



# Panel Paper 2: Institutional Form

Separating prudential regulation and other functions

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# Purpose



- This slide pack discusses proposals that Phase Two consider a new institution to separate prudential regulation from the Reserve Bank of New Zealand (“separation”).
- The Treasury and RBNZ were not actively considering separation, given the issue was investigated around 10 years ago and the costs and uncertainty of institutional change may be material.
- However, the issue has been raised during stakeholder consultation suggesting the Panel should consider the objectives the stakeholders maybe seeking to achieve and the range of solutions that may be available.
- Two separate but related points are:
  - whether there should be a separation of making the rules from enforcing the rules?
  - whether the RBNZ’s role as a supervisor under AML legislation should be moved to another agency?

# Previous consideration of the issue

- In 2005 Cabinet agreed that officials undertake a review of the domestic institutional arrangements for financial sector regulation.
- The advice at that time was :
  - that the benefits from consolidating systemic oversight and prudential regulation outweighed any potential risks.
  - Given the skill base and other roles, the Bank should undertake both systemic oversight and prudential regulation.
- New Zealand operates a “twin peaks” regulatory model that separates prudential and conduct regulation into different entities.
- The prudential regulation of banks, insurance, and non-bank deposit takers are consolidated within a single prudential regulator – the RBNZ.

# Core functions of the RBNZ

## The Reserve Bank:

- manages monetary policy to maintain price stability
- regulates banks, insurers and non-bank deposit takers, for the purpose of promoting the maintenance of a sound and efficient financial
- is responsible for the policy development and the setting of rules relating to the regulation of banks, insurers and non-bank deposit takers
- uses prudential instruments to manage the system-wide (systemic) risks that can develop during financial cycles
- supplies New Zealand banknotes and coins
- operates the ESAS and NZ Clear payment and settlement system
- acts as the lender of last resort
- is an AML/CFT supervisor and is responsible for monitoring banks, life insurers, and non-bank deposit takers.

# International Experience

- International experience is more varied and less conclusive for regulatory governance compared to the consensus that exists around monetary arrangements.
- For a variety of reasons, many major economies created standalone specialist prudential regulators before the Global Financial Crisis (GFC). The scope of the RBNZ's functions may have been considered to be broad compared to most other developed economies.
- However, post-GFC there has been an increased focus on the importance of coordinated systemic oversight, most notably in a crisis situation. A range of solutions are possible and countries responded in different ways involving systemic oversight committees (U.S), increased interagency work and coordination (Australia), or via a move to place prudential regulation back into the Central Bank (UK and Europe).
- While trade offs may exist, the UK and EU explored internal governance solutions. The FSB Peer Review of the UK's governance changes suggested that internal solutions had addressed several known risks:

*A large scope of responsibility is vested in a small number of senior executives. In addition, this institutional model may expose supervision to lower prioritisation in terms of status, shared resourcing, and policy-making priorities. The UK authorities are alert to these risks and they have made commendable efforts to address them, including via the appointment of independent external members to the FPC and PRA Board as well as the involvement of senior BoE management in supervisory decisions at the PRA. It will be important to ensure that the close and equal partnership between the PRA and the rest of the BoE endures ”*

# Regulatory effectiveness and change management

- The IMF (Abrams & Taylor) note that “*Institutional structure is a second order issue to be considered once the various conditions for effective regulation are in place ... a serious disadvantage*” of institutional change can be “*the unpredictability of the change process itself.*”
- The IMF noted that institutional change may be effective, but risks around uncertainty, staff loss, and short to medium term impacts on regulatory effectiveness would need to be considered.
- The IMF suggest the first priority should be to ensure the prerequisites for an effective supervisory structure are present. These include:
  - a) Clear objectives
  - b) Independence and accountability
  - c) Adequate resources
  - d) Effective enforcement powers
  - e) Comprehensive regulation
  - f) Cost efficient regulation
  - g) Structure of regulation should reflect the structure of the industry it regulates

# Alternative courses of action

Argument ...	Alternatives ...
Objective clarity may be enhanced through separation into different entities	<p>The UK achieve a similar outcome via separate committees, which will be considered within the scope of this review.</p> <p>The use of function-specific objectives for supervision and regulation will also be considered.</p>
Specialisation of the labour force is greater within a specialist agency.	<p>Hiring and labour force decisions are delegated to a Chief Executive.</p> <p>Clear objectives may be more important than institutional form in influencing internal decision making processes.</p>
Separate agencies can better manage conflicts between monetary and financial objectives.	Separate committees, objective clarity, and clarity as to how priorities are set and conflicts resolved are proposed to be considered as part of a comprehensive review.
Policy overlaps and synergies require functions to be combined or separated.	Australia and the UK have effective regulatory regimes with different institutional solutions. Policy coordination may be accomplished in a range of ways and is not considered to be unique to any functional form.
Attention of senior management is higher within a specialist agency.	<p>Regulatory failures have occurred in a range of countries with very different institutional forms.</p> <p>The UK peer review did identify management experience and attention as a risk, but the FSB member countries felt that this risk may be managed via internal governance. Dedicated supervisory resource, internal governance changes including committees, and the Bank's objectives will be considered within a comprehensive review.</p>
Additional agencies are costly and set up costs could be high.	The set up costs would need to be weighed against the anticipated benefit of standalone regulatory agency.
Organisational change	A change to institutional form may trigger a change in approach, but the risks arising from institutional change can be significant. The IMF discuss uncertainty, loss of staff, and the short-to-medium term impact on regulator's effectiveness .

# Separating making the rules from enforcing the rules

- Most prudential regulators abroad have responsibility for both setting regulatory rules, as well as implementing and enforcing these rules. In this regard the Reserve Bank is in line with other regulators such as the PRA (UK), ECB, APRA and the FDIC. The RBNZ is responsible for both:
  - the policy development and the setting of rules relating to the regulation of banks, insurers and non-bank deposit takers; and
  - enforcing the regulatory requirements.
- The issue of separating who is responsible for making the rules from enforcing the rules was discussed in the Productivity Commission's report on regulatory institutions and practices, which noted that the question of which governance model is best depends on the circumstances.
- Structural separation is an option, but other alternatives exist. The Productivity Commission discusses:
  - clear statements of regulatory objectives
  - obligations on regulators to explicitly state how they will interpret their mandate
  - organisational or governance arrangements
  - stronger consultation obligations
  - clear review and appeals avenues.
- For this reason, a direct comparison to 'best practice' is difficult. While many regulators abroad set prudential standards, these regulators operate within governance and regulatory management frameworks that differ significantly from those in place in New Zealand. For example, while APRA sets standards. These standards are disallowable, are assessed by the Office of Best Practice Regulation, and APRA must "comply" with the a direction from the Minister that could be used to set priorities or influence policy.
- Consideration of governance arrangements are already in scope for Phase 2 of the review.

# Should the RBNZ remain a supervisor under AML legislation?

- The Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (AML/CFT Act) places obligations on New Zealand's financial institutions and casinos to detect and deter money laundering and terrorism financing.
- The AML/CFT Act ensures that businesses take appropriate measures to guard against money laundering and terrorism financing. This enhances the reputation of individual businesses, and of New Zealand as a safe place in which to do business.
- A discrete issue is the role of the RBNZ in AML legislation.
- RBNZ is one of three supervisors tasked with ensuring firms comply with obligations designed to help deter and detect money laundering and terrorist financing. RBNZ monitors banks, insurers and NBDTs. The rationale of the three supervisor approach is to have agencies who regularly interact with particular industries and entities to be the relevant operational agencies for AML regulation.
- An argument can be made, however, that AML regulation does not sit closely with the RBNZ's other functions and that it would lead to a more consistent and efficient approach for all entities to be supervised by the same operational agency. It is not clear which agency would be best placed to do this.
- Ultimately, any change in this area would require working with Ministry of Justice (who administer AML legislation) and the other two supervising agencies (DIA and FMA). This could be done in parallel with, or separately from, phase 2 of the RBNZ Act review.