MEMORANDUM FOR	**Independent Expert Panel**
FROM	**Reserve Bank of New Zealand**
DATE	**15 December 2017**
SUBJECT	**Legislative framework for financial stability in the Reserve Bank of New Zealand Act 1989**
FOR YOUR	**Information**

Legislative framework for financial stability in the Reserve Bank of New Zealand Act 1989

This memorandum sets out the current legislative framework for financial stability in the Reserve Bank of New Zealand Act 1989 (the Act). In doing so, it clarifies and corrects the description in the Briefing on Reform of the Reserve Bank. The relevant portion of the Treasury document is at pages 17-21.

It should be noted that the Act sits at the heart of a suite of legislation providing for prudential regulation by the Reserve Bank, which also includes the Insurance (Prudential Supervision) Act 2010, the Non-bank Deposit Takers Act 2013, and the proposed Financial Markets Infrastructure Bill.

The Reserve Bank is of the view that the overall framework for prudential regulation of registered banks is sound, but the opportunity should be taken to improve it through Phase 2 of the Review. Some opportunities for improvement are noted below. Other proposals have been identified and are in development but are not discussed here.

A basic outline of the Act's prudential framework

Part 5 of the Act provides for the registration of banks and their prudential supervision by the Reserve Bank. It also provides for crisis management provisions that apply when a registered bank is in serious difficulties and for macro-prudential policy.

The purposes of the Act are found in section 1A with respect to the financial system (promoting the maintenance of a sound and efficient financial system) as a whole and in section 68 for registered banks specifically. Section 68 provides that the Reserve Bank and the Minister must use the powers of the Act for the purposes of:

- Promoting the maintenance of a sound and efficient financial system; or
- Avoiding significant damage to the financial system that may result from the failure of a registered bank.

Financial institutions may apply to be registered as banks. The Reserve Bank has regard to statutory criteria before deciding to register a bank. Being registered as a bank confers significant advantages on a bank:

- It allows the institution to lawfully carry on business using the word “bank”. This is otherwise prohibited by Part 4 of the Act.
- It increases the institution’s standing in the financial markets and enhances its eligibility to access liquidity facilities from the central bank.

In return, registered banks are subject to prudential requirements such as minimum capital levels and certain restrictions on their activity. The Reserve Bank is mandated by the Act to prudentially supervise banks.

The primary form of regulation is the imposition upon banks of conditions of registration. The Act lists a range of matters to which conditions may relate. Conditions incorporate often-detailed policies of the Reserve Bank which largely operate as rules upon the registered banks. There is a statutory process that must be followed before conditions are imposed which includes a minimum seven day consultation period.

The other important requirement upon registered banks is to disclose detailed financial information to the market and its customers. These requirements are in regulations. The Bank is currently reforming the disclosure requirements by providing a financial “dashboard”.

When a registered bank is in serious difficulties (as defined in the Act) it can be subject to various coercive measures. These include directions from the Reserve Bank to conduct or cease conducting its business in a certain way. Directions may be issued replacing the management and directors of a registered bank. The Bank must obtain the consent of the Minister of Finance before giving a direction.

A bank in serious difficulties can be placed into statutory management. This decision is made by the Governor-General on the advice of the Minister of Finance on the recommendation of the Reserve Bank. Statutory management means the entire management of the failed bank is under the control of the statutory manager, who is also given powers to dispose of its undertaking, place it into liquidation and other measures.

Notable features of a statutory management are:

- A wide ranging moratorium on the pre-statutory management debts of the failed bank, limiting creditors’ ability to enforce such debts. The statutory manager can later release funds to creditors at times of its choosing.
- Statutory considerations that the statutory manager must have regard to in exercising its powers. The primary consideration is the need to maintain public confidence in the operation and soundness of the financial system. A lower ranked consideration is to preserve the position of creditors and maintain the ranking of the claims of creditors.

Statutory management is a long and involved process which may cease many years after it was commenced. One financial institution has been under statutory management since the provisions came into effect, being DFC Limited, which was placed in statutory management in 1989.

The Bank’s Open Bank Resolution policy (OBR) -- that aims to limit fiscal costs to the Crown by providing for haircuts on creditors – relies on the provisions of the crisis management framework to be able to be carried out.

Role of the Minister of Finance in prudential regulation and crisis management

The process of registering banks, applying conditions of registration and prudentially supervising them is undertaken by the Reserve Bank at arm's length from the Minister of Finance. In this regard the Bank has a similar structure to other independent regulators such as the Financial Markets Authority and Commerce Commission.

When it comes to the crisis management provisions of the Act, the Minister has more direct involvement:

- Any direction must be consented to by the Minister.
- It is the Minister who advises the Governor General whether a registered bank is placed into statutory management.
- The Minister decides who must be on the advisory committee that advises the statutory manager on the conduct of the statutory management.
- The Minister approves any vesting of the New Zealand assets and liabilities of an overseas-incorporated bank, or the whole or part of the business of a failed bank, into a newly incorporated New Zealand company.
- The Minister terminates the appointment of a statutory manager.

These powers must generally be exercised in accordance with the recommendation of the Reserve Bank, but the Minister is able to refuse a recommendation and make his or her own inquiries before accepting a recommendation.

The Minister's role reflects the fact that a banking crisis will create fiscal risk for the Crown. Resolving a bank crisis often requires public financial support. The OBR policy includes a government guarantee on pre-statutory management deposits, less an immediate "haircut" on those sums; and on some or all post-statutory management liabilities.

Any decision to offer public financial support is that of the Minister under the Public Finance Act 1989. It is not a decision made under the Reserve Bank Act, nor is it restricted by the Act.

The Minister must act for the purposes of section 68 when exercising powers under the Reserve Bank Act but may take into account fiscal risk. When choosing options or making decisions to resolve a banking crisis he or she may choose the option that involves the least amount of fiscal risk and is able to exercise some control over the actions of the statutory manager or the Reserve Bank through the exercise of the powers noted above.

The Minister, or the Reserve Bank, depending on who contracts with the statutory manager, is able to set objectives for the statutory manager and his or her performance as terms of their contract. Any financial support provided directly to the failed bank, such as a guarantee, can also be conditional on the statutory manager operating in a certain way that protects the Crown's fiscal exposure. The normal care should be taken to avoid any terms that are incompatible with the Minister's or Reserve Bank's statutory powers, but that is not an issue exceptional to the Act or the role of a statutory manager.

There is an opportunity to make targeted enhancements to the crisis management section of the Act. In principle, we would support enhancements such as: clarifying the status of payment transactions that are "inflight" at the time of statutory management is declared; and clarifying the treatment of preferential creditors in statutory management.

Role of the Minister in prudential policy setting

As noted, day-to-day prudential regulatory and supervisory decisions are made by the Bank independently from the Minister. The Minister may however direct the Bank to have regard to a government policy that relates to the Bank's prudential regulatory functions but must not issue a direction that relates to a particular person or brings about a particular result.

Such a policy could, hypothetically, relate to the Government's tolerance for bank failure (e.g. a zero-tolerance regime), the government's policy on competition in the banking sector or a policy relating to a trans-Tasman banking market.

To date the power has not been used. We are not aware of any advice having been tendered to the Minister on the use of the power, nor any clarification sought from legal advisers as to how to use the power, assuming there may be uncertainty as to its effect.

The provision itself is modelled on section 104 and sections 114 and 115 of the Crown Entities Act 2004, which provide for the giving of a ministerial direction to an autonomous Crown entity. The Reserve Bank understands this power has not been used in respect of any autonomous Crown entity.

The Minister writes an annual letter of expectations to the Governor of the Reserve Bank. The main effect of the letter, which is broader than just prudential policy, is a requirement for timely and substantive information on relevant Reserve Bank initiatives and processes, such as significant consultation papers and the preparation of regulatory impact assessments. It is also an input into the statutory statement of intent process.

Macro-prudential policy

As defined by the 2013 Memorandum of Understanding (MoU) between the Minister of Finance and the Governor, the specific objective of macro-prudential policy is to "increase the resilience of the financial system and counter instability arising from credit, asset price or liquidity shocks". Macro-prudential policy is undertaken pursuant to section 68, with a primary purpose of improving the soundness and efficiency of the financial system, not for macroeconomic objectives (although as with other regulations there may be indirect macroeconomic impacts). The MoU envisages macro-prudential policy having as a secondary purpose stabilising the macro economy, which is legally permissible as it is consistent with the primary purpose. It also uses the conditions of registration as the means of imposing macro-prudential requirements upon registered banks.

The Reserve Bank is able to link such policies as Loan-to-Value Ratio (LVR) restrictions to the provision in the Act allowing the Bank to impose conditions of registration relating to registered banks' risk management systems and policies. LVRs are clearly a matter of credit risk management for a registered bank and section 68 allows for the system-wide ("macro-prudential") focus.

The MoU with the Minister was formulated to recognise macro-prudential policy and the LVR tool were new areas for the Reserve Bank. In some respects they are more directly felt by members of the public, specifically bank borrowers, than other prudential policies. In this regard it was felt the Minister should be consulted on the development of such policies. The MoU is clear that the decision to deploy them is the Governor's.

A more specific, identified provision in the legislation empowering macro-prudential policies may be worth considering.

Previous reviews of the Act

Since its introduction in 1989, there have been numerous amendments to the Act designed to ensure it remains fit for purpose. Many of these amendments have been of a more minor and technical nature, while other amendments have been more substantive, reflecting major Reserve Bank and/or governmental reviews of the prudential framework. There have also been two major ‘external audits’ of New Zealand’s financial regulatory landscape and its associated legislative underpinning by the IMF in 2003-04 and more recently in 2016-17.

For example, a major review of the regulatory landscape was conducted in the mid-2000s following the first IMF FSAP in 2003-04. It was the desire of the then Government in 2007-08 that the Reserve Bank take on an increased regulatory role and become the prudential regulator of insurers and non-bank deposit takers (NBDTs).

The Reserve Bank and Treasury negotiated a range of accountability measures to take account of this wider responsibility. The measures enacted in 2008 were:

- Section 68B, allowing for government policy directions as discussed above.
- New procedures for the Statement of Intent to ensure the Minister can participate in the Reserve Bank’s setting of its objectives.
- A requirement on the Reserve Bank to prepare regulatory impact assessments and certain obligations to the Minister in respect of them.
- A new and broadened purpose section for the Bank (section 1A).
- A requirement to publish the Financial Stability Report, including an obligation to report on the Bank’s regulatory activities, and to lay it before Parliament.
- More specific obligation on the Reserve Bank board to monitor the Governor’s performance of the Bank’s prudential regulatory functions.

The comparison benchmark for the Reserve Bank in undertaking this assessment was an autonomous Crown entity model. The Crown agent model, under which a Crown entity is obliged to carry out government policy, was rejected as inappropriate, while a “financial stability PTA” was seen as likely unworkable. The Bank was not seen as directly comparable to an independent Crown entity given its closer relationship with the Minister on many regulatory matters, particularly crisis management, and its role providing policy advice to the Minister on financial policy and supervision matters.

The Bank considers that comparison remains appropriate. It notes the accountability requirements discussed above are in addition to the specific duties of the Governor, which are monitored by the Reserve Bank board and provide grounds for dismissal.

More recently, Treasury has commissioned an independent review of the prudential framework under the Reserve Bank Act by James Every-Palmer QC, which was finalised in August 2017. The Reserve Bank had no involvement in commissioning the report or setting its terms of reference, so it is entirely independent of the Reserve Bank.

The report concludes that the arms-length regulatory model remains appropriate for the imposition of prudential requirements. It does not recommend significant change to the basic framework for prudential regulation but does raise suggestions that should be considered:

- Incorporating the intent of the macro-prudential MoU appropriately into a legislative device.
- Slightly broadening the scope of section 68B to match the provision applying to the Commerce Commission.
- Giving consideration to the due process rights of registered banks in respect of “tailored” prudential requirements.
- Refining, clarifying and making more specific the list of matters to which conditions of registration may relate to.
- Various measures to make prudential requirements imposed by the Bank more transparent.

These are all pointers to potential improvements to the Act, none of which would fundamentally alter its structure.

FSAP

In early May 2017 the IMF released the findings and recommendations of the 2016 FSAP. The IMF commended the Reserve Bank for the quality and professionalism of its staff, however it also found a number of areas in which the Reserve Bank’s approach to regulation fell short of international recommendations. These findings are a reflection of New Zealand’s chosen approach to prudential regulation which dates back to 1996 and were largely anticipated. While the IMF recognised and understood the distinctive approach to prudential regulation and supervision in New Zealand, they nevertheless assessed the New Zealand framework against international standards.

The assessment did recognise that the New Zealand banking system proved resilient during the global financial crisis (GFC) (notwithstanding some pressures on bank funding owing to a reliance on wholesale market funding, a risk that has been substantially reduced by the Reserve Bank’s 2010 liquidity policy).

The IMF came up with a number of recommendations in light of its findings. The broad thrust of these was for a shift towards a more orthodox supervisory model, which as noted above was anticipated. At a simplistic level, this would tilt the existing three pillars approach of market, self and regulatory discipline towards greater reliance on regulatory discipline.

Broadly speaking, the IMF advocated for:

- Greater use of validation and checking via on-site visits of registered banks;
- Significantly more resourcing for the Reserve Bank to undertake supervision, noting that more resources would be needed even if the low-intensity approach was retained; and
- Extending the enforcement regime to include preventive action.

With the exception of on-site supervision, for which new statutory powers would be necessary, a large portion of the IMF’s recommendations can be done without it being necessary to amend the Act.

While the Bank sees merit in maintaining its three-pillar framework, the FSAP process has highlighted a number of opportunities to strengthen the existing framework. Greater alignment with international orthodoxy without adopting the sort of wholesale approach and resourcing that would be necessary to implement the full, highly intensive model seen internationally, could enhance the current framework.

The IMF also had concerns about a lack of clear boundaries between the Reserve Bank and Treasury, noting that unclear boundaries could potentially compromise RBNZ independence and limit its ability to fulfil its supervisory role.

The key recommendation from its Executive Summary is:

> **The approach of the RBNZ to supervision should be strengthened by increasing the weight of regulatory discipline in its three-pillar framework.** The RBNZ approach to supervision relies on three pillars: self, market, and regulatory discipline. The authorities have strengthened regulatory discipline since the last FSAP, but the three-pillar framework should be improved by adopting a more intensive approach to supervision. This would increase the ability of supervisors to be proactive to exercise regulatory discipline and obtain reliable information to enforce self- and market-discipline. The RBNZ is encouraged to issue enforceable supervisory standards on key risks, review the enforcement regime to promote preventive action, and initiate on-site programs targeted on areas of high risk. In addition, clarifying the responsibilities of the Treasury and RBNZ on financial sector issues and reinforcing the role and autonomy of the RBNZ as prudential regulator and supervisor would enhance the ability of the RBNZ to respond swiftly to ongoing and emerging risks.