank increase their focus on its financial sector functions. The Reserve Bank's Board, the Treasury and Parliament's Finance and Expenditure Select Committee currently assess the Reserve Bank's activities and performance, but their focus is largely on monetary policy.

25. To reflect the increase in financial sector activities, it is proposed that a new purpose statement be introduced at the beginning of the Reserve Bank Act that sets out the Reserve Bank's key functions – monetary policy and the promotion of a sound and efficient financial system. It is also proposed that s53 of the Act, which outlines the functions of the Board, be amended to increase the Board's focus on prudential functions when reviewing the performance of the Reserve Bank and the Governor. Neither measure would alter the Reserve Bank's primary focus on monetary policy.

26. It is proposed that the *Financial Stability Report* be provided to the Minister of Finance six monthly and that s/he be required to present it to the House of Representatives, to enhance Parliamentary scrutiny of prudential functions.

Policy Responsibilities

27. With the proposal that the Reserve Bank become responsible for prudential regulation of NBDTs and insurance as well as banks, it is necessary to determine the policy advice responsibilities of the Reserve Bank, Treasury and the Ministry of Economic Development (MED). It is recommended that responsibility for policy issues be based on their fit with an agency's business and strategic direction and the capacity of an agency to provide the advice needed, when requested by the responsible Minister.

28. On the basis of business fit, it is proposed the Reserve Bank be responsible for providing policy advice on prudential regulation and the operation of the financial system. However, by virtue of not being a state sector department, the Reserve Bank has a relationship with its Minister that is formally more arms-length than that of a department. This may create uncertainties about the Minister's ability to seek advice from the Reserve Bank. It is proposed that s33 of the Reserve Bank Act, under which the Reserve Bank provides advice to the Minister, be amended to allow the Minister to require the Reserve Bank to provide advice and information in relation to any areas in which it has the lead role.

29. The Minister of Finance may wish to regularly agree with the Reserve Bank a work programme on the policy issues over which it has lead role, and a process for assessing the Reserve Bank's policy activities. This will be developed in 2007/08, in parallel with discussions with Treasury on the monitoring of the Reserve Bank's performance.

30. It is proposed that other agencies continue to provide advice when prudential regulation raises implications for their areas of responsibility. While MED would no longer provide lead prudential policy advice on NBDTs and insurance, both Treasury and MED would provide advice to their respective Ministers on the implications of prudential regulation for their areas of focus and on related areas that fall within their responsibilities, such as market conduct regulation. Proposed agency responsibilities are as follows:

Reserve Bank	• Prudential regulation: legislation, principles, rules and international agreements for banks, NBDTs and insurance companies • Financial sector developments and financial stability
MED	• Economic development: implications of financial market regulation, quality of regulation and consistency of regulation frameworks • Business/commercial law: financial sector matters, such as market conduct regulation (incl. NBDTs and insurance), changes in disclosure requirements
Treasury	• Economic and strategic advice: affects of legislation and regulations, impact of financial sector regulation on broader government objectives such as economic growth and international connectedness • Central agency role: advice on institutional design, whole-of-government policy coherence • Ownership role: advice on Reserve Bank accountability and performance

Immediate Handover of Policy and Portfolio Responsibilities

31. If Cabinet agrees to the Reserve Bank becoming responsible for policy advice on the prudential regulation of NBDTs and insurance companies, it is proposed that the transfer of policy responsibilities happen as soon as possible. This would increase the resources available for RFPP policy development for NBDTs and insurance. It would also ensure the policy settings developed are appropriate for the Reserve Bank in its future role as prudential regulator.

32. Changes in policy responsibilities imply some changes to Ministerial portfolios, although these are not significant. As with a single prudential regulator, there would be advantages in having one Minister responsible for all prudential regulation. This Minister would be in a position to consider the broader implications of approaches taken in particular parts of the sector. With the proposal to give the Reserve Bank responsibility for prudential policy advice, the Minister of Finance may be best placed to take on these portfolio responsibilities, given responsibility for the Reserve Bank currently falls within the Finance portfolio.

Funding Arrangements

33. The Reserve Bank will need additional resources to undertake prudential regulation of NBDTs and insurance companies. Funding for the new activities could come through public sources (the Reserve Bank's Funding Agreement or a Parliamentary appropriation) or charges on market participants (through levies and/or fees).

34. Companies may be required to pay a charge to the government where their actions generate a need for regulation and where they or their customers receive the benefits of that regulation (in accordance with Treasury's Guidelines on

Setting Charges in the Public Sector). On these grounds, a fee could be charged to both insurance companies and NBDTs: insurance companies because it is their policyholders that benefit from the regulation and NBDTs because the actions of some companies have created a need for regulation. However, in the case of NBDTs, these costs are offset by the significant public benefits associated with greater stability in the NBDT sector and the charges they already pay to trustees for prudential regulation (although this is not paid to government). It is therefore proposed that the cost of prudential regulation of NBDTs be met from public funding and that the cost of regulation of insurance companies be met through a levy.

35. The Committee could consider whether it wishes to also meet the costs of regulating insurance companies through public funding, if it is concerned about overall level of costs being imposed by the reforms. While there are sound reasons for charging a levy, insurance companies will face increased costs through complying with the regulatory changes (such as meeting prudential standards, preparing information for disclosure audit requirements, providing credit ratings).

36. If the Committee does not choose to waive the levy, officials will report back on options for charging in the forthcoming paper on insurance regulation. With approximately 155 insurance providers, the average annual amount levied would be roughly $12,000 per company, but a levy may be charged on the basis of company size or regulatory activity rather than average costs. Officials will consult with industry on the nature of the levy.

37. The Funding Agreement between the Reserve Bank and the Minister of Finance is the mechanism that is currently used to fund the Reserve Bank's activities. It is recommended that the Funding Agreement remain the basis for public funding rather than Parliamentary appropriation and that additional funding requirements be met out of a renegotiated Funding Agreement.

38. The Funding Agreement is consistent with international principles on banking supervision that require the supervisor to be financed in a manner that does not undermine its regulatory independence. To move to an appropriation for these functions could imply a closer relationship between the Crown and the Reserve Bank in terms of regulation of NBDTs and insurance companies than is the case with its other functions. This may have unintended implications for the degree of Reserve Bank regulatory independence (or perceptions of this) in this area.

Assessment of Package as a Whole

39. Overall, the package of proposals in this paper provides sufficient confidence in the Reserve Bank's suitability for the role of single prudential regulator and therefore it is proposed that Cabinet confirm its earlier in-principle decision. The package ensures the Reserve Bank can regulate NBDTs and insurance companies for the purposes identified by government and ensures the government is able to continue to engage with the Reserve Bank on objectives for prudential regulation. It ensures good quality policy advice and information are available to inform judgements about the performance of the sector and the Reserve Bank. It preserves the Reserve Bank's regulatory independence and does not compromise its primary focus on monetary policy.

Financial Implications

40. Once the framework for regulation of NBDTs and insurance is fully implemented (within 3–4 years), the required level of funding for the additional regulatory functions is estimated to be in the order of $3–5 million per annum: approximately $1.3 million for regulation of NBDTs and $1.8 million for insurance companies. The Funding Agreement with the Reserve Bank covers the period to 30 June 2010 but does not account for the new prudential responsibilities.

41. Over the transition phase (the next 2–3 years) additional funding will be needed, but this is likely to be more modest (current estimates are for around $2 million in 07/08, just over $1 million in 08/09 and around $3 million in 09/10). The Reserve Bank will seek the agreement of the Minister of Finance (for subsequent ratification by Parliament) for supplementary funding for its new prudential responsibilities for NBDTs and insurance.

42. The transfer of functions from MED to the Reserve Bank implies only a minimal reduction in MED's funding requirements and only in relation to insurance. Current regulation of insurance and superannuation costs $0.147 million under the Vote Commerce appropriation. MED will transfer the funding currently used for insurance to other parts of MED (i.e. additional Companies Office functions, dispute resolution monitoring and advice) and will seek additional funding to the degree that these funds are insufficient for new functions. This issue will be addressed in the RFPP report back on funding implications in November.

Legislative Implications

43. Two sets of legislative changes are proposed to reflect the Reserve Bank's new role as the single prudential regulator – changes to governance and accountability arrangements in the Reserve Bank of New Zealand Act and new legislative provisions setting out its new regulatory functions and powers.

Legislative changes to governance and accountability provisions

44. Changes to the Reserve Bank of New Zealand Act are proposed to implement the governance and accountability proposals in this paper. A slot on the 2007 legislative programme is sought for a Reserve Bank of New Zealand Amendment Bill in Category 4: To proceed to select committee in 2007. Drafting instructions are to be provided to Parliamentary Counsel in August 2007 and the Bill is to be introduced in November/December 2007. The timing of enactment will be tied to the enactment of related Bills in the Review of Financial Products and Providers.

45. The Minister of Finance is to be the Minister in charge of the Bill and the Reserve Bank is the responsible department, in consultation with the Treasury. The amendments are expected to involve 20 clauses of low to medium complexity. The Reserve Bank may seek to include further amendments to the Reserve Bank of New Zealand Act in the Bill. These amendments relate to other matters, on which policy decisions are expected in July 2007.

Legislative provisions for new regulatory functions and powers

46. As noted earlier, it is proposed that separate legislative provisions be developed for the regulation of NBDTs and insurance. The legislative arrangements (or legislative architecture) need to support the objectives for which financial institutions are to be regulated. This includes both the objectives for each class of financial institution and the systemic objectives of soundness and efficiency. Options for legislative architecture are:

    - including provisions on the prudential regulation of NBDTs and/or insurance companies in the Reserve Bank Act as separate Parts of the Act;

    - developing stand alone Acts on NBDTs and/or insurance; and

    - bringing prudential regulation of NBDTs, insurance companies and banks together in a new Prudential Regulation Act.

47. The first two approaches have the advantage of reflecting that the new functions have many common elements with the Reserve Bank's existing functions. They would require a slightly lower level of legislative change as they do not require re-enactment of existing provisions relating to banking. The third approach has the advantage of drawing together the prudential regulation functions and would set out a framework for prudential regulation as a whole. It has the advantage of separating provisions dealing with prudential regulation functions from those dealing with monetary policy, but could also separate it from other financial sector functions, such as the payment systems. It would also require existing banking provisions to be re-enacted. In all cases, there will need to be coordination between the Reserve Bank Act and any new Acts, in terms of the provisions related to the operation of the Reserve Bank.

48. It is proposed that officials report back on legislative arrangements for the new regulatory functions and powers when they report back on the NBDT regulatory model in July. At that stage, officials will be in a better position to assess the coherence of its purposes and functions across entity types and assess whether there are sufficient commonalities to develop an overarching legislative framework for prudential regulation.

Regulatory Impact Analysis

49. A Regulatory Impact Statement (RIS) has been prepared and the Regulatory Impact Analysis Unit considers the analysis and the RIS to be adequate. The RIS requirements, the RIS consultation requirements and the Code of Good Regulatory Practice have been complied with. A draft version of the RIS was circulated for departmental consultation. The RIS is attached.

Treaty Implications

50. No implications.

Human Rights Act

51. No implications.

Publicity

52. Reference to the Reserve Bank's role as the single prudential regulator will be included in the announcements discussed in the overview paper.

Consultation

53. The proposals in this paper have been developed in consultation with the Reserve Bank, the Ministry of Economic Development, the State Service Commission, the Securities Commission and the Ministry of Justice. The Cabinet Office has also been consulted and their views incorporated. The Department of Prime Minister and Cabinet has been informed of the proposals.

Recommendations

54. It is recommended that the Committee:

1 note that in December 2005 Cabinet agreed in principle that the Reserve Bank be the prudential regulator for the financial sector;

2 agree to confirm the in principle decision that the Reserve Bank be the prudential regulator for the financial sector;

Governance and accountability

3 agree that the Reserve Bank be required to provide a response to any comments made by the Minister of Finance on the financial sector regulatory outcomes set out in the Reserve Bank's draft Statement of Intent, demonstrating how it has taken comments into account in the formulation of its objectives;

4 agree to introduce an authority for the Minister of Finance to direct the Reserve Bank to have regard to a Statement of Government Policy Objectives relating to the financial sector functions and objectives of the Reserve Bank, based on the model that applies to Autonomous Crown entities under the Crown Entities Act 2003, and to demonstrate how it has done so in its Statement of Intent;

5 agree that the Reserve Bank's Statement of Intent requirements be amended so that it contains the information that is required of a Statement of Intent under the Crown Entities Act and that the Reserve Bank's Annual Report requirements be amended so that it reports on the information set out in the Statement of Intent;

6 agree that the Reserve Bank be required to publish the *Financial Stability Report* six monthly and provide it to the Minister of Finance, who is to present it to the House of Representatives, and that the report contain the information necessary to allow assessments to be made of the activities undertaken by the Reserve Bank to achieve its statutory prudential regulation purposes;

7 agree to amend the Reserve Bank of New Zealand Act to include a purpose statement that reflects the increase in prominence of the Reserve Bank's prudential functions and to increase the Reserve Bank Board's monitoring of these functions;

8 agree that the Reserve Bank be required to produce more assessment of the expected net benefits of its policies;

9 invite the Reserve Bank (in consultation with the Treasury) to develop measures of performance for the Reserve Bank's prudential functions and for the financial sector in 07/08 to be included in its Statement of Intent;

Policy responsibilities

10 agree that the Reserve Bank be responsible for the provision of policy advice on prudential regulation to the Minister of Finance;

11 agree to amend the Reserve Bank of New Zealand Act to allow the Minister of Finance to require the Reserve Bank to provide advice and information in relation to any areas in which it has the lead role;

12 agree that the transfer of responsibility for policy advice from MED to the Reserve Bank be effective immediately to expedite the completion of the policy development for non-bank deposit takers and insurance companies;

Funding approach

13 agree that the costs of regulating non-bank deposit takers be met through a renegotiation of the Reserve Bank's Funding Agreement, to be ratified by Parliament;

14 EITHER

14.1 agree in principle that the costs of regulating insurance companies be met through a levy and that, after consulting with industry, officials report back on options for charging a levy when reporting back to EDC on insurance regulation in November 2007;

OR

14.2 agree that, in recognition of the additional costs to be met by companies as a consequence of the reforms, the costs of regulating insurance companies be met through a renegotiation of the Reserve Bank's Funding Agreement, to be ratified by Parliament;

15 direct officials to address the financial implications associated with transferring functions between MED and the Reserve Bank when reporting back to EDC on detailed costings and funding options in November 2007;

Legislative changes

16 agree to add a Reserve Bank of New Zealand Amendment Bill to the 2007 legislative programme in Category 4: To proceed to select committee in

2007, to give effect to the decisions related to governance and accountability arrangements in recommendations 3 – 8 and 11;

17 invite the Minister of Finance to issue drafting instructions to Parliamentary Counsel accordingly;

18 agree that the purposes and functions related to the regulation of non-bank deposit takers and insurance companies be set out in separate legislative provisions rather than included in the provisions of the Reserve Bank of New Zealand Act that relate to the regulation of registered banks; and

19 direct officials to report back on which Acts require amendment and whether new Acts are required to house the purposes and functions related to the regulation of non-bank deposit takers, insurance companies and banks as part of further advice on the regulation of non-bank deposit takers in July 2007.

Hon Dr Michael Cullen
Minister of Finance

Hon Lianne Dalziel
Minister of Commerce

Regulatory Impact Statement

Executive Summary

This paper looks largely at how to give effect to the proposal that the Reserve Bank be the single prudential regulator. It makes proposals for governance and accountability arrangements, policy advice roles and funding approaches. These include new legislative provisions for the Reserve Bank's new regulatory functions, changes to provisions of the Reserve Bank Act that enable the Minister of Finance to engage with the Reserve Bank on government's objectives for the finance sector, additional reporting requirements associated with the Reserve Bank's financial sector functions including its prudential regulation functions, increased monitoring of these functions, transfer in policy responsibilities associated with prudential regulation from MED to the Reserve Bank, a renegotiation of the Reserve Bank's Funding Agreement for regulation of non-bank deposit takers and a possibly a prudential regulation levy on insurance companies. Main impacts will be Reserve Bank's governance and accountability arrangements provide for greater involvement by the Minister on RB financial sector objectives, Reserve Bank will become lead policy agency on prudential regulation, levels of Reserve Bank funding will be increased and a levy may be imposed on insurance companies.

Adequacy Statement

The Regulatory Impact Analysis Unit has reviewed the Regulatory Impact Statement and considers it is adequate according to the adequacy criteria.

Status Quo and Problem

Currently, the Reserve Bank prudentially regulates banks and MED prudentially regulates other financial organisations. Cabinet has decided there will be a single prudential regulator and decided in principle that this be the Reserve Bank.

Government action is required to determine how to give affect to the proposal that the Reserve Bank be the prudential regulator for banks and non-bank financial institutions and ensure it does not undermine the Reserve Bank's monetary policy function. Officials are to report to Cabinet on:

- Whether current governance and accountability arrangements are sufficient;
- Whether legislative changes are required (including which Acts require amendment and whether a new Act is required);
- Ministerial portfolio implications and departmental/RBNZ responsibilities;
- Details of the functions to be located in the Reserve Bank; and
- Funding arrangements.

Current arrangements related to the Reserve Bank's financial sector functions may be insufficient because they relate only to regulation of banks. They may not be able to accommodate prudential regulatory functions and objectives that become relevant if it is to regulate non-bank deposit takers (NBDTs) and insurance companies. They do not enable the government to engage with the Reserve Bank more broadly on the financial sector issues that may arise from having responsibility for prudential regulation across the sector (as well as its other financial sector functions, such as the operation of the payments system).

The costs of maintaining the status quo relate to the limitations of existing arrangements, as follows:

- It is unlikely under existing provisions of the Reserve Bank Act that the Reserve Bank would be able to regulate NBDTs and insurance companies for the objectives determined by the Government through the RFPP process.

- Governance arrangements do not give the government many formal opportunities to engage with the Reserve Bank on financial sector objectives.

- Reporting and monitoring of prudential regulation functions does not provide much information on which the RB can be held accountability for the exercise of these functions.

- Policy advice provisions do not allow the Minister to seek policy advice on prudential regulation and do not extend to NBDT or insurance issues.

- Current funding levels do not incorporate the costs associated with the new functions.

The benefit of current arrangements is that they provide a clear separation of legislative requirements for monetary policy and financial sector functions within the Reserve Bank of New Zealand Act (RBA), and of the performance of these functions within the Reserve Bank. The Reserve Bank cannot use its monetary policy tools to achieve financial sector objectives or vice versa. All proposed changes to the RBA maintain the separation in financial sector and monetary policy functions to ensure the independence of monetary policy. No other options for preserving this separation were considered as the status quo is seen to be sufficient.

OBJECTIVES

To change the Reserve Bank's institutional arrangements so that government can have sufficient confidence that the Reserve Bank is a suitable agency to become the single prudential regulator. For the government to be satisfied of this, it needs to be assured that:

- Legislative arrangements enable the Reserve Bank to exercise its functions for the purposes determined by government.

- Governance arrangements allow the government to engage with the Reserve Bank on financial sector objectives.

- Accountability arrangements provide sufficient information and monitoring of the Reserve Bank's prudential regulation functions.

- The Minister to able to obtain the policy advice s/he needs on prudential regulation.

- Funding arrangements are appropriate to the new functions.

To ensure these changes to institutional arrangements preserve the independence of Reserve Bank's monetary policy functions.

ALTERNATIVE OPTIONS

The package of proposals relate to the following issues: purpose and functions; objectives for prudential regulation; accountability; policy responsibilities and funding approach. Options considered, but not adopted, are as follows:

Purposes and functions related to regulation of NBDTs and insurance

Extend the banking related purposes and functions in RBA to cover NBDTs and insurance.

Key features:

- existing arrangements and focus of the RBA largely maintained
- NBDT and insurance purposes to be tailored to fit within this regulatory approach

The benefit of this is that it would maintain the RB's focus on stability of financial system as a whole. However, there are key differences with NBDTs and insurance that would make it difficult to formulate functions and purposes that are broad enough to satisfactorily cover all entity/industry types within the prudential purposes and functions currently set out in the Reserve Bank Act. Therefore, it would be more effective to have separate purposes and functions for each entity type.

Objectives for financial sector policy

Introduce a financial sector equivalent of the Policy Targets Agreement used with monetary policy where the Minister of Finance and the Reserve Bank agree the objectives for financial sector policy.

Key features:

- New document between Minister of Finance and Reserve Bank
- Document requires mutual agreement by Minister and Governor to financial sector objectives

This would meet the objective of ensuring the Reserve Bank's financial sector objectives were aligned with (or not inconsistent with) government's objectives for the financial sector. However, it may not be a very suitable mechanism for formulating objectives. The monetary policy Policy Targets Agreement is used to agree the proxy to be used to assess whether objectives have been met, rather than to determine the objectives themselves.

Give the Minister of Finance the authority to direct the Reserve Bank to make changes to the financial sector outcomes specified in the Statement of Intent

Key features:

- The Minister would have the power to direct the Reserve Bank on how its objectives were described in the Statement of Intent

This would give government a greater degree of certainty that the Reserve Bank's objectives were aligned with the government's objectives. However, this level of engagement could compromise the Reserve Bank's independence, raising political risks to the government (perceived endorsement of regulatory approach and lobbying) and risks to the quality and credibility of financial regulation. In some areas of regulation, it can be difficult to draw a line between setting objectives and determining outcomes for individual regulated entities.

Accountability

Introduce new reporting documents, such as an output agreement.

Key features:

- Reserve Bank produce a new accountability document outlining the outputs it will produce to contribute to the achievement of the objectives set out in its SOI and performance measures associated with this

This would introduce similar mechanisms as are used with state sector agencies, increasing cross-government coherence in reporting. However, it would require a new agreement between the Reserve Bank and the Minister and associated reporting that would deliver no advantages over enhancement of existing documents.

Policy responsibilities

MED or Treasury responsible for policy advice on prudential regulation.

Key features:

- RB would undertake prudential regulation functions

- MED or Treasury would provide policy advice to the Minister of Commerce and/or the Minister of Finance on policy matters related to prudential regulation

- RB would continue to provide advice on the operation of the financial system

MED and Treasury have more conventional policy agency relationships with their Ministers making engagement with the Minister more straightforward. However, they will be more removed from the business of prudential regulation than the Reserve Bank, so will not be well-positioned to provide well informed policy advice.

Funding approach

Fund new prudential regulation functions through a Parliamentary appropriation.

Key features:

- Additional funding required for new regulatory functions to be sourced through a Parliamentary appropriation by the Reserve Bank

- Other Reserve Bank functions to remain funded through the Funding Agreement with the Minister of Finance

Parliamentary appropriation would better reflect the group that benefits from regulation of NBDT regulation – the general public. It would also provide government with a mechanism for ensuring funding decisions are consistent with its objectives. However, it is a different funding approach than is used for the bulk of the Reserve Bank's activities and would imply a closer relationship between the Reserve Bank and the government in terms of regulation of NBDTs and insurance companies than is the case with its other functions. This may have unintended implications for the degree of regulatory independence in this area.

PREFERRED OPTION

The preferred option is a package of proposals as set out below:

Purposes and functions related to regulation of NBDTs and insurance

Develop separate legislative provisions for the purposes and functions related to the regulation of NBDTs and insurance.

This is preferred because it will ensure the objectives for each entity type will articulated in legislation in a manner that recognises the government's objectives for that entity type. This reduces the risks that broad objectives will be developed that do not entirely address the government's intentions. However, it means the Reserve Bank will be required to regulate in different ways and for different purposes. Risks may arise because it may be difficult for the Reserve Bank to balance individual purposes and functions with the achievement of overall financial stability objective. The legislation will need to specify what the Reserve Bank is to give priority to in these cases.

Options for where the separate legislative provisions associated with the new regulatory powers and functions are to be housed (e.g. separate Acts for NBDTs and insurance, new Parts of the Reserve Bank Act or a stand alone Prudential Regulation Act) will be considered as part of the report back on NBDTs in July. These options will include consideration to the relative priorities the Reserve Bank will give to individual purposes and functions and the achievement of overall financial stability.

Objectives for financial sector policy

Change the RBA provisions to give Minister of Finance a formal authority to:

- *require the Reserve Bank to provide a response through the Statement of Intent process to any comments made by the Minister on the financial sector outcomes set out in the Reserve Bank's draft Statement of Intent, demonstrating how it has taken comments into account in the formulation of its objectives and, if not, why not; and*

- *direct the Reserve Bank to have regard to a statement of Government policy objectives relating to the financial sector functions and objectives of the Reserve Bank and to demonstrate in its Statement of Intent how it has done so.*

This is preferred because it would provide a process through which the Minister and the Reserve Bank can engage on their respective objectives for the financial sector, with the intention of aligning these objectives. It provides the government with mechanisms for signalling its priorities to the Reserve Bank. At the same time, it guards against the risks of government involvement in regulatory functions – perceptions of government endorsement of regulation, inconsistency in regulatory approach over time, lobbying by industry and risks to international reputation. The Minister would not be able to direct the RB in relation to any independent regulatory functions. It limits the Minister's involvement to the setting of objectives and maintains Reserve Bank independence over the exercise of regulatory functions. The Reserve Bank has concerns about the nature of government engagement and would be concerned that its regulatory independence was compromised by any Ministerial power to direct on its independent functions.

Accountability

Amend the RBA to:

- require more ex ante information in the SOI about the Reserve Bank's intended financial sector actions and performance measures;

- require the Financial Stability Report to be published 6 monthly and be provided to Parliament for accountability purposes; and

- require more information be provided on assessment of net benefits of Reserve Bank's policies

- increase the monitoring focus of the Reserve Bank's Board, Treasury and Parliament on financial sector functions; and

- introduce a new purpose statement at the beginning of the RBA setting out the Reserve Bank's key functions of monetary policy (primary function) and promotion of a sound and efficient financial system.

These proposals are preferred because they provide the government with more information on which to assess the impact of new regime and the performance of the Reserve Bank as regulator. This approach is preferable to introducing a new accountability document as it is consistent with public sector reporting arrangements. It would bring the content of the RB's SOI and Annual Report into line with standard practice in the public sector. It would provide greater transparency around the Reserve Bank's policy and regulatory processes. It will impose some (not significant) costs on the Reserve Bank in terms of meeting new reporting requirements.

The monitoring elements of the proposals ensure the information provided through enhanced reporting is used by the Reserve Bank's monitoring agencies to assess performance. They will impose some (not significant) additional duties on the monitoring agencies. Compared to current arrangements they increase the relative focus of monitoring agencies on financial sector policy vis a vis monetary policy. However, they emphasis the continued primacy of the monetary policy function.

Risks arise through the difficulty of assessing the performance of the regime and the Reserve Bank as regulator. The Reserve Bank develop measures of performance in 2007/08, in consultation with Treasury.

Policy responsibilities

Make Reserve Bank responsible for policy advice on prudential regulation. Require MED and Treasury to continue to provide advice when prudential regulation raises implications for their areas of responsibility. Amend RBA to allow the Minister to require the Reserve Bank to provide policy advice.

This proposal is preferred because advice on prudential regulation will fit best with the Reserve Bank's functions. It will ensure the Minister has access to advice on prudential regulation that is informed by the practice of prudential regulation. It will involve the transfer of functions from MED to Reserve Bank.

Risks arise because the relationship between the Reserve Bank and the Minister is more formally arms-length than that of a department, as the Reserve Bank is not a state sector department. Therefore, it is proposed that the RBA be amended so that the Minister can seek policy advice from Reserve Bank.

There are also risks that the government's ability to pursue its objectives for financial sector will be compromised if the Reserve Bank is given lead policy responsibility for prudential regulation. The government will not be able to direct the Reserve Bank to carry out actions to fulfil these objectives where those actions involve the Reserve Bank's independent regulatory functions. To ensure the government is able to pursue its objectives, MED and the Treasury are to continue to provide advice on the implications of prudential regulation on economic transformation and government broader objectives (respectively). The Minister is also to be given powers to engage with the RB on objectives, as outlined under *Objectives for financial sector policy* above.

Funding approach

Fund prudential regulation of insurance through an industry levy.

It is proposed that insurance companies be charged a levy to meet the costs of the Reserve Bank's prudential regulation functions. A fee would be charged on the grounds that the purpose of insurance regulation is policyholder protection, so it is insurance policyholders that benefit from the increase in regulation. It is expected that insurance companies will pass the costs on to their policyholders.

There are risks that a levy will impose a cost on small insurance companies at a time when they are facing a significant increases in costs (including compliance costs) as a consequence of the regulatory requirements proposed. With approximately 155 insurance providers, the average annual amount levied would be roughly $12,000 per company, but a levy may be charged on the basis of company size or regulatory activity rather than average costs.

The Cabinet paper suggests that EDC could consider whether it wishes to meet costs through the Funding Agreement rather than through a levy, if it is concerned about the overall level of costs being imposed by the reforms.

If the Committee does not choose to waive the levy, officials will develop options for charging (including charging on the basis of company size or regulatory activity) and will consult with industry on the nature of the levy. They will report to Cabinet with recommendations on the approach to levying as part of the report back on insurance regulation in November.

Fund prudential regulation of NBDTs through Reserve Bank's Funding Agreement with Minister of Finance.

The Reserve Bank's regulation of NBDTs will be funded through the Reserve Bank's Funding Agreement (this does not include fees charged by trustees or the cost of obtaining a credit rating). The purpose of NBDT regulation is to increase the stability of the financial system and increase the public's confidence in the system. The benefits of regulating NBDTs therefore accrue to the general public and so the cost of regulation is to be met through public funding. The Funding Agreement is the mechanism used to fund RB functions. It preserves the Reserve Bank's regulatory independence.

Risks are that the Funding Agreement is less transparent than a levy or a Parliamentary appropriation. However, this can be managed through processes for negotiating the Funding Agreement between the Minister and the Reserve Bank.

Significance of proposal

The most significant impact of the proposals is a closer relationship between the Reserve Bank and the government around the development of financial sector objectives and policy. While this will represent a change in the way the Reserve Bank engages with the Government, it will be limited to objectives and policy and will not affect its regulatory independence. It will bring the process of engagement between the Ministers and independent regulators into line with practices used elsewhere in the public sector for the development of regulators' objectives and policy. As such, the changes are not seen to be significant. There will be some (not significant) associated increases in requirements for Ministerial time, Ministerial departmental support and Parliamentary time associated with the proposals.

There may be levies charged to insurance companies. The magnitude of these costs will depend on the levy approach developed for insurance regulation. There may be minor business compliance costs associated with charging a levy.

There are no health, environmental, economic, social or cultural costs associated with this proposal.

IMPLEMENTATION AND REVIEW

Changes to the Reserve Bank Act will be needed to give effect to the proposals above. These changes are to be introduced as part of the RFPP package of legislation in November 2007. Notification of the Reserve Bank's role as single prudential regulator will be included in publicity associated with this suite of papers. There are no enforcement requirements. The Reserve Bank and the Treasury are to develop measures of performance for prudential regulation over 2007/08.

CONSULTATION

The following government agencies have been involved in developing the options in the paper: Treasury, Reserve Bank, Ministry of Economic Development, State Services Commission, Ministry of Justice and Securities Commission. No industry consultation was undertaken as this is an issue of government machinery to be determined by Cabinet. However, if insurance companies are to be charged a levy to meet the costs of prudential regulation, officials will consult insurance companies on the nature of that levy.

The main concerns about the package are that it should not compromise the independence of the Reserve Bank in carrying out prudential regulation (a concern of the Reserve Bank shared by the other members of the working group). Concerns about regulatory independence have been taken into account in the formulation of proposals around Ministerial engagement on government objectives and funding arrangements. The proposals in the package ensure government remains removed from the Reserve Bank's regulatory decision-making.