RESERVE BANK ACT REVIEW: SCOPING PHASE TWO

THE TREASURY
Kaitohutohu Kaupapa Rawa

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Terms of Reference

Over-arching goal of the Review

"The goal of the review is to modernise New Zealand's monetary and financial stability policy frameworks and the Reserve Bank's governance and accountability settings. This will ensure that the Reserve Bank's approach supports good economic management and reflects the changing environment in which New Zealanders live and work, which will support the development of a New Zealand economy that delivers sustainable and shared prosperity. The independence of the Reserve Bank remains paramount and will be protected."

Terms of Reference for Phase Two of the Review:

"In line with the Government's coalition agreement to review and reform the Reserve Bank Act, the Reserve Bank and the Treasury will jointly produce a list of areas where further investigations of the Reserve Bank's activities are desirable. This list will be produced in consultation with the Independent Expert Advisory Panel. This list, and the next steps for the review, will be communicated early in 2018. This phase of the review will incorporate the review of the macro-prudential framework that was already scheduled for 2018."

The Panel may like to consider whether specifying Phase Two-specific goals in the terms of reference would be appropriate.

Contents

- This slide pack outlines a range of topics that could be considered as part of Phase Two of the review, grouped under seven broad areas:

  1) Over-arching objectives and coherence of the legislation
  2) Decision-making and governance
  3) Macro-prudential policy
  4) Prudential regulation
  5) Supervision and enforcement
  6) Resolution and crisis management
  7) Other cross-cutting and miscellaneous issues (including funding and issues raised by stakeholders)

- Under each heading, the Treasury and Reserve Bank have provided some views to help inform the Panel's consideration of what should be in and out of scope of the review.

- Officials propose this initial conversation with the Panel to be exploratory, with a focus on decisions at the next meeting. The Minister in due course will need to balance the desire to conduct a holistic review of the existing legislation against the resource costs needed to deliver practical outcomes in a reasonable legislative timeframe.

1) Over-arching objectives and coherence of the legislation

Status quo: Sections 1A and 68 of the Act define the objectives of financial stability as:

a) Promoting the maintenance of a sound and efficient financial system

b) Avoiding significant damage to the financial system that could result from the failure of a registered bank

Potential Issues to Review as part of Phase Two:

★ a) Scope of objectives
- Are systemic objectives still appropriate for prudential regulation?
- How should institutional stability and consumer protection be considered?
- Should other objectives (such as avoiding fiscal risk) be included?

b) Clarity of objectives
- How permissive or prescriptive should objectives be?
- Should objectives be equally weighted or hierarchical?
- Are there principles that should be taken into account in achieving the objectives or when exercising powers (e.g. section 4 of IPSA)?

c) What is the appropriate level of influence for Parliament or the Minister over objective setting?

d) Does the Act provide a coherent framework for the range of the RNBZ's roles and responsibilities?

Reserve Bank Priorities: In principle the RBNZ is open to exploring all of these issues, but notes that a change in objectives would have cascading effects across a wide variety of the Bank's functions. Such outcomes may be desirable, but would be difficult to implement in a tight legislative time frame.

Treasury Comment: The IMF noted that broad concepts in the Reserve Bank's statutory purposes have allowed the Bank to develop a supervisory philosophy that departed from conventional practice. The importance of specifying clear objectives for regulation has become accepted practice. The Productivity Commission noted that clear regulatory roles are critical to regulator accountability and focus, compliance by regulated firms, predictable decisions and enforcement, and regime legitimacy.

★ *The star icon indicates issues that were also flagged as part of, or related to, IMF FSAP recommendations*

2) Decision making and governance

Status quo: The Reserve Bank is currently governed by a single decision maker, but Phase One has introduced a Monetary Policy Committee and leaves open the role of the current Board.

Potential Issues to Review as part of Phase Two:

a) Accountability to the Board, the Minister, and Parliament

b) Consistency with best practice governance and accountability frameworks (such as the Crown Entities Act)

c) The role of the Minister across all financial stability functions and the balance with or boundary around operational independence

d) How should the Board's role evolve?
- Should the Board have more governance functions?

e) How should the Bank's financial policy decisions be made?
- Should there be a Financial Policy Committee and, if so, what should be the mandate and structure of such a committee?

Reserve Bank Priorities: In light of Phase One of the Review , changes to the constitution and the management of the Reserve Bank inevitably must be considered as part of Phase Two. Although challenging, all of these issues could be investigated within a tight legislative timeframe.

Treasury Comment: Strong governance is critical to effective future performance of the regime. The Productivity Commission noted that the RBNZ's governance arrangements were *"largely designed for its primary function of monetary policy. Little specific regard was given then to the governance issues applicable to its regulatory functions."*

★ *The star icon indicates issues that were also flagged as part of, or related to, IMF FSAP recommendations*

3) Macro Prudential Policy

Status quo: The Government has stated that Phase Two of the RB Act Review will incorporate the review of the macro-prudential framework that was already scheduled for 2018.

Potential Issues to Review as part of Phase Two:

a) What is the scope of macro-prudential policy – how do we define it and what market failures does it target relative to prudential policy? (eg. time varying vs. point in time vulnerabilities)

b) What are the objectives of macro-prudential policy and how do they relate to other policy areas?

★ c) Which macro-prudential tools should be available, how should they be specified in legislation (versus other instruments), and who should they apply to (regulatory perimeter)?

d) The transparency, accountability, and evaluation processes for decisions on calibration of tools

e) How should decision-making arrangements be governed? What are the respective roles of the RBNZ, the Government, and Treasury?

Reserve Bank Priorities: The RBNZ agrees that issues (c), (d) & (e) are priorities for the review. In principle, the RBNZ also supports examining (a) & (b) as part of Phase Two, but notes that policy work and legislative change in these areas would be complex and will add time to the process. Extending the regulatory perimeter (c) would also be a major change.

Treasury Comment: Defining the scope of the policy area and the objectives it is targeting are the necessary starting points for a review of any regulatory regime. All of the issues identified above are integral to constructing a cohesive and well functioning framework.

★ *The star icon indicates issues that were also flagged as part of, or related to, IMF FSAP recommendations*

4) Prudential regulation

Status quo: Banks currently 'opt-in' to the banking regime and then become subject to conditions of registration. The Bank has a high degree of regulatory independence but is subject to accountability and transparency obligations. The Bank is subject to judicial reviews of its decisions.

Potential Issues to Review as part of Phase Two:

a) What are the objectives of the prudential regime and how are these set?

b) How should banks be regulated?

- Conditions of registration or a legislative instrument?
- Scope of regulation: what activities of banks are regulated and what powers does the RBNZ have?
- What are the appropriate safeguards and requirements for due process, accountability and transparency (consultation, judicial review, merit review, Parliamentary oversight)?
- What is the appropriate balance between operational independence and Ministerial determination of New Zealand's risk appetite?

c) Who should be subject to prudential regulation?

- Opt-in or compulsory registration based on activity?
- Relationship with other legislation such as the Non-Bank Deposit Takers Act

Reserve Bank Priorities: The RBNZ considers the existing regulatory framework to be sufficiently flexible and fit for purpose, but would support a contained review of (c) focused on Part 4 of the Act, and a contained review of (b) focused on improving the regime in line with the recommendations and issues traversed by James Every-Palmer QC.

Treasury Comment: The Treasury agrees with James Every-Palmer QC that "*the divergence between the statutory framework and the current practice of prudential regulation that has arisen over 30 years indicates that it is an appropriate time for a stocktake to assess the robustness of the statutory framework*."

★ *The star icon indicates issues that were also flagged as part of, or related to, IMF FSAP recommendations*

5) Supervision and enforcement

Status quo: The legislation largely permits the RBNZ to choose which supervisory model to adopt, although it does not envisage on-site inspection. The RBNZ has adopted a relatively low-intensity supervisory approach with an emphasis on self and market discipline.

Potential issues to Review as part of Phase Two:

★ a) Are the supervisory model, and the resources currently dedicated to it, still appropriate?

b) Should there be objectives for supervision and what is the appropriate level of influence for Parliament and the Minister over objective setting?

★ c) Does the Act constrain the choice of supervisory model and are further supervisory powers required?

★ d) Is the existing compliance and enforcement regime appropriate? For example, is there too much emphasis on criminal offences (should sanctions be more graduated and easier to apply, e.g. administrative fines)?

★ e) Risks and associated recommendations identified by the IMF in FSAP

Reserve Bank Priorities: The Bank agrees that issues (c) and (d) should be included as part of Phase Two. The Bank would also welcome a discussion on (a), (b) and (e), however, given supervisory resources take time to build up, the Bank would recommend that these aspects be dealt with outside the scope of Phase Two.

Treasury Comment: Choices around supervision influence the performance of the regime. Ministers should have a role in deciding how these choices are made and setting the appetite for risk. While implementation of alternative supervisory models may take time, this is an opportunity to review the approach and to consider the IMF's concerns.

★ *The star icon indicates issues that were also flagged as part of, or related to, IMF FSAP recommendations*

6) Resolution and crisis management

Status quo: The Act provides a statutory framework for managing a bank failure, centred on the role of a statutory manager with powers for the Reserve Bank to direct the statutory manager.

Potential Issues to Review as part of Phase Two:

★ a) What are appropriate resolution objectives?

★ b) Clarification of roles and responsibilities of the Minister, Treasury, Statutory Manager, and Reserve Bank

★ c) Review of resolution powers (including: conversion of securities, temporary public ownership, departure from creditor rankings and provision for creditor safeguards), procedures, and reporting

★ d) Should deposit insurance be introduced and what form should it take (pre-funded or ex-ante) and what consequential issues does it introduce (including for the Open Bank Resolution policy)?

Reserve Bank Priorities: The Reserve Bank considers the existing framework is appropriately flexible and fit for purpose (a view partly based on legal opinions) and recommends limiting the scope of Phase Two to specific legislative changes that would add clarity and reduce legal risk in defined areas. The Bank would also support investigating a minimal threshold of depositor protection as part of OBR.

Treasury Comment: The IMF noted that significant work was required to make OBR a credible option. A crisis management framework consistent with best practice and with clear roles and responsibilities is required for New Zealand to be prepared for a crisis. The review should consider the merits of deposit insurance and aim to deliver an enabling framework that allows for the development of effective resolution options over the medium term.

★ *The star icon indicates issues that were also flagged as part of, or related to, IMF FSAP recommendations*

7) Other issues

Status quo: The Reserve Bank's current funding model involves a five yearly agreement between the Governor and Minister of Finance that specifies how much of the Bank's revenues can be retained by the Bank to meet its operating costs, with the remainder going to the Government. The Act contains other provisions that were established in 1989 that are now either out of date or obsolete.

Potential Issues to Review as part of Phase Two:

a) How the RBNZ is funded

b) Sections 16-24 of the Act on foreign exchange are out of date and impractical to implement. They should be reviewed and clarified or repealed as part of a legislative tidying-up exercise.

c) Other Sections of the Act are either obsolete, out of date, or unlcear (e.g. provisions relating to the 1989 transition and the provisions relating to the appointment of an acting governor), and should be clarified or repealed as part of a legislative tidy-up.

Other issues to be progressed outside Phase Two:

Non-legislative mechanisms to improve fiscal and monetary policy co-ordination.

Reserve Bank Priorities: The Bank would welcome a review of outdated and unclear provisions in the Act (b) and (c), but believes the existing funding model does not need to be urgently revisited, as it is consistent with the Bank having budgetary independence (a). Provisions to allow fees or levies to be charged could be accommodated.

Treasury Comment: While acknowledging that maintaining a degree of budgetary independence is an important factor for monetary policy, the Treasury believes that other options for funding Reserve Bank activities should be considered in the lead up to the review of the current funding agreement which expires in 2020. The Treasury agrees that outdated and unclear provisions in the Act should also be reviewed.

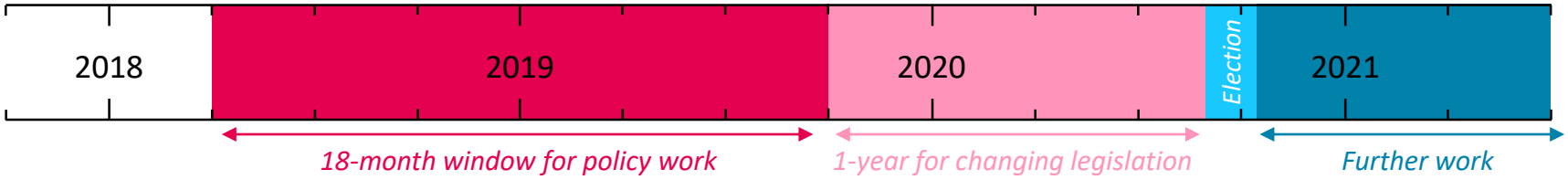
★ *The star icon indicates issues that were also flagged as part of, or related to, IMF FSAP recommendations*

Summary: Reserve Bank Priorities

- **Reserve Bank Priorities** – The Reserve Bank recommends that Phase Two should focus on reforms to the Act that are both necessary and achievable in a tight legislative timeframe – relatively quick wins that can be enacted before the end of this political term (see indicative timeline).

	In Scope for Phase Two	Longer-term work
1. Financial stability objectives	Clarifying objectives via secondary instruments	Review financial stability objectives in the Act
2. Decision making and governance	FPC; Role of Board; Role of Minister	
3. Macro-prudential policy	Toolkit; Role of Government	Macro-pru objectives; Regulatory perimeter
4. Prudential regulation	Part 4 review; JEP recom-mendations	Broader approach to prudential regulation
5. Supervision and enforcement	Supervisory model; Enforcement regime	Supervisory resources
6. Resolution and crisis management	Clarify RB/ Gov roles; De minimis in OBR	Deposit insurance; Objectives and Powers
7. Other issues	Legislative tidy-up	Funding model

Indicative timeline for changes during the current political term



Summary of the Treasury's view

- The Reserve Bank is one of New Zealand's most important regulatory institutions but its legislative framework is increasingly out of date.
- All of the areas identified in this slide pack should be given serious consideration for inclusion in the review of the Act. A review of them together would produce a strong foundation for the Reserve Bank going forward for a significant period of time.
- A review does not necessarily mean that all areas would change, but the outcome is unlikely to be coherent if we continue with a piecemeal approach to review and reform of the Act.
- An inclusive review presents an opportunity to think broadly about how a legislative framework that has been in place for nearly 30 years should best be revised and reformed to reflect changes in financial sector regulation, the global economic landscape, and public sector governance and accountability frameworks that have occurred over that time.
- An inclusive review is supported by the Productivity Commission's advice to take a holistic approach to thinking about regulation and by the wide range of recommendations from the International Monetary Fund.
- The Treasury welcomes the opportunity to discuss the approach to Phase Two further with the Panel.

Annex: IMF FSAP Recommendations

Macroprudential Framework	**Time[1]**
Strengthen arrangements for macroprudential policy by increasing communication efforts; by increasing the transparency of the process to adjust the framework; and by maintaining an accountability framework that does not jeopardize the integrity and independence of the macroprudential decision-making process (¶23).	C
Introduce DTI measures in the macroprudential toolkit (¶25).	I
Implement DTI measures if the changes to the LVR do not reduce the risks in the housing sector (¶25).	I
Increase capital buffer requirements to reflect the concentration of the financial sector in four banks (¶26).	I
Crisis Readiness, Management, and Resolution	
Strengthen domestic crisis management arrangements by reaching ex ante agreement on roles, responsibilities, and processes; prepositioning, mobilization, logistics, and communications plans; and testing through simulation exercises (¶42).	MT
Reconsider the merits of deposit insurance, or in the absence of policy support, introduce a limited depositor preference to provide legal certainty for the *de minimis* exemption in OBR (¶44).	MT
Revise the RBNZ Act to provide greater clarity and certainty in resolution, by inserting objectives in resolution including protection of depositors and the public interest and requiring accountability reporting against these objectives; by clarifying that the RBNZ is the sole resolution authority, and inserting an express requirement for ministerial consent for resolutions with fiscal or systemic implications only (¶42).	MT

[1] I (immediate) = within one year | ST (short-term) = 1-3 years | MT (medium-term) = 3-5 years | C = continuous

Annex: IMF FSAP Recommendations (cont.)

Financial Stability and Financial Sector Resilience	**Time**[1]
Increase RBNZ resources for the supervision and regulation of banks, insurance companies, and FMIs (¶30, 36).	ST
Strengthen cooperation and collaboration arrangements with Australian authorities (¶32).	ST
Clarify responsibilities of the Treasury and RBNZ on financial sector issues to reinforce the role of RBNZ as prudential regulator and supervisor (¶31, bullet 4).	ST
Issue enforceable standards on key risks, governance, risk management, and controls to make RBNZ's supervisory expectations more transparent and support supervisory preventive action (¶31, bullet 1).	ST
Review and extend the enforcement regime to promote preventive action and enhance sanctions powers, including by eliminating ministerial consent for directions, and making compliance with RBNZ policy documents evidence of prudent practice (¶31, bullet 2).	MT
Initiate on-site programs to test the foundation of the three pillar approach and directors' attestations, and increase supervisory engagement with institutions in order to require appropriate action (¶31, bullet 3).	ST
Refine FMA supervision by a) direct monitoring of aspects of asset management relevant to financial stability; b) ensuring quality of Financial Markets Supervisors; and c) enhancing insurance intermediary and conduct regulation and supervision (¶30, 34).	I
Expand the FMA's regulatory perimeter to include licensing and supervision of custodians and appropriate oversight of wholesale asset managers (¶35).	ST
Adopt and implement proposed FMI legislation on regulation, oversight, and enforcement powers (¶36).	I
Adopt the PFMI through detailed requirements in secondary legislation; change the frequency of FMI self-assessments in the proposed regime from three to two years; and enhance compliance of the designated FMIs with PFMI requirements (¶37).	ST
Ensure that designated nonfinancial businesses and professions are subject to AML/CFT requirements, particularly company service providers, lawyers, and accountants (¶39).	MT
Expand data collection and modeling efforts to develop structural models for credit risk in commercial real estate (CRE) and corporate portfolios (¶13).	MT

[1] I (immediate) = within one year | ST (short-term) = 1-3 years | MT (medium-term) = 3-5 years | C = continuous