Attachment: Reserve Bank Act – issues for phase 2

Framing the Act

Should the Reserve Bank house both the monetary policy and bank supervision (and payments system policy/oversight) functions?[1]

1. This is not something I was going to raise, but I understand it has been raised by others. Hence, some brief elaboration on the issue.

2. One view (which I prefer) is that bank supervision is a natural – and necessary – extension of being banker to the banks (which is the sine qua non of being a central bank). If the bank supervision function was to be 'split out', as it is in some countries, eg, Australia, it would need to be on the basis that the Reserve Bank would maintain close collaboration with the separate supervisory authority (almost as if the central bank had 'outsourced' supervision to its 'sister agency'). A central bank cannot properly perform the function of lender of last resort without that.

3. Another consideration is whether, if bank supervision was to be split out from the Reserve Bank, the Bank would still need to remain involved with oversight of the banking supervision, for monetary policy purposes. It is more apparent now, post the GFC, than it was before, that the 'monetary conditions' facing firms and households are the result of more than just the monetary policy of the central bank; shifts in the policies and practices of the commercial banks – through which the central bank's policy is transmitted – also matter. Would some overlap, if not duplication would be the unavoidable result?

4. The case for splitting the functions seems to rest mainly on a view that bank supervision and monetary policy involve different skill-sets and aptitudes: at the risk of over-simplification, law and accounting versus macro-economics and a regulatory mind-set versus a more market-oriented mind-set – things that do not go together naturally, or well. But is that part of a problem to be managed, or is recognising and formalising a separation the better solution? When the Queen asked 'why did no-one see it (the GFC) coming?' should part of the answer have been: because 'we were too occupied in our own little worlds and did not see the larger picture'; or because 'we were insufficiently specialised and as a result missed detail we otherwise might have spotted'?

5. There is also a question about how many separate agencies a very small country like New Zealand can afford?

If the RBNZ is to retain its existing collection of responsibilities (for monetary policy, prudential supervision and the payments system), how to frame the Act to foster an integrated approach?

6. The 1989 Act turned the RBNZ into, primarily, a monetary policy institution. Section 8 expressly provided for monetary policy to be the Bank's 'primary' (widely understood as 'pre-eminent') function'; the other functions were separate and, more or less, 'clip-ons'.

---

[1] The principal question in these respects in New Zealand concerns whether to locate banking supervision within the Reserve Bank. Less attention is paid to the payments system. It is worth noting that when banking supervision was moved out of the RBA, the RBA was given a larger role with respect to the payments system – including taking over responsibility for competition policy issues (relating to access, interchange fees, etc). These aspects of payments system policy in NZ remain with the Commerce Commission and have received less attention than has been the case in Australia.

7. That is how things worked for a while, at least for the first decade or so. But today the Reserve Bank is playing a much wider role. The prudential supervision function is now the 'largest' function, at least in terms of staff numbers (having expanded from about 15 staff in the early/mid 1990s to about 70 today). Hence, there is a question whether statutory expression of the Reserve Bank's role now needs to be broadened? A step in that direction was taken in 2008, with the addition of a new section 1A which provides:

> **1A Purpose**
>
> (1) The purpose of this Act is to provide for the Reserve Bank of New Zealand, as the central bank, to be responsible for—
>
> (a) formulating and implementing monetary policy designed to promote stability in the general level of prices, while recognising the Crown's right to determine economic policy; and
>
> (b) promoting the maintenance of a sound and efficient financial system; and
>
> (c) carrying out other functions, and exercising powers, specified in this Act.

However, the section 8 designation of monetary policy as the primary function remained.

8. With the Act up for review again, is it time to take a further step toward casting the statutory role of the RBNZ more broadly, say, under an umbrella (unifying?) role of maintaining 'monetary stability', where monetary stability encompasses both 'price stability' (stability of the monetary unit of account) and 'financial stability' (stability of the monetary means of payment and store(s) of value)? [2, 3]

Another question concerns how much of the detail on all of that should go into the RB Act itself, and how much would be better located in separate legislation/regulation/policy statements.

9. The Act today (by numbers of section) is mostly a specification of the RB's financial sector supervisory functions (approaching 200 sections, compared with less than 100 for everything else). Might it be preferable to confine the RB Act to a statute focused on the RB as an institution (its constitution, governance and management), with just a 'bare bones' specification of its functions, leaving the detail for each of those to be located elsewhere; for example, in:

- A PTA (or its equivalent under a Monetary Policy Committee)
- A prudential supervision Act (or Acts – currently the detail of the bank supervision function is covered by the RB Act, but with separate Acts for supervision of non-bank deposit-takers and insurance companies); along with 'prudential' regulations or 'policy statements'
- A statute covering currency/payments/supervision of the payments system?

10. Might this kind of approach enable a more step-wise process for updating the Reserve Bank Act if, as seems possible, there will be a reasonably long list of quite big policy issues to consider (see below)? If such an approach were to be adopted, might that also enable the regime, subsequently, better to be kept up-to-date as policy circumstances, issues and understandings evolve?

[2] See Corrigan (1990) and Cunliffe (2018) for expansions on this kind of framing of the role of a central bank.

[3] The insurance supervision role does not fit with this conception of a central bank as a 'monetary' institution; it is more of a clip-on by virtue of being prudential in nature. This lack of 'fit' is another reason why it might make sense to separate out the supervisory functions, but the question remains whether that outweighs the inherent connection between a central bank and its customers, and also the limit on the extent to which a very small country can 'afford' multiple (separate) agencies.

Issues relating to the Constitution and Governance of the Reserve Bank's prudential role

Where should the boundary be drawn between policy & operational dependence/independence for the Bank's supervisory role(s)?

11. This is a question about where does 'policy' end and 'operations' begin?

12. The boundary is inherently more blurred for prudential policy than it is for monetary policy – at least when monetary policy is conceived of as being confined to use by the central bank of its own balance sheet. That limits the central bank to implementing monetary policy by either adjusting the interest rate at which it issues its liabilities (the OCR) or the credit terms on which it does that (something that is reasonably rare).[4]

13. Prudential policy works on a broader canvas. It not about the central bank's own balance sheet, but about the balances sheets of others. It therefore involves the property rights of others. How much scope should a supervisor have to determine the policy governing how it goes about doing that? The trick is to provide enough scope for the supervisor to be effective (not to 'tie its hands behind its back'); but no so much that it can trample over the rights of others unnecessarily and without good cause.

14. Here a little bit of the history on the evolution of the statutory basis for bank supervision in New Zealand might be useful.

15. In the beginning (under the 1986 Reserve Bank Amendment Act) the policy was to have no (prescriptive) prudential standards or ratios; once registered, based on a 'qualitative' assessment, banks were to be free to run their businesses as they saw fit, with intervention by the Reserve Bank reserved to if/when the bank was in, or was thought to be approaching, serious financial difficulty, or insolvency.[5]

16. The 1989 Act carried over the basic structure of the 1986 Act (which had been in effect for only a short while), but, inter alia, added some scope for the Bank to impose (and vary) conditions of registration relating to 'carrying on business in a prudent manner'.[6] These were to be confined to:

(a) capital adequacy;

(b) separation (from related interests);

---

[4] Although it did happen during the GFC, when the RBNZ (and other central banks) engaged in 'credit easing' i.e., a willingness to issue its liabilities in exchange for a wider range of 'collateral, to include those of greater credit risk than hitherto (e.g., residential mortgage-backed securities and some classes of commercial paper).

[5] See Doughty (1986).

[6] Under the 1986 Act, conditions of registration played a narrow role; eg, as 'conditions precedent' for the registration to take effect, for example, that the bank had actually to commence business. However, in what, arguably, was a departure from the envisaged policy of not applying any prudential ratios, initial new bank registrations were made subject to the condition that they maintain 'adequate capital' – with this being interpreted by reference to the (then forthcoming) Basel I standard. The four already existing 'trading banks' (then BNZ, Westpac, the National Bank and ANZ), were deemed by the Act to be registered and, therefore, were not subject to any conditions of registration, but were asked voluntarily to comply to the same standard.

(c) large exposures;

(d) internal controls

(e) such other matters as prescribed by regulation (this to require any extension of scope to be justified through the regulation-making process, in effect to 'keep the supervisors on a tight leash')

In implementing the Act, the Bank introduced conditions of registration relating to (a) and (b), but chose not to apply conditions in relation to (c) and (d).

17. In a 2003 amendment to the Act, the following were added:

(f) risk management systems and policies; and

(g) out-sourcing arrangements.

The first of these, arguably, substantially widened the scope of the Bank's policy independence with respect to prudential supervision – risk management policies is a reasonably broad term. Under it, the Bank has introduced prudential standards/requirements with respect to liquidity and the LVR restrictions that took effect in 2013. While the Bank and the Minister have entered into a memorandum of understanding on the scope of the Bank's 'macro-prudential' instruments, final decision-making rests with the Bank.

18. Which leaves questions about whether the boundary between 'policy' and 'operational' independence is appropriately drawn? There would seem to be at least two levels to this question:

- Is the present boundary, as above, too wide, too narrow, or about right?
- Is the boundary drawn in the appropriate manner; ie, the Act prescribes the matters on which the Bank can prescribe conditions of registration, whilst leaving it to the Bank to determine the policy to apply in each case?

19. A related consideration is the desired 'style' of supervision – 'black letter' prudential 'regulation' or a more discretionary 'risk-management' approach. A less prescriptive, more discretionary (risk-management based) approach unavoidably involves the supervisor having to have more independence to operate; whereas the regulatory approach is perhaps more amenable to policy (the regulations) being a matter for the government, and for the supervisor to administer.

20. While evolution of the Reserve Bank's prudential role since 1986 has been by no means entirely linear or unidimensional, the overall direction of travel seems to have been toward a more prescriptive and detailed 'regulatory' model. (Overall, that seems to have been the tendency internationally as well.) The Bank's prudential rules over time have tended to become more 'regulatory' in character; and certainly much more detailed (the Banking Supervision handbook, including prescription of the disclosure requirements, now runs to nearly 700 pages). [7]

21. There are some parallels here with the 'rules' versus 'discretion' debate in monetary policy. And in that regard, the inflation targeting framework we now have for monetary policy is often described as one which provides for 'constrained discretion'. Central banks have discretion in managing the short-medium run trade-offs, but subject to a long run constraint.

[7] For interesting insights on the tendency for supervisory requirements to have become increasingly detailed, see Haldane (2012)

Measurement and accountability frameworks

22. It is widely thought that central banks' monetary policy operational independence is founded on the ability to hold the central bank to account on the basis of whether or not it achieves the inflation target; and that for prudential policy there is no feasible counterpart.

23. But are the differences really that large? To be sure, (almost?) everyone agrees that 'inflation' is the only sensible thing for monetary policy to target in the long run. But does an inflation target provide a basis for holding the central bank to account for managing the short-medium run trade-offs, which arguably matter at least as much – as Keynes put it, "in the long run we are all dead"? Also, are we as confident as we once were that 'price stability' can sensibly be encapsulated in a single measure (such as the CPI)? Certainly we seem to be seeing an increased emphasis today on the 'flexible' in 'flexible inflation targeting', and a need to take a wider view of what constitutes 'price stability'. The 2012 PTA introduced a need to "monitor a range of prices, including asset prices", although for what purpose is not clear.

24. Regarding 'financial soundness' to what extent does our inability similarly to measure that stem from it being something that just, so far, has not received all that much attention? And with attention, might we be able to do better than hitherto? Of course, we already have some measures, such as capital adequacy ratios, although those have proved wanting. Most of the banks that failed during the GFC, on the day before they failed, met the regulatory standards of capital adequacy. The real issue was on the other side of the balance sheet – in particular loan asset valuations (they weren't worth what they were stated to be worth). Is that an area where we can do better – perhaps, for example, drawing on Minsky's typology of loan assets (hedge loans, speculative loans, and Ponzi loans) to categorise lending institutions' assets accordingly? Might something like that have given a better chance of having 'seen it coming'? History tells us that its poor credit practices (in particular, lending against asset valuations rather than the debt-servicing capability of the borrower) that lies behind most financial crises. Certainly, as we now know, a sizeable proportion of NZ finance company lending would have fallen into the 'ponzi' category;

25. In sum, when we stand back and take a look at measurement and accountability frameworks for monetary policy and financial stability policy, is it really the case that we have something that works well for one but not at all for the other? Or is it more a case that while measurement frameworks can get us so far in both spheres (with further to go in the prudential area); in both cases it is only so far? If so, where else do we need to look to build a robust framework for operational independence?

Decision-making checks and balances

26. Decision-making at the RBNZ on prudential matters occurs under the same governance and decision-making arrangements as apply for monetary policy. That is, all the decision-making powers of the Bank are vested in the Governor, with the Board playing performance monitoring and advisory roles.

27. There is a question whether that concentration of decision-making powers for prudential matters is appropriate. It generally is regarded as quite <u>inappropriate</u> for that kind of decision-

making power to be concentrated in the chief executive of a commercial bank; is it any less inappropriate in a central bank? This question did not receive any attention when the 1989 Act was constructed, given that the main focus then was on monetary policy and that the Bank's prudential role up until then had been very limited, and under the 1989 Act was to remain quite confined. That is no longer the case. Hence there is a question about whether the revised Act should retain a 'single decision-maker' for prudential matters or, as the Minister has ready decided for key monetary policy decisions, to shift the decision-making to a committee.

28. If it is thought that committee-based decision-making would be more appropriate (with a structure of delegations operating from the Committee downwards), there will be questions about:

- the composition of the Committee (executive members and non-executive members)
- the relationship with the Bank's Board of Directors, that is, if the Committee is not to be the Board of Directors.
- the relationship between the powers of the Committee/Board and the powers/role of the Minister. This includes with respect to both policy matters (what should fall within the province of the Board and what within the province of the Minister); and the exercise of intervention powers (in particular where to draw the line between 'business as usual' and 'reserve' powers', and whether additional checks and balances should apply in the case of the latter).

29. The current Act provides the RBNZ with powers to give a Bank a direction, and to initiate the cancellation of a bank's registration, or appointment of a statutory manager, but in all such cases reserves a role for the Minister, who must also agree.

30. The powers of direction, initially, in 1986, were confined to serious situations (insolvency, approaching insolvency, conduct that could cause damage to the financial system, etc), but in 1989 were extended to include 'failure to conduct business in a prudent manner' (see para 16 above). However, the Bank still could not, itself, give a direction to a bank, nor cancel a bank's registration for failing to comply with a condition of registration – those powers continued to require the agreement of the Minister.

31. In 2013, the Act was amended to make failure to have complied with a condition of registration an offence under the Act. This gives a 'dual' enforcement track – with the Governor additionally being able to take a prosecution in the Courts, and the Court able to impose monetary fines. This provides the Bank with a means of enforcing conditions of registration without having to resort to the (probably disproportionate) sanction of recommending cancellation of registration. The check/balance in these cases is in the Court rather than the Minister.

32. In sum, in reviewing the Act, it would seem opportune to review whether it provides the appropriate structure of checks and balances for exercise of the powers provided for in the Act, including for the exercise of 'reserve posers'. How should those be configured amongst the Governor, the Board (or Committee), the Minister, and the Courts?

Some current and prospective policy issues (that potentially bear on the construction of a revised RB Act)

Deposit(or) protection

33. Providing protection for deposit(or)s has never been one of the purposes of prudential supervision in New Zealand. Although it has generally been acknowledged that prudential supervision will have this (side) effect, to a greater or lesser degree, it has always been disclaimed as a 'yardstick' against which the effectiveness of prudential supervision should be assessed. Rather, provided the 'financial system' has not been significantly damaged, prudential supervision can be considered to have 'done its job'.

34. On this view, the only 'money' in New Zealand which the public can regard entirely as 'monetary' in character is the notes and coin liabilities issued by the Reserve Bank. Given that the Reserve Bank is bankruptcy proof,[8] those and only those, comprise money that can be regarded and used by the public as free from default risk.

35. Most (if not all) other countries see a wider role for the state in relation to the 'institution of money'.[9] They recognise that nowadays the money used as a monetary store of value and means of payment comprises mostly (overwhelmingly so by value) the money issued by commercial banks. And there is wide acceptance of there being advantage in this set of mixed, or two-tier, monetary arrangements, compared with the alternatives. The alternatives are, essentially, to bring everything within the central bank i.e., nationalise the banking system, or to have no central bank, i.e., 'free banking', under which each commercial bank issues its own, separate, currency.

36. One way of understanding today's mixed central bank-commercial bank monetary arrangements is in terms of the central bank having (largely) 'outsourced' the means of payment and store of value functions of money; whilst having retained to itself the unit of account function, that is, the right to define the national unit of currency. And arguably, just as central banks generally hold commercial banks responsible for functions they have outsourced,[10] most governments retain some responsibility for the functions of money they have 'outsourced'.

37. Typically this includes provision of 'deposit insurance', and the bank supervision that goes with that. On a bank failing, the insurer pays out on the insured deposits (more or less immediately), and has a corresponding claim in the liquidation of the failed bank's assets. The premium required to cover any shortfalls are paid by the banks, either ex ante, e.g., annually or, in some countries, only ex post a loss actually occurring.

38. More recently, post the GFC, an additional (or perhaps alternative) approach has emerged – in the form of proposals to 'ring-fence' the 'monetary' functions of commercial banks, and to confine the assets 'backing' the liabilities issued by that part of the bank 'inside the ring' to those that are

---

[8] Only a central bank can pay its liabilities with its own liabilities.

[9] See Cunliffe (2018)

[10] See BS11 in the Reserve Bank's Banking Supervision handbook. https://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/banks/banking-supervision-handbook/Final_BS11_200917.pdf?la=en

highly monetary in character, leaving 'risk' business outside the ring (the Volcker rule in the US, the Vickers rule in the UK and the Liikanen rule in the EU).[11]

39. Australia has had a long-standing, and in some respects similar, but also quite different approach. In Australia 'deposits' in Australia have a preference over all other obligations of a bank (in respect of assets in Australia). This provides a high level certainty that deposits will be paid in full; although, lacking a bank-specific 'resolution regime', that by itself has not provided assurance that they would be paid quickly. To address the latter need, Australia in 2008 introduced a 'deposit insurance' mechanism, under which deposits up to A$250,000 (increased to A$1m during the GFC) will be paid more or less immediately. The insurance fund would take over the deposit-holders' preferential claim against the (failed) bank's assets and, in the unlikely event, given the preference, of those being sufficient, also has recourse to surviving banks for payment of an (ex post) 'insurance premium'.

40. The RBNZ has held a long-standing view that arrangements such as these result in a material loss of market discipline – that removal of risk to depositors that their bank might become insolvent would sufficiently lessen market disciplines as to weaken, not provide an underpinning for, public confidence in 'money' (or if not that, result in an unacceptable fiscal burden).

41. More recently, however, the possibility has been floated of establishing, under the Open Bank Resolution procedure, a preference for deposit balances up to a (modest) capped amount; this amount to be available in full immediately, along with a percentage of account balances above the cap.

42. The distinctive feature of this (and the Australian) 'depositor preference' approach is that the remaining creditors of a failed bank carry all of any deficiency in the net assets of a failed bank (including that avoided by the 'preferred' depositors). This, perhaps, can be seen as reflecting a view that the preferred 'deposits' were never part of the bank's general funding, but more akin to money placed with the bank for 'safe-keeping', or under 'custodianship'. This differs from the traditional 'deposit insurance' model under which insured deposits participate in the loss on liquidation, but with that share of the deficiency in net assets covered by the insurance fund and, ultimately by the premiums charged to all banks.

43. With the Reserve Bank Act under review, is it opportune to consider what model New Zealand should adopt for the future? Options include:

- a traditional deposit insurance model?
- ring-fencing the 'deposit-taking' (or transactional deposits) business and making it (next to) bankruptcy proof (by confining the composition of assets 'inside the ring' to very low or no risk assets)?
- a depositor preference, either for all deposits (as in Australia), or for deposit balances up to a capped amount?
- some combination of the above (as in Australia)?
- none of the above, and retention of the status quo?

[11] I am unsure of the details on the extent to which these recommended approaches have so far been implemented.

The 'systemic' stability objective – what is it, and what does it mean?

44. The purpose of the RB's prudential supervision role is stated in the current RB Act as "promoting the maintenance of a sound and efficient financial system". Given the absence of a deposit(or) protection objective, the focus has been on maintaining confidence in, and the functioning of, 'the system'.

45. Which raises questions about what this means in practice? If adoption of a 'depositor protection' role and objective is not to be adopted, and NZ is to retain its distinctive focus on 'systemic' objectives, is there a need to be clearer about what those objectives are?

46. One interpretation is that supervision should be concentrated more on 'big' institutions than on small ones. The damage to confidence in and the functioning of the financial system is likely to be at least proportional, and perhaps more than proportional, to the size of a failed institution.[12] This focus on the size of an institution is reflected in section 73(2)(b) of the Act which lists, amongst others, 'size of the business or proposed business' as a factor to be considered in determining whether or not to register an institution as a bank. Does this imply that small institutions are not 'systemic' and therefore do not justify supervision for a 'systemic' purpose?

47. Focusing supervision on the 'too big to fail' institutions can be viewed as both necessary and problematic. Banks that are 'too big to fail' represent a (sizeable) risk to the financial system (and/or the government budget). But might recognition of this 'reality' actually exacerbate the problem, if it confers competitive advantage on the large banks, owing to their being perceived safer, and therefore able to raise funds more cheaply, than smaller banks. For these reasons, Mervyn King, former governor of the Bank of England, once said: "if a bank is 'too big to fail, it is [simply] too big".

48. The Reserve Bank's 'Open bank resolution' mechanism is directed toward mitigating the 'too big to fail' problem; by providing the means by which any bank (large or small) could be recapitalised, including from depositors' funds, and thereby prevented from 'failing'. In theory, with depositors equally exposed to loss, whether the bank is large or small, OBR 'levels the playing field'. Whether that is the public perception, however, is unclear, including given questions about whether OBR could credibly be operationalised. The IMF has commented with respect to OBR that "There are many complexities to be addressed if OBR is to be seen as a truly credible alternative to a bail-out." The IMF has also suggested that to be operationally credible, OBR needs to be legislated, rather than being left for the RB to implement using discretionary powers under the statutory management regime. [13]

49. Over-laying these issues is that the four largest banks in NZare owned by one of the four large (and systemically-important) banks in Australia. This parentage provides each of the New Zealand subsidiaries/branches with a 'source of strength'; and can also expose these banks to the travails of their parents. Both – the potential for support from, and exposure to problems in, the parent – will have reduced somewhat as the result of the policies adopted and implemented by the Reserve Bank in 2002-6, to raise some 'firewalls' between the banks in NZ and their Australian

---

[12] This interpretation is reflected in section 73(2)(b) of the Act which lists, amongst others, 'size of the business or proposed business' as a factor to be considered in determining whether or not to register an institution as a bank. Does this imply that small institutions are not 'systemic' and therefore do not justify supervision for a 'systemic' purpose?

[13]See http://www.imf.org/en/Publications/CR/Issues/2017/05/10/New-Zealand-Financial-Sector-Assessment-Program-Technical-Note-Contingency-Planning-and-44899

parents. The RBNZ introduced its outsourcing policy, which put a stop to outsourcing a range of functions, including to the parent group, if it would mean that the bank in NZ would lose the ability to operate in a crisis on a 'stand-alone' basis. APRA reduced the extent to which an Australian parent can support its NZ subsidiary.[14]

50. Another way of thinking about 'systemic risk', besides too big to fail, is in terms of 'inter-connectedness'. This has received a lot more attention since the GFC. But is it really anything new – or that should be new? It seems to imply greater recognition than existed before that banks carry a wide range of exposures within the system – not just direct credit exposures (from inter-bank lending and placements) but also market replacement risk (MRR) on 'in-the-money' derivatives, and a range of settlement and payments exposures.

51. But, arguably, there is nothing new in any of this. Well-managed banks will – or at least should – have been managing those risks, including by having had counterparty limits in place for all these risks and systems for monitoring exposures against those limits. But perhaps many banks were not so well manged in these respects? I do not have a much information on that but, what I do have, suggests it was at least part of the reason why, in the GFC, inter-connectedness within the system turned out to be such a critical point of fragility. Certainly, since the GFC, inter-bank/inter-institutional exposures have been substantially reined in. If this is a correct assessment, to what extent is 'inter-connectedness' a source of 'systemic risk' any more or different from all the other exposures that banks carry and need to manage? Is this what is meant by supervision in NZ having a 'systemic' focus or objective – that there is a particular focus on ensuring effective risk-management of the exposures within the system, so as to limit the extent to which problems in one institution can be transmitted to others? Is it in this sense that prudential supervision is thought of as having less of a deposit protection, or individual institution, objective, and to be more focused on the 'financial system'?

Macro-prudential policy

52. If these are things that might give NZ supervision a 'systemic' (rather than deposit protection) focus, what about macro-prudential policy? Where does that fit in?

53. The core idea seems to be that there is an (aggregate) credit cycle – a tendency for lenders, collectively, to ease credit standards 'over the cycle' until they over-reach, something that may become apparent only with an economic 'shock', whereupon they, again collectively, and abruptly tighten credit standards. The idea seems to be there is a tendency for banks to behave in a herd-like (systemic?) manner and that 'macro-prudential' policy has a role in moderating the cycle; or at least in making the system more resilient to the cycle.

54. The emerging practice has been to make systematic, and across the board, adjustments to prudential standards so as to 'lean against the cycle'. This contrasts with the more traditional approach to supervision which involves setting some baseline standards, and for supervisors to manage the risk from there, raising the bar when the risks being run by a bank are considered to warrant that (the so-called Pillar 2 of the Basel regime). The latter has parallels in how commercial

[14] Australian parents could previously provide contingent funding to their New Zealand subsidiaries (under APRA's APS 222) up to 50 percent of the parent's Tier 1 capital. APRA has since tightened its prudential requirements relating to related party exposures to the New Zealand subsidiary banks. The Australian banks have been required to reduce their non-equity exposures to 5 percent of Tier 1 parent capital. Source: http://www.imf.org/en/Publications/CR/Issues/2017/05/10/New-Zealand-Financial-Sector-Assessment-Program-Detailed-Assessment-of-Observance-Basel-Core-44903 Para 30.

banks manage the risks they carry on their customers. It requires the exercise of a fair amount of judgment and risk-management capability. Whereas macro-prudential policy involves more of a ‘regulatory, or ‘one size fits all’ approach – a common bar applicable to all banks, and which is recalibrated for all on the basis of shifts in credit policies and practices in the aggregate (or for the ‘average’ bank).

55. Clearly there is a spectrum here. That spectrum ranges from when prudential supervision was almost entirely judgmental (when the main instrument was the governor’s ‘eyebrows’), to detailed prescription, in effect regulation, of the policies banks are to follow, and systemic adjustments to those regulatory ‘levers’.

56. Most bank supervisors operate somewhere between the end-points on that spectrum, under regimes that involve some combination of ‘rules’ and ‘discretion’. For example, both the RBNZ and APRA have taken supervisory steps to ‘lean against’ relaxation by banks of their credit standards for residential mortgage lending. The RBNZ introduced quite specific and detailed LVR limits and APRA has issued a more wide-ranging ‘practice guide’ on residential mortgage lending, with a focus on debt serviceability. The RBNZ’s approach seems to have been more ‘regulatory’ in character than that of APRA, although the differences are perhaps more in ‘style’ than in substance – with the notable exception that of difference in the primary point of focus – adequacy of collateral in the case of the RBNZ, debt servicing capability in the case of APRA.

57. Clearly there are also advantages and disadvantages to a judgemental versus a regulatory approach. A rules (regulatory) based regime:

- is less prone to regulatory forbearance;
- is less resource intensive, or at least requires a different kind of resource – more regulatory (administrative) capacity, less risk-management experience.

But

- is more of a ‘one size fits all’ approach and may, over time, to see banks become more of the nature of utility companies, selling commoditised products;
- is more susceptible to missing the institutions that take (excessive) risks outside of what is covered by the rule-book; and/or
- can lead to ever-extending regulation.

58. The question here goes back to what ‘style’ of prudential supervision New Zealand is seeking? Everyone probably agrees that there needs to be a ‘macro’ element in prudential supervision. But is that best understood in terms of:

- (so-called) micro-supervision that is performed with ‘macro-awareness‘,i.e., ‘lifting one’s head off the page and taking in the broader picture of what is going on around you’; or
- applying ‘across-the-board’ prudential regulation (without paying much, or so much, attention to risk at the level of the individual institution)?

Where does NZ want to be on that spectrum? And what kind of legislative framework is needed to steer things in the desired direction?

Disclosure

59. Disclosure requirements have been a central element of the New Zealand approach to prudential supervision since its inception under the Reserve Bank Act 1986. That 1986 legislation

brought banks' deposit-taking within the scope of the prospectus requirements of the (then) Securities Act. It put bank deposits onto essentially the same footing as any other 'debt security' issued to the public e.g., a company raising funds by way of debenture securities.[15] This reflected a strong policy principle at the time that there should be a 'level playing field' covering anyone raising funds from the public.

60. However, banks were removed from that disclosure regime by the Reserve Bank Act 1989. There were issues under that regime arising from when a bank was in serious financial difficulty. The Securities Act prospectus regime was a continuous disclosure regime, requiring immediate disclosure of a material change in circumstances as soon as that became known to the directors (under penalty of strict liability for non-disclosure). There were also, for banks probably unworkable, 'machinery' requirements that kicked in pending the filing of a memorandum of amendment to the currently registered prospectus.

61. These features of the Securities Act regime brought some policy tensions to the fore when some banks encountered serious problems post the 1987 share market crash. It is well-established that, for a bank in serious financial difficulty to survive, 'the solution' needs to be announced at the same time as the problem. The Securities Act formulation did adequately not allow for that. Re-instatement of the exemption for deposit-taking by banks from the Securities Act requirements, and provision of a new disclosure regime for banks in the Reserve Bank Act (without the same continuous disclosure requirement) addressed those policy tensions, at least to some extent.

62. However, the underlying tension, between banks needing to keep the market continuously informed, and the need for time to develop solutions before releasing seriously bad news to the public, has not entirely gone away, including for banks that are listed companies subject to continuous disclosure obligations). This issue – of the tension between continuous disclosure obligations and avoiding premature disclosure of serious problems that could cause financial instability – is not unique to New Zealand. [16] But, in some respects, it may be more stark here, given the absence of 'deposit protection' arrangements and the correspondingly greater emphasis on disclosure as the means available by which depositors are to protect themselves.

63. There is a question concerning whether this 'circle can be squared' and if so how? Or does the present requirement that directors sign off disclosure statements at discrete but reasonably frequent (quarterly) interval strike about the best possible balance? Does this give the directors (and RB) enough time to come up with a resolution plan (unless they are unlucky and a serious problem emerges only shortly before the 3 month deadline?) And does it provide depositors with reasonable ability to protect themselves (unless they, unluckily, are caught out the other way)? Is it about the best that can be done? Or does it strengthen the case for some form of deposit protection?

64. A related question concerns the standard of responsibility that attaches to the directors who sign off a disclosure statement. Section 89A of the Reserve Bank Act provides for what seems to be something close to 'strict liability'. That is, an offence, including a criminal offence, is committed if information disclosed is not true (including not true by omission), unless it can be proven that there were reasonable grounds to believe, and it was believed, to be true (the onus of proof is on the

[15] Although banks remained exempt from the requirement to appoint a trustee to oversee compliance with the terms of the prospectus; given that the RB would be prudential supervisor.

[16] See, for example, https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/BoE-Waives-Banks'?pr_id=968075

director). This, I think, was taken in 1989 from the corresponding provisions of the Securities Act of the time. The successor to the Securities Act, the Financial Markets Conduct Act, places greater reliance on, and access to, civil redress; and requires that for criminal sanctions to be applied there must be some element of knowledge and fault. Would importing similar provisions into the Reserve Bank Act now be appropriate? Or, given the less strict obligations under the Reserve Bank's disclosure regime regarding continuous disclosure, is there a case for retaining a higher standard of responsibility for directors of banks, so as better to ensure that what they do disclose is not false or misleading?

Non-bank deposit-takers

65. Up until September 2008, so-called 'non-bank deposit-takers'[17] were 'regulated' under the Securities Act. That was essentially a disclosure-based regime, under which 'non-bank deposit-takers' were required to comply with the prospectus and trustee requirements of that Act[18]

66. In 2008, the Reserve Bank Amendment Act 2008 introduced a transitional regime for non-bank deposit-takers, basically providing for hitherto self-determined prudential standards included in trust deeds to be prescribed by the Reserve Bank, but still monitored by Trustee companies.

67. In 2013 this transitional regime was replaced by a new Non-bank Deposit-takers Act. This introduced a requirement for non-bank deposit-takers to be licensed, and also a more developed supervisory framework (including RB determined prudential standards), although with monitoring still to be undertaken by (licensed) trustee companies.

68. Between 2006 and 2012, approaching 70 finance companies in New Zealand failed, with losses that have been estimated at over $3 billion that affected between 150,000 and 200,000 depositors. Comparatively few 'non-bank deposit-takers remain operating under the Non-bank Deposit-takers Act.

69. There is a question whether the stage has been reached where the separate supervisory arrangements for registered banks and non-bank deposit-takers should be folded into a single regime? Could that be done, for instance, by restricting use of the word 'deposit', as well as the word 'bank', to registered banks only? This would bring New Zealand into line with the Australian regime, where to take deposits an institution, including banks, must be licensed and supervised by APRA as an 'Authorised Deposit-taking Institution' (ADI).

---

[17] Defined as institutions borrowing and lending money, and encompassing institutions commonly known as 'finance companies', building societies and credit unions.

[18] The trustee requirements were essentially that the issuer execute a trust deed, which could include (self-determined) prudential ratios, which the appointed trustee would monitor compliance with. It had some of the characteristics of a 'self-regulation' model.

e-Money

70. The current Reserve Bank Act includes a number of sections dealing with currency (bank notes and coin). Looking ahead, there is question whether the Reserve Bank Act will need to cater for new forms of central bank money – e-money.

71. Questions are starting to be asked about whether usage of central bank notes and coin increasingly is being accounted for by the ‘underground economy’. The fact that the highest denomination notes comprise a steadily increasing proportion of the value of notes on issue is consistent with this possibility, i.e., the share accounted for by notes used for making ‘everyday’ payments is declining. (In NZ, the share accounted for by $50 and $100 denomination notes has increased from 50% in 1998 to 73% in 2017, while the share accounted for by $10 and $20 notes has fallen from 45% to 24%). The very low level of interest rates during the past decade may also have been a factor in this shift, with high denomination notes having been used as a store of monetary value to a greater extent than when interest rates were higher.

72. Nowadays, retail payments mostly entail electronic transfer of commercial bank issued (deposit) money, using debit cards, credit cards, phone apps and internet banking. This has raised the question whether central banks should also provide electronic means by which people can hold, and make payments using, central bank electronic money. On way to achieve this would be for people to hold central bank money in electronic form directly (in effect, as a balance with the central bank). Another, amounting to much the same thing, wold be for central bank money to be capable of being carried in an ‘electronic wallet’ such as a stored value card, or on a mobile device (the electronic equivalent to a ‘paper’ bank note). The Reserve Bank of Australia has recently discussed these possibilities (see Lowe (2017).

71. While it is probably too early to be making legislative provision for the Reserve Bank to issue ‘e-dollars’, it is a subject that nonetheless has a bearing on some contemporary issues – in particular relating to deposit protection. If electronic forms of money at some stage begin to take over from physical notes and coin (at least in the ‘above ground’ economy), there will be a question whether those should be available only as commercial bank issued money (as now) or also as central bank money. And if the latter, whether central banks should run the technology for that, or perhaps ‘outsource’, including, as one possibility, have commercial banks provide the central bank e-money as ‘agent’ for the central bank. Or, equivalently, for commercial banks to issue e-money guaranteed by the central bank, in effect, equivalent to how commercial bank money up to certain amounts today in most countries is ‘guaranteed’ (by a deposit insurance fund).

72. These are not questions that need answers now. But it will be evident that that are not unrelated to current issues regarding the status of bank-issued money relative to central bank issued money (deposit protection). In addressing those, would it be just as well to do so with half an eye to the future?

References

Corrigan, E. Gerald, *Central Banks and the Financial System*, Speech on Central Banking Issues in Emerging Market-Oriented Economies at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 23 - 25, 1990

Cunliffe, Sir Jon, *Looking after our money*, Speech given by Sir Jon Cunliffe, Deputy Governor Financial Stability, Member of the Monetary Policy Committee, Member of the Financial Policy Committee and Member of the Prudential Regulation Committee University of Warwick Monday 26 February 2018

Doughty, Andrea, *New Banks and Financial Structure Reform*, in Financial Policy Reform, Reserve Bank of New Zealand, 1986.

Haldane, Andrew G., *The dog and the Frisbee,* Speech by Mr Andrew G Haldane, Executive Director, Financial Stability, Bank of England, and Mr Vasileios Madouros, Economist, Bank of England, at the Federal Reserve Bank of Kansas City's 366th economic policy symposium, "The changing policy landscape", Jackson Hole, Wyoming, 31 August 2012.

Lowe, Philip, An eAUD?, Address by the Governor of the Reserve Bank of Australia to to the 2017 Australian Payment Summit, Sydney – 13 December 2017.