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The Treasury
1 The Terrace
Wellington

Dear Sir/Madam,

SUBMISSION - REVIEW OF THE RESERVE BANK OF NEW ZEALAND ACT 1989

I am pleased to make this submission on Phase 2 of the Government's review of the Reserve Bank of New Zealand Act 1989 (RBNZ Act) and related matters relating to the Reserve Bank (RBNZ). This submission should be read in conjunction with the earlier submission I made on Phase 1 of the review. Treasury has my permission to release this submission publicly.

By way of context, I make this submission as someone with a comprehensive understanding of the RBNZ Act and the governance and operations of the RBNZ. I also bring considerable knowledge of international financial sector regulation and institutional arrangements, drawing on my international consultancy career. In this context, I worked at the RBNZ from 1983 to 2007, for many of these years in a senior capacity specialising in financial stability and regulatory issues. I then worked at the Australian Prudential Regulation Authority (APRA) from 2008 to 2013 in a senior advisory capacity, including working within the Australian Council of Financial Regulators. While at APRA, I represented Australia on committees of the Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS). My submission is informed by this background, including the trans-Tasman issues arising between the RBNZ and APRA in which was actively engaged for five years. It is also informed by the extensive consultancy work I undertake with the International Monetary Fund (IMF), World Bank, Financial Stability Institute, and KPMG Australia, Malaysia, Indonesia and Hong Kong.

My submission is made having regard to relevant international principles and accepted good practice in the areas of financial sector regulation and supervision. In particular, I have had particular regard to the following:

- The *Core Principles for Effective Banking Supervision* (Core Principles), issued by the BCBS.

- The *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes), issued by the FSB.

- The *Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles*, issued by the IMF.

- The IADI *Core Principles for Effective Deposit Insurance Systems* (IADI Principles), issued by the International Association of Deposit Insurers (IADI).

I have also taken into account the findings and recommendations of the IMF FSAP for New Zealand - the *Financial System Stability Assessment* (FSSA) - released in May 2017.

In addition, I have drawn on the findings of the case study on financial sector regulation which the NZ Productivity Commission engaged me to prepare for its review of regulatory frameworks in New Zealand - *Productivity Commission Inquiry into Regulatory Institutions and Practices - Case Study: Regulation of the financial sector*, released in February 2014. The case study has been widely distributed within the financial sector and is effectively in the public domain. For your convenience, I am attaching a copy of the case study to the email by which I convey this submission to The Treasury. I urge Treasury to have close regard to the findings and recommendations in this case study.

In this submission I address all of the issues identified by The Treasury in its paper on the scoping of Phase 2 of the review of the RBNZ Act, together with other issues I consider to be germane to the review. However, I start with an issue that is not identified in the scoping paper, but which I think is fundamental and should be considered by The Treasury and the Government – i.e. should the RBNZ be the agency to perform prudential regulatory and supervisory functions.

Should the prudential regulatory and supervisory function be retained in the RBNZ or moved to a new agency established for the purpose?

Consideration should be given to whether the RBNZ is the appropriate agency to conduct prudential regulation and supervision of banks, Non-Bank Deposit-Takers (NBDTs) and insurers, as well as Anti-Money Laundering (AML) regulation and supervision for such entities. Equally, it is legitimate to question whether the RBNZ should have the responsibility to regulate payment and settlement systems and associated Financial Market Infrastructure (FMI), given that some of them are owned and operated by the RBNZ. This presents an inherent conflict of interest and arguably reduces the effectiveness of FMI supervision.

In many countries (e.g. Australia, Canada, France, Germany, Japan, South Korea, Sweden, Switzerland) the prudential supervision authority is completely separate from the central bank, often having been moved out of the central bank following a comprehensive review of regulatory institutional arrangements. In some countries, such as the United Kingdom, the prudential supervision authority is a separate agency, but under the oversight of the central bank. South Africa is currently in the process of adopting a 'twin peaks' model similar to that in the United Kingdom.

In New Zealand, there has never been a serious consideration of the benefits and costs of separation of the prudential regulatory and supervision function from the RBNZ. In contrast, Australia and many other countries have had comprehensive, independent assessments of this and other aspects of regulatory institutional arrangements that resulted in major changes to regulatory architecture. Some of these reviews, as in the United Kingdom, occurred in part because of perceived regulatory failures. In that regard, New Zealand has had more than its fair share of financial institution failure or regulatory non-compliance which would, in any

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other country, raise serious questions about the competency and suitability of the regulator (i.e. the RBNZ in this case). It is puzzling and worrying that, despite the failure of DFC in 1989, the substantive failure (and government-funded rescue) of BNZ in 1990, the multiple failures of finance companies in the period 2007 to 2011, and the failure of insurers, there has been no government enquiry into the adequacy of the RBNZ's performance as prudential supervision authority, and no wider enquiry into financial system regulatory architecture. This is not to suggest that any of these financial institution failures were primarily attributable to regulatory failure by the RBNZ. They were attributable to multiple causes, many of which had nothing to do with regulatory failure. Nonetheless, some aspects of the financial institution failures can be attributable, in part, to inadequacies in the supervisory framework applied by the RBNZ.

More recently, the apparent failure of the RBNZ to promptly identify the non-compliance by Westpac with internal model requirements raises further questions about the competency of some aspects of the RBNZ as the supervisory authority.

In a different but equally relevant context, the concerns raised by many parties, including banks, insurers and industry associations, about the lack of adequate consultation by the RBNZ on regulatory proposals, its dismissive attitude to those who raise constructive objections to its policy proposals and the lack of robust cost/benefit assessments of its regulatory initiatives ought to raise legitimate concerns about the way the RBNZ conducts itself in its regulatory functions. The financial sector case study undertaken for the Productivity Commission's review of regulatory institutions and practices provided numerous references to industry concerns based on discussions with industry representatives. More recently, the IMF FSSA and other FSAP reports have identified significant shortcomings in the RBNZ's approach to supervision and the adequacy of its capacity in this area.

In my assessment, many of the concerns referred to above relate to an underlying issue – the culture of the RBNZ, including its long tradition of being overly defensive of any criticisms, its 'fortress like' mindset relating its independence, its territorial 'turf protection' mindset and a misconstrued argument as to what 'independence' means. More generally, many of the deficiencies with the RBNZ's current approach to prudential supervision can be linked to the generally dismissive view successive governors and senior management have held towards prudential regulation and supervision from the very outset of the RBNZ acquiring this function in 1986. This mindset hampered effective prudential regulation and supervision from the early development of supervision in the mid to late 1980s, and ever since.

It is noteworthy that the only review ever undertaken of the prudential supervisory regime since its inception in 1986 was the internal review conducted by the RBNZ in the early 1990s. That review was poorly structured, inadequately resourced and self-serving. It involved no external experts. Treasury had little, if any, input. The RBNZ Board played no substantive role in the review. It was largely driven by those in the RBNZ (mainly from the Economics Department) who had a philosophical bias against prudential regulation and supervision, and yet no substantive understanding of the issues. The analysis in the review was superficial, ill-informed and driven far too much by philosophical bias. The review led to a substantial gutting of the supervisory function, rendering the RBNZ even less effective as a supervisory authority than it had been in the preceding years. It brought about some constructive changes, such as the bank disclosure regime and director attestation framework, which were beneficial and sensible reforms, but left the RBNZ ill-equipped to identify and proactively respond to emerging stress in the banking system, and hopelessly under-resourced to deal with a banking crisis should one occur. The review led, for some time, to the absurd outcome that the RBNZ

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supervision function should be based only on information that is publicly available and not privately accessed by the RBNZ. No other supervisor in the world operates on that basis, for good reason. Nor do trustee-based supervisors or credit rating agencies. Sensibly, this naïve approach was progressively abandoned in later years and supervisory resources were increased. Nonetheless, remnants of that mindset continue to this day and continue to undermine the effectiveness of supervision.

A fresh assessment of the adequacy of regulatory architecture is well overdue. An assessment should be undertaken by Treasury, supplemented with independent experts selected and appointed by Treasury, to evaluate the benefits and costs of three regulatory architecture options:

- Retaining the prudential and supervisory function in the RBNZ, but under much-strengthened governance, accountability and transparency arrangements.

- Establishing an agency to conduct prudential regulation and supervision, with its own statute, governance and accountability arrangements, but where it is under the overview of the RBNZ, much like the arrangement in the United Kingdom, where the UK Prudential Regulation Authority operates as a subsidiary of the Bank of England.

- Establishing a completely separate government agency – a New Zealand Prudential Regulation Authority (NZPRA) – under its own statute and governance and accountability arrangements, reporting to the Minister of Finance, and completely unconnected with the RBNZ.

Of these three options, I favour the third one – the creation of a new government agency, a NZPRA, that is completely separate from the RBNZ. This is the Australian and Canadian model, and one that is prevalent in many countries in the OECD. In my assessment, there are several persuasive reasons for separating the prudential regulatory and supervisory function from the RBNZ:

- It would reduce the concentration of excessive power in one agency. Currently, the RBNZ has an excessive range of powers compared to most central banks in comparable countries, especially given the odd governance arrangements applicable under the RBNZ Act (with powers being vested in the Governor, and the Board being largely irrelevant) and the inadequate accountability arrangements applicable to the RBNZ. A narrower span of functions would reduce this concentration of power and assist in the promotion of a less arrogant, dominant regulatory agency.

- It would enable the NZPRA to focus on the job at hand, without senior management being distracted by other tasks, such as monetary policy, and without the hinderance of an unsupportive organisational culture, rooted in deep scepticism as to the value of prudential regulation and supervision. Since the inception of supervision, in 1986, the RBNZ has viewed supervision as little more than a necessary evil. It has been the poor cousin to monetary policy and has been generally under-resourced when compared to prudential regulators in other comparable countries. Scrutiny from the RBNZ Board has been negligible.

- It would enable a senior management team to be appointed with the skills, knowledge and experience to perform the role effectively – i.e. people with deep knowledge of banking, insurance and regulatory issues. The current senior management team – and its predecessors – fundamentally lack the skills, knowledge and experience required for the role, with few exceptions. Mostly, the RBNZ is dominated by macroeconomists. For all their talents, they know little about banking and even less about insurance, and still less about technical regulatory issues. They are not sufficiently qualified to do the job entrusted to them.

- It would enable the NZPRA to build the depth of knowledge and skills in its staff to perform the functions required of them. Currently, although the RBNZ has some able people in the supervisory area, it lacks the depth and breadth of ability that APRA or OSFI bring to the job – even allowing for obvious differences in size. This hinders their effectiveness. For example, the RBNZ staff lack the knowledge needed to conduct in-depth reviews of bank and insurer risk management systems. Similarly, if the RBNZ were tasked with conducting an asset quality review of a bank to assess its capital position to determine whether to provide emergency liquidity assistance or to invoke resolution, it would lack the capacity to do this, especially under acute time pressure. In short, the RBNZ lacks the ability to do the job entrusted to it. A properly structured NZPRA would be much better equipped to do the job, led by senior management with the right blend of skills and knowledge, and with a supportive mindset committed to the mandate of the NZPRA, and undistracted by other responsibilities.

- Separation of the supervisory function from the RBNZ would also remove potential conflicts of interest between functions in the RBNZ. For example, conflicts of interest of one type or another exist between:

    - *The role of supervisor and lender of last resort.* The RBNZ is the lender of last resort to individual banks and the banking system as a whole, but should only provide liquidity of this nature on the basis of a bank being assessed as prudentially sound (adequately capitalised or being restored to capital adequacy) and with sufficient collateral, and where financial stability considerations justify liquidity support. There is an inherent conflict of interest in the same agency performing the supervisory assessment on capital adequacy and undertaking the decision as to whether to provide liquidity via lender of last resort. The lender of last resort decision should be made for financial stability purposes and with the protection of the RBNZ balance sheet firmly in mind. It requires robust scrutiny by the financial markets division of the RBNZ of any supervisory assessment of a bank's capital position. Separation of lender of last resort and prudential supervision enables the RBNZ to exercise independent scrutiny of any supervisory assessment and to make the lender of last resort decision solely in its capacity as central bank.

    - *The role of macro-prudential and micro-prudential regulation.* The RBNZ currently conducts both macro-prudential and micro-prudential regulation. There is the potential for conflict to arise between these functions if located in a central bank, given the central bank price stability mandate. The macro and micro-prudential regulatory functions should be complementary; both should be directed to the sole objective of financial stability. However, the RBNZ has arguably used macro-prudential policy for wider purposes - to enable it to pursue monetary policy objectives by seeking to attenuate asset price inflation and reduce potential wider inflationary pressures. The ostensible argument advanced by the RBNZ for its use of macro-prudential policy is to counter the risks to financial stability that could arise from excessive asset price inflation. However, given that stress tests of the banking system suggest that banks would generally be resilient to even large falls in asset prices, it is questionable whether the macro-prudential policy initiatives taken by the RBNZ can really be justified on these grounds. If the function of macro-prudential policy were vested in a separate NZPRA, with clearly defined policy objectives anchored to financial stability, then this potential for misdirected used of macro-prudential policy would be much reduced; it would be solely focused on financial stability and subject to a decision-making structure that does not involve the senior management of those responsible for price stability objectives.

- *The operator of payment and settlement systems and the supervisor of such systems*. The RBNZ is seeking to acquire stronger powers to regulate and supervise payment and settlement systems. This raises an obvious conflict of interest to the extent that the RBNZ is also the owner and operator of some of the key payment and settlement systems in the country (i.e. ESAS and NZClear). It is highly questionable that the entity that owns and operates key parts of the payment and settlement systems should also be charged with regulating and supervising these (and other payment) systems. A far more satisfactory arrangement would be for the regulatory and supervisory functions to be vested in a separate agency – a NZPRA.

Taking into account these factors, among others, a strong case can be argued for separation of the prudential regulatory and supervisory function from the RBNZ, as has been done in so many other countries.

What of the arguments for retaining the prudential function in the RBNZ? The argument generally advanced by the RBNZ in favour of retaining supervision is the alleged synergy between the prudential function and the other functions of the RBNZ. For example, it has been argued by some in the RBNZ that the RBNZ is better equipped to perform the supervisory function because of its payment system operation, exchange settlement function and monetary policy operations. This argument is fragile at best, and largely illusory. The insights gained by the RBNZ from these other functions have little bearing on its role as prudential regulator and supervisor. Interaction between the different departments within the RBNZ in my time at the RBNZ was very limited and had no effect of prudential policy decisions. It might have increased in more recent times, but I very much doubt that there is any substantive input from these other parts of the RBNZ to the supervision function.

If one looks at our near neighbour, Australia, the separation of supervision from the Reserve Bank Australia (RBA) had no deleterious effect on the supervisory effectiveness of APRA; if anything, it enhanced it by enabling APRA to focus on its key functions without the distraction of the other functions of the RBA. To the extent that central bank insights have a useful role to play in informing prudential supervision, they can be harnessed efficiently and effectively through well-structured coordination between the supervision authority and the central bank, as happens regularly in Australia through the Council of Financial Regulators and bilaterally between APRA and the RBA.

I therefore believe that The Treasury and Government should seriously consider separating all of the prudential regulatory and supervisory functions (micro and macro) from the RBNZ, together with associated AML functions, and vesting them in a separate NZPRA. The NZPRA would be established by an Act of Parliament with a clearly defined mandate, objectives, powers and accountabilities. It would be subject to robust governance, possibly including a

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board appointed by the Minister of Finance and an executive decision-making committee. The objectives of the NZPRA would appropriately relate to the pursuit of a sound and efficient financial system, but would also include the protection of depositors and policyholders.

If prudential supervision is retained in the RBNZ, what should be the statutory objectives?

Under the RBNZ Act, the RBNZ is required to exercise its powers in Part V 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 could result from the failure of a registered bank. Broadly, these purposes are appropriate, given that they seek to balance soundness (i.e. financial stability and resilience) and efficiency (including dynamic efficiency, productive efficiency and dynamic efficiency). However, in contrast with many supervisory authorities, there is no reference to any notion of depositor protection (or, in the *Insurance (Prudential Supervision) Act 2010*, policyholder protection). This was a deliberate omission from the RBNZ Act and its predecessor, the *Reserve Bank of New Zealand Amendment Act 1986*, reflecting the philosophy of the period that eschewed any notion of consumer protection for moral hazard reasons.

I think a case can be made for refining the objectives in Part V of the RBNZ Act (and making parallel changes to the other Acts relating to prudential supervision) to better reflect the purposes for which prudential regulation and supervision are conducted – i.e. to promote the resilience of financial institutions, stability of the financial system and confidence of depositors and policyholders. The formulation of objectives should include reference to financial system efficiency, but there needs to be a recognition that prudential regulation and supervision has very little capacity to contribute to efficiency outcomes; the most that can be achieved is to exercise prudential-related powers in ways that minimise or avoid adverse efficiency outcomes (e.g. by avoiding excessive compliance costs and applying regulation in a competitively neutral manner). To this end, I suggest a reformulation of the objectives along the following lines:

"The RBNZ will exercise its prudential regulatory and supervisory powers for the purposes of:

- promoting financial system stability and the prudent management of risks in regulated financial institutions; and
- promoting the confidence of depositors and policyholders in the financial system; while
- seeking to avoid excessive compliance costs or adverse impacts on financial system efficiency."

For the powers that relate to the resolution of a bank or insurer, I suggest that the purposes be more closely aligned to the FSB Key Attributes, given that they more precisely capture the economic substance of what a resolution authority should seek to achieve in resolving a failing financial institution. In that regard, I suggest something along the following lines:

"The RBNZ will exercise its powers to resolve a failing financial institution for the purposes of:

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- maintaining the continuity of systemically important functions and the stability of the financial system;
- minimising adverse impacts on the economy;
- protecting depositors and policyholders;
- subject to the above, minimising fiscal costs and risks; and
- subject to all of the above, avoiding where possible adverse impacts on the financial systems of other countries."

Much as there is a policy targets agreement for monetary policy, there should be a similar arrangement for prudential policy that translates high-level statutory objectives into more specific policy targets. This should be set periodically by the Minister of Finance. In parallel, I have recommended in Phase 1 of the RBNZ Act review that the Policy Targets Agreement (PTA) for monetary policy be replaced with a Statement of Policy Target that is set by the Minister of Finance from time to time. It should not be subject to the agreement of the Governor or the RBNZ. The RBNZ should have operational independence in performing monetary policy, but not policy target independence. The government should specify the policy target. In the same vein, the government should specify a policy target for prudential policy. This would strengthen the accountability of the RBNZ by providing a set of criteria against which its performance can be assessed.

Unlike the PTA for monetary policy, which (currently at least) contains a quantitatively expressed inflation target, the equivalent for prudential policy is more amenable to a set of qualitative criteria rather than quantitative targets. For example, the policy statement might contain references to the need for the RBNZ to:

- promote the resilience of regulated institutions to enable them to withstand severe financial shocks (which could be supported by minimum quantitative targets based on stress testing);
- achieve a low (but not necessarily zero) failure of financial institutions;
- minimise the risk of inter-institutional contagion;
- maintain a competitively neutral regulatory framework;
- avoid excessive compliance costs;
- consult openly and thoroughly with regulated entities and other interested parties;
- maintain close coordination and cooperation with the FMA and Treasury;
- maintain close coordination and cooperation with APRA and the RBA;
- proactively identify and respond to emerging stress in financial institutions;

- maintain the capacity to resolve a failing financial institution in a manner that maintains the continuity of critical functions and services, avoids disruption to the financial system, maintains financial system stability, provides prompt access to depositors' funds and minimises fiscal risks and costs.

The Act should require the RBNZ to report comprehensively to the Minister and publicly on its performance against each criterion using a comprehensive set of performance metrics agreed with The Treasury. The RBNZ Board should be charged with the responsibility to monitor and assess the performance of the RBNZ against the criteria and by reference to the performance metrics. To date, the Board has been ineffectual in monitoring and assessing the RBNZ in all of its functions – and especially with respect to prudential regulation and supervision. It needs to be subject to much-strengthened reporting requirements and resourcing to do the job properly.

Treasury also needs to strengthen its capacity to monitor the RBNZ in this area. Currently, it is not doing enough in this regard, largely due to under-resourcing. A strengthening of Treasury resourcing in this area is therefore important.

If prudential supervision is retained in the RBNZ, what should be the decision-making structure?

The current decision-making structure of the RBNZ is flawed. As with monetary policy, prudential policy decisions are vested in one person – the Governor. This concentrates far too much power in the hands of one person and creates an excessive risk of misuse of that power and poor-quality decision making. This risk is especially worrying if the Governor is prone to volatile decision-making behaviour, is not genuinely open to thorough consultation with affected parties and/or does not handle pressure well.

Accordingly, I recommend that the governance arrangement be changed so that all prudential policy formulation and implementation decisions are made by a small committee (a Prudential Supervision Committee) comprising the Governor and two Deputy Governors, plus 3 or 4 external persons appointed by the Minister of Finance for specified terms (e.g. 3 years, with the capacity for reappointment). The committee would be empowered to delegate some decisions, such as on institution-specific matters, to a sub-committee comprising the Governor and at least two others, with a further capacity for routine operational matters to be delegated to lower-level staff, but where the Prudential Supervision Committee remains accountable for the exercise of all delegated powers.

As per my submission on Phase 1 of this review, I recommend that the appointment process in the RBNZ Act be changed, such that the Governor and two Deputy Governors are appointed by the Governor-General on the recommendation of the Minister of Finance. The Board should be removed from the appointment process; it is ill equipped to perform the role and lacks suitable accountability in that regard.

As in my earlier submission, I recommend that the Board be retained, but that it solely be responsible for performance monitoring and assessment (including in respect of all of the RBNZ's functions and management of its risks). It should also have the power to recommend to the Minister that the Governor, Deputy Governors or external members of the Monetary Policy Committee and Prudential Supervision Committee be removed from office where

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specified statutory grounds for removal can be justified. The Board should comprise only non-executive directors appointed by the Governor-General on the recommendation of the Minister of Finance. The Governor should not be a member of the Board. The reporting obligations of the Board should be greatly strengthened, including a requirement for at least six-monthly reports to the Minister of Finance (with subsequent public disclosure), where these reports are stand-alone and not connected with those of the RBNZ. The Board should be provided with resources to enable it to perform the monitoring and assessment role, including the capacity to engage external appointees/consultants.

The decisions of the Prudential Supervision Committee should be subject to ex post public disclosure on similar terms as should be applied to a Monetary Policy Committee, subject to the preservation of commercial confidentiality in respect of individual financial institutions.

Prudential powers and legislation

The RBNZ's statutory powers to conduct prudential regulation and supervision are comprehensive and, in most respects, align with international principles and best practice. That said, I recommend that the powers in Part V of the Act be reviewed to provide a fresh assessment of their adequacy by reference to the BCBS Core Principles and taking into account the recommendations of the IMF FSAP reports. I am aware of some gaps and deficiencies that would benefit from strengthening, as well as inconsistencies between Part V of the RBNZ Act and the prudential powers in the Insurance (Prudential Supervision) Act (IPSA). The statutory changes should include a strengthening on the obligations on the RBNZ to consult with affected parties, including a minimum statutory period for consultation and an obligation to publish in a timely manner the points raised in submissions and the RBNZ's responses to those points.

In the course of that review, I suggest that consideration be given to removing all prudential powers from the RBNZ Act and incorporating then, with suitable revisions, in a new Act – i.e. a Banking Supervision Act or something similar. This would be consistent with prevailing international practice and with the IPSA. It would also pave the way for moving prudential supervision to another agency.

I also recommend that the Non-Bank Deposit-Takers (NBDTs) be brought under direct regulation and supervision by the RBNZ, with the current trustee-based supervisory model being discontinued. The NBDT supervisory arrangement established in 2007/08, in which the RBNZ acquired prudential regulator powers but trustees continued as supervisors under trust deed arrangements, was a compromise that reflected the RBNZ's reluctance to take on the role of NBDT supervisor. It has served as a suitable interim regime, but makes little sense going forward, given that NBDTs are, in substance, just mini banks and should be subject to a competitively neutral regulatory framework. Moreover, if, as I recommend, deposit insurance is established, then NBDTs would appropriately be brought within its ambit and should therefore be subject to robust supervision to counter moral hazard risks. In most countries, NBDTs are subject to prudential supervision by the prudential regulatory authority, albeit with an appropriate scaling-down of regulatory and supervisory requirements to take into account their smaller size and lower level of complexity. This should be the forward path for New Zealand.

Administration of the RBNZ Act and other laws conferring powers on the RBNZ

The RBNZ should no longer have administrative responsibility for the RBNZ Act, IPSA or any other Acts which confer powers on the RBNZ. It should not have the power to undertake reviews of its Acts. That power should reside in The Treasury, with the RBNZ being consulted on any such review, but with The Treasury very much holding the pen. It is completely anomalous and unacceptable that a regulatory agency should have the power to review/administer its own laws. No other regulatory agency has this power to my knowledge. Certainly, the FMA does not have it, and nor does the Commerce Commission. It represents a fundamental conflict of interest and undermines the integrity of any reviews of the relevant laws. I note that, of all the many countries I have reviewed in my IMF and World Bank consultancy capacity, not one of them has as an arrangement in which regulatory agencies administer and review their own laws – for very good reasons. The arrangement is completely without justification. The Treasury needs to increase its resourcing to perform the role or engage external experts from time to time to assist it.

Prudential supervision

The RBNZ has long maintained a 'three pillar' approach to supervision, these being 'market discipline', 'self discipline' (essentially bank corporate governance and risk management) and 'regulatory discipline'. This framework is appropriate and provides a useful way of seeking to balance the different means by which financial institution soundness and resilience can be promoted. The only problem is that it is an unbalanced framework as currently calibrated. It is a bit like a three-legged stool, but where each leg is of a different length. The result is a stool that wobbles precariously and is not a safe place to sit. A recalibration of the three legs needs to be achieved to restore balance and provide an effective foundation on which the pursuit of financial system stability can sit.

I see a few things that need attention in this regard:

- The market discipline pillar needs to be strengthened by moving away from very detailed bank disclosure statements to ones that better identify the key risk and risk management parameters, while still retaining sufficient conventional financial and prudential data. More use of comparative data across banks is also needed. Moreover, the disclosure requirements for insurers and NBDTs should be brought more into line with bank disclosure requirements, albeit with appropriate modifications.

- More emphasis needs to be placed on financial literacy to enable ordinary depositors and policyholders to understand key disclosures. This is a major gap at present. The RBNZ needs to lift its game in this area, as does the FMA, working collaboratively together, and with the Commission for Financial Capability and the Ministry of Education.

- The self-discipline pillar can be strengthened by introducing more comprehensive corporate governance and risk management requirements for banks, insurers and NBDTs. These need not be intrusive in a regulatory sense; indeed, they should not be. But they should raise the bar on minimum requirements for governance (including minimum size of board, board committee arrangements, director performance and director attestations) and risk management (including requirements for banks, insurers and NBDTs to have comprehensive risk management frameworks, risk appetite statements, risk culture frameworks and risk management testing and audit requirements). A closer alignment with the kinds of requirements APRA has in place would be desirable, albeit somewhat less intrusive in style.

- The regulatory/supervisory pillar is the weak link in the chain – the shortest leg in this wobbly stool. The RBNZ has long eschewed the use of on-site examinations and comprehensive off-site monitoring, ostensibly on the grounds of moral hazard and being 'fixed with private knowledge'. These arguments are mainly nonsense and are self-serving; they reflect the old culture in the RBNZ of being the 'reluctant regulator' and, to some extent, also reflect the lack of suitable competence in the RBNZ's senior management team to perform the supervision function. As a result of the hands-off approach to prudential supervision, I have no doubt that the RBNZ is under-equipped to perform the role of supervisor. They have some good people, but generally lack the skills, knowledge, experience, organisational mindset and quality of data to promptly detect and respond to emerging stress in banks, insurers and NBDTs (as well as FMIs) or to supervise effectively. They have an inadequate in-depth understanding of banks' and insurers' risk management frameworks and where the deficiencies might lie. They are therefore not well placed to proactively identify and resolve emerging problems before they become obvious (by which time one could be looking at resolution, with attendant costs and risks). They lack the ability to perform asset quality reviews and therefore to assess the accuracy of banks' and insures' capital adequacy figures. In short, the RBNZ is poorly placed to perform the role of supervisor and falls well short of the standards demonstrated by the likes of APRA and OSFI, among many others.

  I am not suggesting that the RBNZ become a 'heavy-handed' regulator and supervisor. Far from it. I want to avoid excessive compliance costs and moral hazard risks as much as the next person. However, the current arrangement leaves the RBNZ dangerously ill-equipped to do the job Parliament has given it, and creates a considerable risk that New Zealand could face serious bank and insurance distress and failure situations in the future, with the likelihood of government-funded bail-outs. What is needed is a recalibration of the regulatory/supervisory pillar to better align it to international principles and practice. This suggests the need for the RBNZ to buy in staff with greater expertise in banking and insurance risks, replacing staff who lack the skills and knowledge to do the job. It also suggests the need for an intelligently designed, risk-based approach to supervision that includes regular thematic and occasional deep-drill on-site assessments, but on a needs-only basis. Closer collaboration with APRA is needed; the current level of collaboration is inadequate, especially as regards coordinating on-site assessments. The RBNZ also needs to strengthen its capacity to detect emerging stress at an early stage, through enhanced use of early warning indicators and stress testing (including reverse stress testing). They also need to strengthen their prompt corrective action framework and introduce recovery planning requirements for banks. (In that regard, it is bizarre that the RBNZ has placed so much emphasis on bank resolution planning – with the predominant focus on separation of the New Zealand subsidiary from the parent bank) and zero attention on recovery planning. Most supervisors globally have done the opposite – and quite logically. They have started with recovery planning and only then moved to resolution planning.

  A fundamental review of the RBNZ approach to supervision is needed to strike the right balance. This review should be led by Treasury and involve external, independent experts. RBNZ internal reviews of its own performance are no substitute for properly designed external reviews – and where Treasury, and not the RBNZ, choose and appoint the independent experts to undertake the review.

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There is also a need to strengthen the RBNZ's accountability for its performance on prudential regulation and supervision. Currently, no one reviews its performance in any meaningful way – not Treasury and not the RBNZ Board. In contrast, APRA is under constant scrutiny by the Australian Commonwealth Treasury and the Office of Best Practice Regulation (OBPR), which is affiliated to the Australian DPMC. APRA has also been subject to numerous commissions of enquiry. In contrast, New Zealand has lamentably done absolutely nothing in this space for decades. It is therefore high time that the Government established rigorous assessment of the RBNZ (and FMA) of their performance through independent processes – including the RBNZ Board (in the case of the RBNZ), Treasury (in the case of RBNZ and FMA) and, I suggest, the establishment of a body similar to the Australian OBPR to undertake rigorous assessments and cost/benefits analyses of the RBNZ's and FMA's (and other government agencies') proposals for regulation. The current quality of cost/benefit analysis is very inadequate.

The RBNZ approach to consultation on prudential policy and regulatory initiatives is seriously deficient and borders on unprofessional at times. Too often, the RBNZ has released proposals for consultation and allowed far too short a period for affected parties to make well-researched submissions. The RBNZ has given the strong impression, all too often, that it has little interest in the submissions it receives – i.e. that it is consulting for the sake of appearance and has no intention of modifying its approach in light of submissions received. It provides inadequate responses to submissions and displays an excessively aggressive and defensive tone in the replies it does provide. Moreover, the quality of the consultation documents is generally very poor when compared to those of other regulatory agencies in comparable countries. The economic argumentation for policy proposals is generally poorly developed and too often self-serving. Cost/benefit analysis is typically provided to justify the RBNZ's preferred option, rather than being objectively and rigorously developed. And, as noted above, the external, independent scrutiny (by Treasury or others) of the cost/benefit analysis and regulatory impact statements is far from adequate. All of these deficiencies need to be rectified by imposing on the RBNZ much stricter requirements on consultation and cost/benefits analysis, and by bringing much stronger external scrutiny to the process.

Macro-prudential regulation

The RBNZ has been active in the development of macro-prudential policy in recent years. Macro-prudential policy has a valid place in the toolkit to deal with macro-financial imbalances and stress points, with a view to reducing these imbalances and stress points before they cause significant damage to the financial system and economy. I commend the RBNZ on having developed a framework for this work and for entering into the MOU with the Minister of Finance on the matter. However, I do not commend them on the quality of the analysis undertaken or the consultative process they have adopted. Indeed, the lack of meaningful consultation, and the inadequacy of the analysis of the policy options and the costs and benefits of each, is shameful. The objectives of policy have been insufficiently developed and the economic argumentation for the policy options selected has been shallow. The analysis of costs, benefits and risks is clearly inadequate.

What is needed now if a fundamental, independent review of the macro-prudential policy function. As argued earlier in this submission, my first preference is to remove this function from the RBNZ, together with all other prudential functions, and vest them in a separate agency. Aside from that, what is needed is a thorough reassessment, led by Treasury, of the:

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- the objectives and rationale for macro-prudential policy;
- the need for a thorough process of consultation on all policy proposals;
- the need for rigorous cost/benefit analysis conducted by an independent party (not the RBNZ);
- the need for periodic ex post assessments of the efficacy of policy initiatives; and
- the need for an assessment of unintended consequences of policy initiatives.

The MOU needs to be revisited, taking into account the recommendations made by the IMF in the FSSA issued in 2017. It should be subject to regular review.

The policy objectives for macro-prudential policy (as with micro-prudential policy) should be set by the Minister of Finance from time to time, and the RBNZ should be held to account for performance against these objectives based on assessment criteria and performance metrics agreed between The Treasury and RBNZ.

As with all aspects of the RBNZ, the RBNZ's independence should be limited to the implementation of policy; it should not apply to the setting of policy objectives. The RBNZ is merely an agency of Parliament and needs to be treated as such, with attendant transparency and accountability.

Financial crisis management

The RBNZ has a reasonably comprehensive range of statutory powers for bank and insurance resolution. That said, there are numerous gaps, including the absence of resolution funding arrangements, the absence of explicit bail-in powers, inadequate resolution objectives and the lack of appropriate resolution safeguards (especially the 'no creditor worse off' framework). The powers and associated safeguards should be reviewed by The Treasury, in consultation with the RBNZ, with reference to the FSB Key Attributes. Significant amendments are justified in my assessment.

The RBNZ has made much of its 'Open Bank Resolution' (OBR) policy framework. As one of the original authors of that policy in its early stage of development, I support its intent – i.e. to provide a resolution option that enables continuity of critical functions, prompt access to a proportion of transaction balances in a bank resolution process and minimisation of fiscal costs and risks. However, it has been poorly developed. As currently devised, it is largely unworkable and would, if used, create a major risk of triggering runs on multiple banks. Ironically, in its current form, I think OBR would actually impose much greater fiscal risk and contingent liability than would a conventional, intelligently designed government bank rescue.

The viability of OBR is undermined by the absence of any total loss absorbing capital (TLAC) requirements for banks in the form of contractually bail-in-able debt. This is something that many countries are now implementing, but the RBNZ appears to have ignored or rejected (but without any public consultation). OBR is further undermined by the absence of deposit insurance. Under the RBNZ's current (rather naïve) conception, OBR could be applied with a

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'de minimus' exemption for 'small' deposits. It completely ignores the inherent uncertainty of this – i.e. there is no statutory exemption for small deposits, no definition of what 'small' is and no attempt to lock in the exemption. If an exemption is applied, it would be at the whim of the Minister of Finance at the time. It would also be unfunded. In effect, it would pass the cost to larger depositors and therefore strengthen their incentives to run on the bank and possibly on other banks. In short, OBR is ill-conceived in its present form. It is only workable if accompanied by deposit insurance or a properly structured and funded de minimus exemption, and with contractual bail-in debt.

The Treasury should lead a review of the RBNZ's bank resolution framework, starting with the viability of OBR and the need for deposit insurance, following on from the recommendations made by the IMF. Deposit insurance also needs to be assessed as a mechanism for small depositor protection and prompt pay-out/deposit account transfer for small banks and NBDTs, given that OBR does not apply to these entities and there is currently no mechanism for any form of depositor protection or prompt access to depositors' funds. The RBNZ's only argument against deposit insurance is the contention that it would undermine market discipline on banks and exacerbate moral hazard. This argument is a nonsense. Market discipline arises not from small, retail deposits, but from wholesale deposits, bondholders and other banks. Deposit insurance would have next to no adverse effect on market discipline or moral hazard. The argument advanced by the RBNZ is fallacious. New Zealand in now the only advanced OECD country without deposit insurance. Either the rest of the world has got it wrong or the RBNZ has got it wrong. It is a fair bet that it is the latter.

In the same vein, Treasury should lead a review of insurance policyholder compensation options, with a view to establishing a sensibly-structured scheme that provides interim cover for policyholders following the failure of an insurer and a mechanism for funding pay-outs to valid claimants and the transfer of long-term insurance (e.g. life or health cover) to another insurer in the event of an insurance failure. The absence of these arrangements creates a risk of major hardship for policyholders in an insurer failure and a greater likelihood of the government being pressured to undertake a bail-out (which is clearly undesirable).

Another failing in the RBNZ's approach to bank resolution is their preoccupation with stand-alone resolution for the Australian banks operating in New Zealand. They are embarking on an unjustifiable requirement for the Australian banks to either have local back-up for all core systems or other arrangements which enable the subsidiaries to operate on a stand-alone basis, at massive cost to the banks and their (New Zealand) customers. The RBNZ approach is based on a presumption that separation of the subsidiary from the parent bank is the optimal resolution option for New Zealand. They are wrong. The option that is most likely to produce the least-cost resolution for New Zealand is one in which the subsidiary remains in the parent group; this would almost certainly require lower capital injection than would be achievable in a separation and a much-reduced risk of destabilisation to the New Zealand financial system and economy. This can still be achieved via OBR by arranging for the conversion of liabilities in the subsidiary to equity in the parent bank, and a reciprocal cascading of equity from the parent bank to the New Zealand subsidiary.

The RBNZ should be required by the Government to enter into comprehensive cross-border coordination resolution planning with the Australian authorities, with a view to seeking to achieve an arrangement that minimises the resolution costs for New Zealand and Australia. Treasury should lead this process. I note that the Australian authorities have long been willing and ready to do this. The resistance has solely come from the RBNZ. In the meantime, lower-

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cost fall-back options for local functionality for stand-alone options should be actively pursued with the Australian banks in New Zealand. Much lower-cost options than those being required by the RBNZ are available, as submitted to the RBNZ by the four Australian banks in 2016. Sadly, these submissions have been largely ignored by the RBNZ. Real progress is only likely to occur if the RBNZ is directed by the Government to pursue this course and Treasury is actively involved.

I hope this submission is helpful. I am happy to discuss it with The Treasury.

Yours sincerely

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