Phase 2 of the Reserve Bank Review.

Review of current Financial Stability Role, Responsibilities and Institutional Arrangements

A decade on from the GFC and nearly 30 years since the Reserve Bank of New Zealand Act 1989 came into effect, we are long overdue an informed, thorough and bi-partisan review of our over-arching policy objectives, institutional arrangements, governance frameworks, operational delivery and preparedness in relation to financial stability.

Although the Reserve Bank is not the only agency involved in financial stability, its role is potentially better defined and more prominent than other. To do justice to the issues involved, a narrow focus on the Reserve Bank is counter-productive. Any review needs to consider the wider "system" and how the system as a whole operates as much as considering the roles, responsibilities and functioning of individual agencies.

The Reserve Bank of New Zealand Act 1989 dates from the period immediately following the substantial de-regulation of the New Zealand Financial Sector, including the move from a fixed to a floating exchange rate.

Like any legislation, the 1989 RBNZ Act is in part at least a reflection of the environment and events of its time. But those times were radically different to the current environment. For example, OBR was certainly not contemplated at that time and the banking sector was significantly smaller and less concentrated than it is now and by comparison, the levels of indebtedness that we now seem to take as given would have been considered almost unimaginable at the time.

These alone are good reasons to step back and consider whether the Act itself remains appropriate and more generally, whether the wider institutional arrangements in relation to financial remain appropriate.

Further, events such as the GFC also tell us about the need to expect the unexpected and the benefits of being prepared.

The approach to such a review is not rocket science. The key element for me however is undertaking a thorough and comprehensive current state assessment (strengths, weaknesses, opportunities etc). Understanding the current state is critical to meaningful consideration of the appropriate overarching objectives / goals in relation to financial stability.

The above would include:

- a thorough assessment of our preparedness in the event of a severe crisis impacting the financial sector;
- our understanding / confidence in the outcomes that we could expect to achieve using current tools;
- an assessment of alternative international models, especially those that operate within a similar environment; and
- equally thorough assessment of the performance / behaviours of the current agencies, especially around inter-agency engagement.

I expect that across the various agencies, much of this work has already been done.

Specific Issues

In terms of specific issues / observations:

- Bi-partisan support across parliament is critical, at least around the high level framework / goals and direction;
- I, and I know many others, do not consider OBR is currently credible. There is also real doubt over whether it could ever constitute a credible option:
    - Even accepting that the likelihood of a major systemic crisis is remote, we have no certainty around the real world consequences in the event we chose to deploy OBR;
    - We have another significant unknown in the form of Kiwibank, owned directly and indirectly by the Government. What is the likelihood that a future Government would stand by and let it fail (remembering that is precisely what OBR involves) and if they don't, how would they justify the preferential treatment accorded Kiwibank retail depositors compared to depositors in other banks;
- Australia remains a potential significant wild card. Australian owned financial institutions dominate New Zealand domestic landscape and an OBR type solution does not appear to be in their playbook:
    - It is unlikely that the actions of New Zealand authorities in areas such as BS11 (Outsourcing) is contributing positively to the trans-tasman relationship;
    - Can we be confident that contemplating the potential deployment of OBR in respect of the New Zealand subsidiary of a major Australian bank, Australian authorities won't pre-empt actions here – they will be at least as well informed, if not better, on the position of the NZ subsidiaries of their major banks as authorities here.
- The reality is that the Reserve Bank is not the only agency in New Zealand possessed of the ability to respond to a financial crisis. While a government bailout may not be an attractive option (but since we do not know with any certainty the full impact associated with OBR that is still a relatively subjective call), it is still an option:
    - And while the Reserve Banks powers are substantial, they are nonetheless constrained. If a trans-tasman solution were ever to be considered, it seems more likely that would be a government to government initiative lead by an agency other than the Reserve Bank.
- Depositor protection is a matter that deserves further consideration. Recent events involving CBL Insurance have highlighted one of fundamental tensions around prudential regulation:
    - I agree that withholding information is generally appropriate but when we preach *caveat emptor* on one hand and on the other, are complicit in deliberately withholding information that is highly relevant to the risks faced by existing and potential customers of the institution concerned, we need to consider how we reconcile the two beating the drum on market discipline is disingenuous;
    - Retail investors are poorly placed to evaluate credit risk at the best of times and if we want to maintain credibility, there needs to be a more balanced approach;
    - Depositor protection, within limits, is one obvious option.
- Independence is an area where we have taken a broad brush approach which is neither necessary nor desirable:
    - Prudential requirements at the system level are a risk / return trade-off;

    - Drawing the logical comparison with monetary policy, why should we be concerned with government setting the target for prudential policy when we are quite comfortable they do so for inflation;
    - The ultimate consideration in both cases is the broader real economy and we should not need reminding that Treasury is the Governments lead macroeconomic adviser.
- Crisis management and crisis resolution are specialist skills. If we reflect on the past decade, there is a depth and breadth of expertise in that sphere, including in relation to financial crises, that resides outside the Reserve Bank and Treasury for that matter:
    - Treasury at least is better integrated into a whole of government perspective:
    - [*redacted*];
    - If the status quo is to be retained, any review needs to ensure the institutional arrangements and overall governance framework are designed to deliver effective and meaningful cross agency co-ordination.

Conduct of the Review

It is my considered opinion that any review of over-arching policy objectives, institutional arrangements, governance frameworks, operational delivery and preparedness in relation to financial stability needs to draw on a wide range of experience and expertise; much more than is likely to be the case for the Monetary Policy Review.

There are many individuals, myself included, who have a depth and breadth and skills and experience that is directly relevant to such a review.

In my case, the 1 ½ hours I and two other external participants spent discussing the potential scope of the review with Treasury and Reserve Bank officials barely the scratched the surface. This submission goes further but is still far from comprehensive.

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