Panel Paper: Changes to institutional form involving separation of the Reserve Bank's prudential functions

27 March 2018

Purpose

At the fourth panel meeting, the Panel asked for further advice setting out the key benefits and costs of separating the monetary and prudential functions of the RBNZ into different institutions.

This report builds on *Panel Paper 2: Institutional Form* discussed at the fourth independent expert meeting on 16 March.

Context

The question of institutional form was investigated around 10 years ago; in the New Zealand context many of the traditional arguments for and against housing prudential supervision within the central bank came to the fore during the Review of Financial Products and Providers (RFPP) and Domestic Institutional Arrangements discussions in the mid-2000s. Various institutional models were considered by officials and in the end the risks were viewed as being outweighed by the benefits of co-locating monetary policy and prudential regulation (expanded to include NBDTs and ultimately the insurance sector).

The Treasury and RBNZ were not actively considering separation as part of the scoping for Phase 2 of the RBNZ Act review. However, during stakeholder engagement a number of participants suggested the review should explore the merits of separating the Reserve Bank's prudential functions from its monetary policy functions and creating a standalone regulator.

There were mixed views expressed by stakeholders on the merits of separation. Those in support of separation argued that it would result in better decision making and drive a cultural change they viewed as necessary to complement the prudential framework. They tended to emphasise a pre-GFC international trend towards separation, the different skill sets required, role clarity and mandate, and practical issues such as resourcing. Those against separation, or not convinced of its merits, focussed on several international examples of reintegration post-GFC, the inherent synergies between monetary and financial policy, as well as the costs, fragmentation and disruption caused by structural separation.

The goals for structural reform

When considering institutional reform around prudential policy, the IMF (Abrams and Taylor, 2000) suggests that maintaining and enhancing supervisory capacity and the effectiveness of supervision should be the primary goal. Institutional structure is only a matter of concern to the extent that it can assist in achieving this overarching objective.

While institutional design has a role in supporting effective supervision, the IMF identify several essential prerequisites that contribute to desired outcomes:

- Clear objectives
- Independence and accountability
- Adequate resources
- Effective enforcement powers
- Comprehensiveness of regulation
- Cost efficient regulation
- Effective regulation that takes into account industry structure

During the 2016 New Zealand FSAP the IMF did not raise any specific concerns with the current broad institutional setting for financial policy whereby a set of prudential functions and responsibilities are currently co-located within the Reserve Bank.

The following two sections highlight some arguments raised by a range of authors including the European Central Bank (ECB) and the IMF for and against a unified approach. We have also considered recent changes at the ECB and at the Bank of England (BoE).

Arguments in favour of retaining the status quo

Information-related synergies

Central banks are themselves active players in financial markets and systems and, in the course of their monetary policy operations, naturally interact with private financial institutions. Insights and experiences gained from these monetary policy operations may support supervisory duties and vice versa.

Systemic risk

One outcome of the GFC has been a move towards better understanding and addressing 'systemic risk'. As Nier (2009) argues, central banks are at the centre of the development of this new area, where macro-prudential policy implies an "expanded role of central banks that goes beyond the tools already typically at their disposal … allowing synergies to be exploited between existing and new regulatory tools to mitigate systemic risk".

Lender of last resort

Central banks are concerned with the soundness of the financial system as a precondition for the effective transmission of monetary policy (with banks the instruments of this transmission). Similarly, a central banks' lender of last role implies a concern with crisis prevention and management.

Scale, capacity and capability

Although economies of scale are difficult to measure in a regulatory organisation, the argument may be most applicable in countries with small financial systems, such as New Zealand. In these countries, the benefits of merging the administrative functions or sharing overhead may be high.

Independence and technical expertise

Central banks are generally recognised as a source of research and analysis on the banking and financial system. They gain knowledge on the structure and performance of the domestic financial system through their active presence in financial markets.

A central bank also has strong guarantees around its independence that can provide a defence against political interference in the supervisory function. However, this argument features on both sides of the debate (see below).

Some authors noted the cross-over of central banking and regulatory skillsets, notably with respect to operational financial market staff. Having separate entities may make it difficult to attract and retain skilled staff as the organisations may compete especially within a smaller market.

Arguments against combined prudential supervision and central banking

Objectives, independence and accountability

It may be difficult for a single agency to strike an appropriate balance between the different and potentially conflicting objectives of monetary and financial policy. By way of contrast, clear objectives assigned to a specialist agency may, in certain circumstances, act to increase transparency and accountability.

The ECB (2001), for example, highlights the potential for conflicts of interest between the supervisory and monetary policy functions. Supervisory concerns about the fragility of the banking system might lead a unified central bank to adopt a different stance for monetary policy than may be warranted for the pursuance of price stability alone.

Transfer of independence and/or culture from monetary to regulatory functions has been highlighted as a potential disadvantage.

Moral hazard

Depending on how the prudential objectives are defined, the failure of a regulated institution may be seen as a supervisory failure. As the lender of last resort, a central bank may (theoretically) have an incentive to delay action should a regulated entitiy experience financial distress. For example, by offering emergency liquidity to support an institution that is already insolvent.

Management attention and resourcing

Regulatory functions may receive less attention within a unified structure. Senior decision makers that have a broader mandate to fulfil may struggle to pay the same amount of attention compared to managers within a dedicated agency.

The internal allocation of resources may prioritise one function over another.

Avoiding excessive concentration of power in the central bank.

Some articles discussed a potential “concentration of power” (Abrams and Taylor), although delegating responsibility for stable prices and a stable financial system to a single entity is normally subject to a system of checks and balances with certain provision for government input (i.e. via the policy targets agreement).

Scale

Dis-economies of scale may occur if a unified agency is assigned an ever-increasing range of functions that require it to perform competing tasks, which may be only tangentially connected to its core functions.

Key considerations in the New Zealand context

The transparency that comes from a single objective may come with risks. Separating related areas of policy into separate organisations that act independently will not necessarily always provide the best outcome. The key question is whether conflicts are better handled by internalising them within a single agency (where competing objectives will have to be weighed up), or by separating them across agencies where responsibilities must be coordinated.

Limitations of institutional restructure

The IMF states that changing the structure of an institution cannot guarantee effective supervision and should only be considered once the various conditions for effective regulation are in place. Changing the structure of the regulator will not necessarily address the root causes of the weaknesses of supervision.

International evidence

International evidence supports the IMF’s conclusions. A range of institutional structures have been adopted by different countries with no clear correlation in terms of regulatory effectiveness.

There was a trend towards separation before the global crisis, but this has reversed post-GFC with the Bank of England and ECB acquiring regulatory functions. In the UK, in particular, the previous separation of prudential regulation from the BoE was reversed after the aftermath of the GFC.

Llewellyn (2006) sets out that the institutional structure of regulation and supervision has recently become an issue of public policy debate in several countries. But international experience indicates a wide variety of institutional regulatory formats suggesting there is no universal ideal model. There are advantages and disadvantages in all forms of institutional structure including unified agencies.

Risks and costs

Separation would be a major undertaking, which would create significant uncertainty for the organisation and its staff. The creation of a new agency would also increase the complexity of the review with implications for the timetable. There are also significant transaction costs associated with the process of separation and set up of a new organisation.

Alternatives

Separation and unification exist as ends of a spectrum. The design, governance, and structure around either alternative varies greatly between jurisdictions. This suggests New Zealand has a large number of more moderate alternatives short of separation that it could consider.

The presenting arguments stakeholders raised in support of separation, such as the relative weight placed on regulatory functions, culture, mandate, and resourcing could, for the most part, be addressed directly via a more targeted response.

The Panel has observed that the Bank's regulatory functions have grown in size and importance, suggesting the relative weight given to each function within the Act could be reconsidered (i.e. monetary policy previously being the primary function). In line with this, we recommend a review that considers the governance arrangements, the Bank's objectives and mandate, and the settings and safeguards around regulation.

Proposed next steps

The proposed review has not been agreed or commenced, and the concerns raised by stakeholders have not been assessed in any level of detail. Notwithstanding this, there are a wide range of options a review could consider to address the concerns raised by stakeholders. Thus, while we accept there may, in certain circumstances, be merits from changes to organisational structure, in forming a recommendation we have put significant weight upon the risks the process may entail.

On balance we do not recommend structural separation. We consider that any required changes could be achieved through means other than institutional separation.

For this reason, we recommend that this process should:

- Consider and seek to better understand the issues or concerns raised by stakeholders;
- Identify the range of solutions available that directly target or address these concerns.

Sources

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