THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Treasury Report: Summary of Stakeholder Engagement on the scoping of Phase 2 of the Review of the Reserve Bank Act

Date:	21 March 2018	**Report No:**	T2018/721
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the summary of stakeholders' views on the scoping of Phase 2 of the Review of the Reserve Bank Act **Refer** this report to the following Associate Ministers of Finance – Hon Parker, Hon Jones and Hon Shaw	23 March 2018

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
James Haughton	Senior Analyst, Financial Markets	9(2)(k) (wk)	n/a (mob)	✓
Chris White	Director, Commercial Operations	9(2)(k) (wk)	9(2)(a) (mob)	

Actions for the Minister's Office Staff (if required)

Refer this report to the following Associate Ministers of Finance – Hon Parker, Hon Jones and Hon Shaw

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Treasury Report: Summary of Stakeholder Engagement on the scoping of Phase 2 of the Review of the Reserve Bank Act

Purpose of Report

1. This report provides you with a summary of the views emerging from stakeholder engagement on scoping Phase 2 of the Review of the Reserve Bank of New Zealand Act 1989 (the Review) and is intended to help you in making recommendations on the scope of Phase 2 of the Review. This report has been agreed by both Treasury and the Reserve Bank.

2. A draft of this report was attached to the Treasury report: Reserve Bank Act Review: Fourth Independent Expert Advisory Panel Meeting March 2018 (refer to T2018/598) and referred to in the Treasury Report: Announcement of Phase 1 of the Review of the Reserve Bank Act 1989 Decisions and the March 2018 PTA (refer to T2018/652). There have been no substantive changes between this final version and the draft previously provided.

Background

3. The summary is largely based on stakeholder meetings hosted by the Treasury that were held under "Chatham House Rules" during February and early March. The summary is therefore thematic with no views attributed to any individual or institution. The Reserve Bank participated in meetings not involving regulated industry (such as economists and academics) and a member of the expert panel participated in meetings with regulated industry (such as banks and their advisers).

4. Views were sought from a range of stakeholders, including industry, economists, academics and financial consultants. The range of views and focus areas will inevitably be influenced by the degree of interaction with the Reserve Bank and industry experience. This summary of stakeholder feedback makes no attempt to evaluate the views of individual stakeholders.

5. 18 written submissions were received on Phase 2 and are listed in the appendix. These submissions are incorporated into this summary and will be published in due course.

6. We have grouped the views of stakeholders into the following topics:

   a Scope of the review

   b Purpose and objectives

   c Decision making and governance arrangements

   d Prudential regulation

   e The macroprudential framework

   f Resolutions and crisis management

g Supervision

h Resourcing

i Relationship with the Australian Prudential Regulation Authority

j Other issues

Scope

7. Many stakeholders were supportive of a review with a broad scope focusing on financial policy. There was not full consensus on all issues and not every stakeholder raised every issue. However, when the views of stakeholders are aggregated, a picture emerges of a desire for a comprehensive review.

8. Many stakeholders focused their comments on specific aspects of financial policy, covering issues such as objectives, decision making and governance, the prudential framework, supervision, crisis management and resourcing.

9. While stakeholders expressed a wide range of views, a number of issues that stakeholders raised may inform but do not directly relate to the legislation and could be addressed in other ways. Some of these matters relate to the inter-connected policy mandate, supervisory approach, internal processes and relationships with agencies and industry. Careful thought is required as to which issues should be advanced as part of a legislative package and which could be explored through alternative avenues.

10. Many stakeholders emphasised that the context, risks, international practice, roles and responsibilities had changed significantly over the past thirty years. These stakeholders tended to argue that now was a good time to have broad review to assess how well the current Act reflects best practice and addresses the current challenges we face. Some of these stakeholders noted the focus on independence for monetary policy and a disclosure based regime at the time of enactment as opposed to a platform for extensive prudential regulation. Some stakeholders questioned the focus on market-discipline and whether the Open Bank Resolution Policy (which allows for a distressed bank to be kept open for business while placing the cost of a bank failure primarily on the bank’s shareholders and creditors (which includes depositors)) was realistic. Many stakeholders thought that bailing in depositors could be problematic for the government although a number acknowledged that the focus for the review should be on protecting depositors and not on bailing out the failing bank

11. While there was strong support for a broad based review of financial policy, the majority of stakeholders noted that a broad review would be a very significant task. Some stakeholders noted that decisions had been consciously taken previously to depart from international norms, some of which focused on New Zealand not having deposit insurance. A number of stakeholders cautioned against extensive legislative change and suggested that other instruments could be used to address some of the issues. Others noted that the Reserve Bank had many other functions beyond financial policy and questioned how a review would affect these functions.

12. Some stakeholders noted that they were satisfied with the current framework and supported an incremental approach to the review. These stakeholders thought no clear problem definition had been provided and pointed to the fact that the Reserve Bank had been able to adapt its approach within the current framework. These stakeholders also noted that the regime was fundamentally appropriate and pointed to the fact that New Zealand had come out of the financial crisis relatively unscathed. Further, these stakeholders warned against a broad review, noting the time it would take to undertake such a review, and that it could lead to worse outcomes.

Purpose and Objectives

13. There was general consensus that clear objectives and purpose is important and strong support for reviewing the objectives and purpose of the Reserve Bank. Many stakeholders argued that clear objectives provide greater clarity of roles, accountability and legitimacy. There was a range of views expressed with some focused on reviewing the objectives and responsibilities and others focused on clarifying the current objectives.

Overall objectives and purpose of the Reserve Bank

14. Many stakeholders thought the objectives and purpose of the Reserve Bank should be revisited. Some stakeholders thought greater attention needed to be given to stable economic growth and welfare as the overall objective and focus on the Reserve Bank's contribution to this objective. There was general agreement that the objectives should be linked to what the Reserve Bank can control and influence, and that it would be unreasonable to burden the Reserve Bank with objectives that it has an insufficient ability to control.

15. Several stakeholders thought the current objective centred on systemic stability is too narrow and that it was legitimate to consider the interests of depositors and the soundness of individual institutions. Some stakeholders noted that there was disproportionate emphasis by the Reserve Bank on monetary policy and wanted to see equal weight given to financial stability given the enormous costs and distributional effects a crisis involves.

16. Several stakeholders emphasised that objectives should be dynamic and should allow flexibility to respond to changing conditions. Most stakeholders cautioned against objectives that are too prescriptive and preferred higher level goals or objectives that the Reserve Bank is responsible for achieving. Given the need for the Reserve Bank to be able to evolve, the objectives need to be flexible enough to allow this.

17. Some stakeholders thought the objectives were set at an appropriate level and if they are added to it would create complexity, blur accountability and potentially undermine the Reserve Bank's independence.

Lack of clarity

18. Many stakeholders thought the current objectives needed further clarity. Some highlighted the balance between soundness and efficiency and expressed a view that there is a disproportionate focus on soundness.

19. A number of stakeholders noted that the current objectives of soundness and efficiency were broad and argued for greater clarity on how performance against the objectives is assessed. A number of stakeholders noted the reach of prudential regulation encompassed multiple objectives and that there was potential for conflict across objectives and other policy areas. Some stakeholders thought greater clarity was needed around overlapping policy areas and responsibilities. They suggested tools that could assist such as secondary objectives, legislative principles, government policy statements and policy target arrangements.

Depositor objectives

20. There was strong support for reviewing how the Reserve Bank considers the interests of depositors. Some stakeholders questioned whether the current supervisory structure, which has developed out of the objectives of the Act, focused too much on the soundness of the financial system and not sufficiently enough on looking after depositors. Several stakeholders thought depositors should be at the heart of the framework given their critical importance to bank viability. Several stakeholders queried whether the Reserve Bank had a sufficient mandate to consider depositors under the Act and noted the contrasting position in Australia.

21. A number of stakeholders pointed to political reality and that in a crisis politicians would want to protect depositors and suggested that introducing some form of depositor protection should be considered.

Decision making and governance

22. Many stakeholders had views on decision making and governance of the Reserve Bank, suggesting that this area should be a priority for review. There was not consensus on all issues and not every stakeholder raised every issue. However, there was some overlap in the range of issues expressed and a general consensus that governance and decision making around prudential regulation should be reviewed.

The board, accountability and process

23. Most stakeholders thought the current arrangements with the Reserve Bank Board (the Board) was unusual and a number argued that it did not provide an effective accountability framework. They expressed a range of views on this topic including:

    a. A number of stakeholders argued that the Board should have a clear mandate and objectives covering all the Reserve Bank's primary functions and strategy.

    b. Other stakeholders emphasised that the Board only had a monitoring role and thought the Board did not provide sufficient challenge to the decisions of the Governor. They thought that the Board should have a genuine governance role and scrutinise the actions of decision makers. These stakeholders argued the Board should function more like a typical company board with cascading delegations from the board to the executive.

    c. Some stakeholders argued that the skills and expertise of the Board needed to be reassessed to ensure it covered the Reserve Bank's main functions and could provide the challenge role required.

d Several stakeholders argued that alternative governance and accountability models should be considered. The Financial Markets Authority, the Commerce Commission, the Australian Prudential Regulation Authority (APRA) and the Prudential Regulation Authority (the PRA) in the UK were noted as examples.

24. A number of stakeholders thought that the Board arrangements could be improved but questioned the focus on the governance arrangements alone. Several stakeholders expressed concerns about the line between governance and management being blurred and noted that the Board is not intended to be a decision maker. Other stakeholders argued that the Board should not be looked at in isolation from the whole decision making and accountability framework. One stakeholder argued that a number of departments and agencies effectively operate under a single decision maker model with no formal governance arrangements.

25. A few stakeholders noted that where an agency is responsible for both policy and review there can be accountability problems. These stakeholders argued that the Reserve Bank should not have administrative responsibilities for any legislation that confers powers on the Reserve Bank on the basis there may be an inherent conflict of interest.

26. However, several stakeholder thought the current governance arrangements were largely fit for purpose and that caution should be applied when looking at this area as they considered that there was not a problem to be addressed.

The independence of the Reserve Bank and the role of the Minister of Finance

27. Many stakeholders argued the case for independence in monetary policy was well made but less clear in financial policy. These stakeholders tended to raise concerns about the reach of financial regulation and distributional effects. Many stakeholders thought that the Reserve Bank should be operationally independent for prudential regulation but that there is also a role for government in setting the objectives and policy direction. In general, there was no consensus on what operational independence looks like outside of monetary policy. These stakeholders expressed a range of views including the following:

a Some stakeholders supported reviewing the roles and responsibilities between the Minister of Finance and the Reserve Bank. They typically emphasised the need for clarity and transparency of process.

b Most stakeholders agreed that the Minister should not be involved in operational decisions or decisions on individual regulated entities. A few stakeholders thought the Government should be involved in decisions about the setting of the rules but not in the enforcement of the rules. However, others raised concerns about politicising financial stability issues and supported the Reserve Bank's independence in rule making, noting that an institution with a longer term view should be undertaking this policy making process with suitable accountability and transparency under the Act.

c A few stakeholders argued that the Minister should be involved in matters involving higher level policy or direction decisions and matters relevant to the Ministerial Portfolio (such as fiscal or systemic risk). A couple of stakeholders noted the Reserve Bank's discretion in crisis management had led to policies such as the outsourcing policy and Open Bank Resolution. They argued that these decisions needed Ministerial involvement because they involved judgments about how to best protect New Zealand's financial system.

d There was debate about the appropriate mechanism for government involvement but no consensus. Stakeholders noted tools such as a policy targets agreement, government policy statement, memorandum of understanding, statement of intent and direction powers as examples. A number of stakeholders thought the existing framework provided sufficient scope for government involvement. While some stakeholders noted that the Government already had the ability to use section 68B to issue a government policy statement with which the Reserve Bank must have regard to, one stakeholder noted the section 68B powers of direction were more of a "nuclear option" that would never really be used in practice. However, another stakeholder said that because section 68B had not been used that it may be perceived as a "nuclear option" even though in essence it is not.

Separation

28. A number of stakeholders suggested exploring separating out the responsibility for monetary policy from prudential policy and supervision. Although these stakeholders agreed that the question of separation should be part of the review, there were mixed views about the merits of separation.

29. Some stakeholders favoured structural separation and argued that it would result in a culture of better decision making and create a platform for change. Several of these stakeholders thought the question of separation is fundamental to the review and noted other advanced countries had moved in this direction. These stakeholders tended to emphasise factors such as the different skill sets required, role clarity and mandate, and practical issues such as resourcing in support of their position.

30. Some stakeholders were either against separation or not convinced on the merits of separation. Those stakeholders focused on the synergies of the skills and knowledge required for monetary and financial policy and to argue that separation would not only be disruptive and extremely costly, but it would not necessarily lead to better outcomes. Some of these stakeholders pointed to the experience in the United Kingdom throughout the global financial crisis (GFC) as an example and noted that the Prudential Regulation Authority has been brought back into the Bank of England following the GFC. Others voiced concerns about fragmentation and co-ordination failures.

Committees

31. There was general support for a committee decision making model although a number of stakeholders did not have strong views. Those in favour tended to point to the greater diversity of skills and expertise as being beneficial. There was also general agreement that introducing a committee would introduce additional complexity and that a committee framework would need to be carefully considered. These stakeholders noted the complexities involved in setting up a committee including skills and expertise, conflicts of interest, resourcing and mandate. A number of stakeholders emphasised the importance of clear objectives and a clear decision making mandate.

32. A number of stakeholders were not convinced of the need for separate macro and micro-prudential committees.

33. However, some stakeholders were not supportive of a committee structure and thought the single decision maker model worked well. These stakeholders pointed to a lack of problem definition and the complexities involved in setting up a committee. These stakeholders argued that if a committee structure was chosen, the design would need careful consideration, including skills and expertise, internal versus external representation, conflicts of interest and accountability arrangements.

Co-ordination

34. Some stakeholders noted the connections between monetary, fiscal and prudential policy and thought that decision making in these areas needed to be better co-ordinated. A few stakeholders suggested that there is a monetary policy and fiscal policy disconnect, in part because they considered that the framing of the Act is around monetary policy.

35. A few stakeholders thought there could be better co-ordination and co-operation among agencies.

Prudential regulation

36. Many stakeholders had views on prudential regulation and a number supported a comprehensive review of the regime. Some of these stakeholders noted the change in the last 30 years in terms of powers, risks and international practice as forming a case for a comprehensive review. However, there was not full consensus on all issues and not every stakeholder raised every issue, but there was some overlap in the range of issues expressed. One stakeholder summarised the key questions as:

    a What is the appropriate framework to use?

    b What sort of process should the Act provide for introducing new conditions and amending existing conditions?

    c What are the appropriate review and accountability mechanisms?

    d What is the appropriate level of government input?

Choice of framework

37. Some stakeholders questioned whether the conditions of registration model was the best basis for regulating banks. A few of these stakeholders wanted clarification of the relationship between the conditions of registration and the banking handbook. A few stakeholders noted that conditions of registration are administrative instruments and subject to limited regulatory oversight (for example, scrutiny by the regulations review committee).

38. A few stakeholders were critical of the conditions themselves. These stakeholders tended to note that conditions were often unclear, there were no materiality thresholds and limited guidance was provided. Issues noted included the following:

    a Unclear conditions put directors in an awkward position given they need to attest to the correctness of all information disclosed.

    b The need for materiality thresholds. The lack of materiality thresholds means that every breach must be disclosed even if it is minor. This takes up a lot of time and is inefficient.

    c There is limited guidance on conditions and the regulator takes a hands-off approach to engagement with industry.

39. Suggestions for improving the regime included having standard conditions and including these in secondary legislation, introducing materiality thresholds, proportional fines or penalties, better use of other regulatory tools, further guidance and engagement with industry and drafting by the Parliamentary Counsel Office.

Regulatory process

40. Some stakeholders felt that engagement and consultation processes were not adequate. A number were unclear on how feedback is treated. A small number thought that decisions were already pre-determined.

41. Some stakeholders were of the view that a lack of suitable skills and expertise is impacting the Reserve Bank's ability to conduct an effective regulatory process. This was related to more general concerns about the adequacy of resourcing discussed at paragraphs 73 and 74 below.

42. A number of stakeholders suggested that the impacts and costs of regulation were not sufficiently considered. The outsourcing requirements were identified as an example.

Review and accountability mechanisms

43. A number of stakeholders felt that the Reserve Bank had too much discretion and that there is limited ability to appeal decisions. The ability to judicially review decisions was not seen as a realistic option for regulated industry. A number of stakeholders noted that judicial review had never been used, suggesting that it is not an effective appeal mechanism.

44. There was no firm view on the type of review process that should be in place. Most stakeholders engaging on the topic did not support appeals for standard conditions but thought non-standard conditions should have an appeals process. Better drafting, guidance, regulatory impact analysis, consultation and engagement would also assist with accountability issues.

Level of government input

45. See comments at paragraph 27 above on the independence of the Reserve Bank and the role of the Minister of Finance.

The disclosure based model

46. A number of stakeholders had views on the disclosure based model underpinning prudential regulation. These views included:

    a Some stakeholders were sceptical about the emphasis on disclosure as being an effective mechanism for market discipline. A few stakeholders argued there is a misplaced focus on market discipline when it came to depositors as they may not be well placed to appropriately exercise this. One stakeholder noted that debt instruments are unresponsive to price signals so these may not incentivise market discipline because many market participants consider there to be an implicit government guarantee of the large banks.

b Others suggested that disclosure is a very effective mechanism for imposing self-discipline on directors and encouraged further and better targeted disclosure. Some stakeholders were supportive of disclosure but noted that it is more effective when raising money from the wholesale market.

Macroprudential

47. There was general recognition by most stakeholders that macroprudential policy is a useful tool to deal with some risks to financial stability. Views expressed by stakeholders tended to focus on the objectives and legitimacy, and the policy process.

Objectives and legitimacy

48. A number of stakeholders thought that greater transparency is needed on what the policy is being used for and its distributional effects. These stakeholders tended to note overlap between monetary, macroprudential and other government policy. A number of stakeholders noted the distributional effects of macroprudential policy and suggested there was a clear role for the Minister of Finance here. These stakeholders argued for a clearer delineation of powers and responsibilities between the Reserve Bank and the Minister of Finance, together with a mechanism for tackling tensions between competing policy objectives.

49. Several stakeholders suggested that the status of macroprudential policy as distinct from prudential policy more generally is not clear. They argued for (1) greater transparency on what is distinct about macroprudential policy, (2) clarity on the co-ordination between macro-prudential and other prudential policy and (3) analysis of the implications that arise from addressing these aspects. A few stakeholders noted the Memorandum of Understanding had no statutory basis and therefore raised issues about the legality of the policy.

50. A few stakeholders debated the efficacy of the macroprudential tools available and suggested there could be a case for clearer objectives or outcomes linked to macroprudential policy.

Policy process

51. A number of stakeholders identified issues with the process of implementing macroprudential policy. Some of these stakeholders argued for implementation criteria so that the market had more certainty on when macroprudential tools would be deployed and withdrawn. Some stakeholders wanted to see more analysis of the effectiveness of the tools and what other alternatives are available to deal with the risks identified. Other stakeholders wanted more consultation and engagement.

Resolution and Crisis Management

52. There was extensive engagement on this topic and some stakeholders thought the whole resolution regime needed to be reviewed. As a general comment, stakeholders tended to suggest that the resolution regime is grounded in theory but that some options may not be workable practically or politically palatable. They argued that there needs to be consideration of other options for resolution and a broader discussion on the objectives of the crisis management framework.

Crisis management and Open Bank Resolution (OBR)

53. A number of stakeholders argued for greater recognition of government's role in the crisis management regime and questioned the premise of the current regime.

    a Some stakeholders thought the government should be responsible or have a role in setting the policy direction for crisis management having regard to the fiscal implications and distributional impacts arising from failure. These stakeholders tended to emphasise the complexities, political realities and the judgment required.

    b Some stakeholders noted the overlapping mandates of different agencies and wanted to see greater clarity on roles and responsibilities for crisis governance.

    c Some stakeholders noted that the crisis management framework is premised on the assumption that systemic banks can fail but questioned whether the government would actually let a systemic bank fail in practice. A few stakeholders argued that the asset and liability profile of the big banks is very similar so if one bank fails the others are likely to follow. A few stakeholders suggested that the market considers there to be an implicit guarantee in place for the banks.

    d A few stakeholders argued that the government needs to be very clear that it is not in the business of bailing out banks. Any crisis management regime needs to be clear about this.

54. Many stakeholders thought the crisis management regime had significant limitations. OBR in particular was highlighted as a policy that lacks legitimacy, will not work in practice and is insufficient as a standalone tool. The lack of attention to depositors was also highlighted. A number of stakeholders suggested that the risks and implications of the crisis management regime needed rigorous analysis and that not all options had been considered. Some stakeholders thought the current crisis management regime is having a detrimental effect on the New Zealand banks' relationship with their Australian parents and suggested more could be done to co-operate and work with the Australian authorities despite the political constraints.

55. Several stakeholders cautioned against making the regime too prescriptive given that a crisis is hard to predict. Any regime needed to be dynamic, provide clarity on roles and responsibilities, and empower agencies to act.

56. A number of participants emphasised the importance of doing the analysis and implementation in advance during a time of stability. A couple of stakeholders noted the deposit guarantee scheme implemented during the GFC as an example of a scheme that was not well thought through and involved undue loss. There was general agreement on looking at international norms and best practice to inform New Zealand's approach.

Depositor protection

57. A majority of stakeholders raised the interests of depositors and a number of these stakeholders raised the merits of a depositor protection regime. Most stakeholders that engaged on depositor protection supported it being included in the review. A number of stakeholders considered that depositor interests were not sufficiently addressed under the current regime and that depositor protection could assist. These stakeholders tended to argue that the current system placed undue weight on disclosure and the avoidance of moral hazard.

58. While there was support for reviewing the merits of depositor protection, most stakeholders tended to note the complexities and costs involved with depositor protection and suggested the design would need to be carefully considered. As an example, a number of stakeholders noted that depositor insurance would be expensive. Pre and post funding models were discussed with no consensus. Two stakeholders supported pre-funding but noted the costs involved. The Australian post funding model was discussed but one stakeholder said that the depositor creditor preference meant it is very unlikely the insurance would ever be called upon.

59. Some stakeholders emphasised the importance of being clear about the problem that depositor protection is addressing (avoiding depositor runs for example). Several stakeholders argued that depositor protection could work alongside OBR and suggested that the review should consider fixing the de minimis amount under OBR to provide greater certainty and possibly to provide an alternative to full depositor insurance. A few stakeholders argued that any scheme would need to be clear that it is directed at depositors not institutions which should be able to fail if they get into distress – they were clear that banks should be allowed to fail.

60. One stakeholder was not supportive of depositor insurance on the basis the depositors can manage risk and depositor insurance erodes self-discipline.

Supervision

61. Many stakeholders had views on the Reserve Bank's supervisory approach and supported it being reviewed. There was debate about the appropriate level of supervision with no clear consensus. Discussion tended to focus on the balance between market and regulatory discipline, accepting that some risk needed to stay with the sector. Many stakeholders thought the supervisory functions of the Reserve Bank are insufficiently resourced.

Supervisory approach

62. Stakeholders' views were very mixed, with some starting from a premise that more intensive supervision is required, others that a low-intensity framework is fundamentally appropriate, with directors and the market having primary responsibility for risk. Thus, although there may be appetite for change, the suggestions for the direction of change are often mutually incompatible.

63. Stakeholders typically agreed there were legitimate choices on supervisory approach which depended on the objectives and responsibilities of the regulator. One stakeholder described a spectrum with a typical regulator making rules and assessing compliance at one end and a risk manager applying judgment on the risks organisations face at the other. Several stakeholders argued that it is not the Reserve Bank's role to cover all risk – this is primarily a job for the institutions. The question is ultimately about risk appetite and the balance between market and regulatory discipline. One stakeholder noted alternative risk mitigation strategies, such as high capital requirements, which shift risk onto the sector.

64. Several stakeholders acknowledged that the Minister of Finance had some role in influencing the supervisory approach taken by the Reserve Bank, though there was not extensive discussion on what the mechanism could be. Some stakeholders argued that it was not appropriate for the Act to prescribe the supervisory approach and that the objectives or principles of the Act will influence this.

65. Many stakeholders were sceptical of some of the IMF's recommendations on supervision contained in its most recent Financial Sector Assessment Program for New Zealand (FSAP). Some of the views expressed included:

a The IMF focus on numbers and headcounts but the quality of resource is more important.

b Regulatory inspectors could not do a better job of risk identification than the institution itself.

c The idea that more intensive supervision will result in better risk identification is misplaced. One stakeholder pointed to some recent financial disasters that were completely missed by auditors who had gone over company books with a fine tooth comb. They argued that if the auditors can miss the risks it is doubtful a regulator will pick them up.

d The costs and resourcing implications for a more intensive supervisory approach would be significant.

66. Several stakeholders wanted the FSAP recommendations on supervision (and more generally) considered as part of phase 2. These stakeholders tended to argue that the Reserve Bank's approach is out of step with international norms and supported more active supervision. Some of these stakeholders suggested that more active supervision is required because of the limitations associated with the disclosure model. A few stakeholders had strongly held views that the approach to supervision is weak and compromised the regulator's ability to perform its role. However, some stakeholders thought the existing supervisory approach is appropriate.

67. Many stakeholders emphasised the uniqueness of New Zealand's banking sector, highlighting concentration, current Australian ownership and the relationship with APRA. These stakeholders typically recognised the value of international norms and best practice but stressed that different approaches can make sense when they relate to differences in the New Zealand market.

68. Several stakeholders wanted to develop more sophisticated approaches for their internal models for capital to address risk but thought that there were limited incentives due to a lack of resourcing available at the regulator to approve new models.

Resourcing for prudential supervision

69. Many stakeholders thought the supervisory functions of the Reserve Bank to be insufficiently resourced. Some of these stakeholders thought that a lack of resources is driving the approach to supervision and regulation as opposed to risk identification and mitigation. The views expressed on resourcing are covered in the section on Resourcing below.

70. A number stakeholders were open to the idea of more supervision. However, some stakeholders caveated their response by saying that there needed to be a change in culture and approach, and that resourcing issues needed to be dealt with, before they would support more supervision.

Relationship with APRA

71. Several stakeholders thought there is considerable scope to co-ordinate better with APRA and to leverage off APRA's approach. They noted that approximately 87% of the New Zealand banking system is monitored by APRA in the course of their oversight of the big-4 banking groups. In this context there is scope for harmonisation of regulatory requirements and standards, opportunities to leverage off APRA's more intensive on-site supervisory approach and opportunities for APRA and the Reserve Bank to co-ordinate approaches. The sovereignty issues and need for a level playing field for domestic banks was acknowledged, as was the recognition that the large banks may not always be Australian-owned.

72. Several stakeholders thought the current crisis management regime is having a detrimental effect on the New Zealand banks' relationship with their Australian parents and on the jurisdictions more generally. These stakeholders noted that the response from Australian authorities to the OBR and outsourcing policies had been a restriction on the amount of exposure permitted to the New Zealand subsidiaries, increasing the cost of capital for these subsidiaries. A couple of stakeholders argued there is a need for political agreement underpinning the relationship of the regulators, but the challenges of an enduring agreement were noted.

Resourcing

73. The majority of stakeholders thought the Reserve Bank is under-resourced and some thought that this is influencing its approach to supervision, regulatory process and engagement with industry. Some of the views expressed included:

    a The functions and responsibilities of the Reserve Bank have increased markedly, but the capability and expertise has not kept up.

    b A broader range of skills and expertise is required including commercial, industry, regulatory and international experience. Several stakeholders thought resourcing tended to favour the Reserve Bank's traditional monetary policy role.

    c Conservative or simplistic approaches are favoured because there is insufficient resource to monitor or supervise more sophisticated approaches to risk. The current capital review was used as an example of this approach.

    d Several stakeholders argued that there is a mismatch between industry and regulator practices due to resources and that industry is being held back by the regulator. Several stakeholders thought there were limited incentives to better manage risk.

    e There is insufficient resource to sustain the current approach. The Netherlands was raised as an example of a jurisdiction with a comparable number of banks but with a far bigger resource base. If more intensive supervision is required, it will be important to recognise the significant cost implications.

    f The contrasting approach of APRA to supervision.

74. Several stakeholders thought that a lack of resourcing contributed to the conservative culture of the Reserve Bank and a lack of capacity to discuss new ideas or genuinely engage with industry. There are simply not the resources available to be more proactive.

Other issues

Anti-money laundering (AML) responsibilities and insurance

75. Several stakeholders questioned whether anti-money laundering (AML) should sit with the Reserve Bank, or whether it should be shifted to the Ministry of Justice. A couple of these stakeholders favoured a single AML regulator and noted potential co-ordination issues with multiple regulators involved.

76. A few submitters questioned whether regulation of the insurance sector should sit with the Reserve Bank. One submitter recommended that the Review include a comprehensive appraisal of the insurance prudential regime overseen by the Reserve Bank.

Culture

77. A number of stakeholders thought that the culture of the Reserve Bank does not encourage a healthy industry and regulator relationship. These stakeholders tended to view the regulator as conservative and not open to new ideas. One stakeholder went further and viewed the regulator as insular and resistant to criticism. A number of stakeholders argued resourcing issues would need to be addressed to help change this culture and improve the regulator's knowledge.

Funding

78. The funding model of the Reserve Bank was not extensively discussed. Several stakeholders were supportive of the current model and had concerns about industry capture and budgetary independence that would arise in alternative models. Several other stakeholders expressed concern over the lack of transparency under the current funding arrangements and noted the case for budgetary independence is made for monetary policy but not for prudential policy. A few stakeholders wanted the funding model reviewed to ensure that the Reserve Bank is sufficiently resourced so that resourcing does not have an impact on policy outcomes. One stakeholder suggested the potential for part funding by industry could be considered to ensure an adequate level of funding is available. One stakeholder had strong views and considered that the Reserve Bank fell well short in terms of the principles and process of parliamentary authorisation of public spending. They recommended that the Reserve Bank be funded annually.

Miscellaneous

79. A few stakeholders queried whether enough focus is being given to the payments system.

80. One stakeholder recommended that Non-Bank Deposit-Takers be brought under the direct regulation and supervision of the Reserve Bank, with the current trustee-based supervisory model being discontinued.

81. One stakeholder was concerned that the capital adequacy framework has a downstream consequence of constraining bank lending to SMEs and wanted the economic costs of this constraint considered when setting the framework.

82. One stakeholder was seriously concerned about New Zealand's access to foreign market funds and derivative markets. They argued New Zealand is heavily reliant on these sources of funding but there are issues that are poorly understood within New Zealand.

83. One stakeholder suggested the exchange rate should have greater prominence in monetary policy considerations.

Recommended Action

We recommend that you:

a **note** the summary of stakeholders' views on the scope of phase 2 of the Review set out in this report

b **note** that we have recommended that this report and other phase 1 and 2 related papers be published online once Cabinet decisions on Phase 1 of the Review have been announced publicly (see T2018/652)

c **refer** this report to the following Associate Ministers of Finance – Hon Parker, Hon Jones and Hon Shaw

Refer/not referred.

Chris White
Director

Hon Grant Robertson
Minister of Finance

Appendix: List of Stakeholders Whose Views are Summarised in the Report

Stakeholders who participated in meetings with the Treasury

1. Kerry McDonald (ex-Chairman of BNZ)
2. Council of Trade Unions
3. Murray Sherwin (Productivity Commission)
4. Brian Fallow (NZ Herald)
5. Sir Michael Cullen
6. Richard Westlake (Financial Sector consultant)
7. John Park (Financial Sector consultant)
8. Bruce White (Financial Sector consultant)
9. Paul Kelway (industry and banking sector)
10. Hugh Fletcher (Chairman of IAG New Zealand Limited)
11. INFINZ
12. John Yeabsley (NZIER)
13. Dr James Every-Palmer QC (banking, competition and regulatory law)
14. Prasanna Gai (Auckland University)
15. David Tripe (Massey University)
16. Shamubeel Eaqub (economist)
17. Martien Lubberink (Victoria University)
18. ASB
19. BNZ
20. Heartland Bank
21. Kiwibank
22. ANZ
23. Simon Jensen (Buddle Findlay)
24. Helen Dervan (Auckland University)
25. Westpac
26. Guy Lethbridge, Emmerline Rushbrook (Russell McVeagh)
27. Mark Reese, Alan Lester (Chapman Tripp)
28. Christina Leung (NZIER)
29. Ganesh Nana (BERL)

30. Bob Buckle (Victoria University)
31. Michael Reddell
32. Arthur Grimes (Motu)
33. Viv Hall (Victoria University)
34. Bryce Wilkinson (NZ Initiative and Capital Economics)
35. Oliver Hartwich (NZ Initiative)
36. Christian Hawkesby (Harbour Asset Management)
37. Ulf Schoefisch (NZIER)
38. Nick Clark (Federated Farmers)
39. Mike Frith (NZ Super Fund)
40. Kirk Hope and John Pask (Business NZ)

Stakeholders who made written submissions

1. The New Zealand Bankers Association
2. Michael Reddell
3. Chapman Tripp
4. Bruce White
5. Geoff Mortlock (Mortlock Consultants Limited)
6. Judy Salter
7. Kerry McDonald
8. John Park
9. Martien Lubberink
10. Alison Paterson
11. Xero
12. Westpac
13. Heartland Bank
14. ANZ
15. BNZ
16. Insurance Council of New Zealand
17. Hugh Smith
18. Tower Insurance Limited