Joint Report: Proposed Scope of Phase 2 of the Reserve Bank Act Review

Date:	5 April 2018	Report No:	T2018/765
		File Number:	MC-1-7-3

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Agree** the recommendations in this report and discuss next steps when meeting with officials on 9 April	Monday 9 April 2018

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Victor Kuipers	Senior Analyst, The Treasury	9(2)(k) (wk)	9(2)(a) (mob)	✓
Chris White	Director, The Treasury	9(2)(k) (wk)	9(2)(a) (mob)	
Chris Hunt	Advisor, Reserve Bank of New Zealand	9(2)(k) (wk)	9(2)(a) (mob)	✓
Victoria Learmonth	Senior Analyst, Reserve Bank of New Zealand	9(2)(k) (wk)	9(2)(a) (mob)	

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

Return the signed report to the Treasury.

If agreed, refer a copy of this report to the Associate Ministers of Finance (Hon Parker, Hon Jones, and Hon Shaw).

Enclosure: Yes

Joint Report: Proposed Scope of Phase 2 of the Reserve Bank Act Review

Executive Summary

This report provides you with advice on matters to be considered in phase 2 of the Review of the Reserve Bank of New Zealand Act 1989 and how the Review should proceed.

You are meeting with officials on Monday 9 April to discuss this report. Officials will be seeking your direction on the scope of the review, on timeframes, and on how the review should be led and managed.

The Independent Expert Advisory Panel has recommended a broadly-scoped and comprehensive review and has proposed a draft Terms of Reference for phase 2 (a copy is attached as Appendix 1). The proposed scope aligns with the range of issues raised in the stakeholder engagement process run by Treasury in February and March. Note, too, that the Cabinet Economic Development Committee has invited you to include depositor insurance in phase 2 of the Review.

Areas that the Panel has recommended be out-of-scope for phase 2 include institutional separation of the Reserve Bank's prudential function, a change to the Australia-New Zealand home-host supervisory relationship, the Reserve Bank's regulatory function over insurers, non-bank deposit takers, and financial market infrastructures, and the Bank's anti-money laundering functions.

The Treasury and the Reserve Bank have worked closely with the Panel in the preparation of its advice and jointly support its recommendation for a broadly scoped and comprehensive review and the draft Terms of Reference.

Ministers will have choices on how the work within the Review is prioritised and sequenced and officials are seeking your views. If the Review were to progress the entire Terms of Reference as a bundle, the agencies anticipate being ready to introduce legislation no earlier than the first half of 2020. If passage of legislation in this term of Parliament is a priority, the agencies think that this can be achieved for a subset of issues with the remaining issues progressed on a longer timeframe. Officials propose that the Review team prepares a detailed work plan, based on your priorities for timeframes, for communication to the public early in the Review process.

Officials seek your direction on whether formal accountability for, and leadership of, the Review should sit with the Treasury, or jointly with the Treasury and the Reserve Bank supported by an experienced and co-appointed project director. In either case, officials recommend that the Review is carried out by a co-located team drawn from staff from both institutions and is overseen by a co-chaired joint steering committee of senior officials.

Officials recommend the Panel should provide advice to the Review team in respect of key decisions and the resolution of difficult issues, and advice and assurance to Ministers as requested.

You have agreed to present a proposed Terms of Reference for phase 2 to the Cabinet Economic Development Committee on 2 May. To meet this timeline and taking into account the House's two weeks' recess in April, your directions to officials on 9 April will inform a draft Cabinet paper that officials aim to provide to you on 13 April.

Recommended Action

We recommend that you:

a **note** the report of the Independent Expert Advisory Panel on the scope of phase 2 of the Review of the Reserve Bank of New Zealand Act 1989 and the Panel's proposed Terms of Reference for the Review (T2018/841, 29 March 2018)

b **note** the summary of the stakeholder feedback on the scoping of phase 2 of the Review (T2018/721, 21 March 2018)

c **note** that the Cabinet Economic Development Committee has invited you to include depositor insurance in phase 2 of the Review (DEV-18-MIN-0031, 28 March 2018)

d **agree** to the Terms of Reference proposed by the Independent Expert Advisory Panel, and supported by the Treasury and the Reserve Bank, for a broadly-scoped and comprehensive phase 2 Review

Agree/disagree

e **indicate** to officials your desired timeframe for the Review

f **note** that the Review team will prepare a detailed Review plan, based on your indicated priorities for timeframes, for communication to the public early in the Review process

g **agree** that formal accountability for and leadership of phase 2 of the Review will sit with:

a. option 1 (Treasury's recommendation):

the Treasury

Agree/disagree

OR

b. option 2 (Reserve Bank's recommendation):

the Treasury and the Reserve Bank jointly with a co-appointed project director

Agree/disagree

h **note** that the Review will be carried out by a co-located team drawn from staff from both institutions and overseen by a co-chaired joint steering committee of senior officials

i **agree** that the Independent Expert Advisory Panel should provide advice to the Review team in respect of key decisions and the resolution of difficult issues, and advice and assurance to Ministers as requested

Agree/disagree

j **agree** that officials prepare a draft Cabinet paper on phase 2 of the Review, based on your decisions on the recommendations above, for your consideration on 13 April, before a final Cabinet paper is lodged on 26 April for the Cabinet Economic Development Committee meeting on 2 May 2018

Agree/disagree

k **refer** this report to the Associate Ministers of Finance (Hon Parker, Hon Jones, and Hon Shaw)

Refer/Not referred

Chris White
Director, The Treasury

Geoff Bascand
Deputy Governor and Head of Financial Stability, Reserve Bank of New Zealand

Hon Grant Robertson
Minister of Finance

Joint Report: Proposed Scope of Phase Two of the Reserve Bank Act Review

Purpose of Report

1. This report provides you with advice on matters to be considered in phase 2 of the Review of the Reserve Bank of New Zealand Act (the Act). The report comments on the report of the Independent Expert Advisory Panel (the Panel) on the scope of phase 2 of the Review and the Panel's proposed Terms of Reference and recommends how to take forward phase 2 of the Review.

2. Officials support the Panel's advice and proposed Terms of Reference for phase 2.

3. You are meeting with officials to discuss this report on Monday 9 April 2018.

Background and context

4. As per the initial terms of reference for the Review of the Act, the goal of the Review is to modernise New Zealand's monetary and financial stability frameworks and the Reserve Bank's governance and accountability settings. You established the Panel to provide input and challenge in the development of options for phase 1 of the Review and to assist with the development of a list of areas to be included in phase 2. Officials and the Panel have reported to you on phase 1. You have recently received the report and proposed Terms of Reference on phase 2 from the Panel.

5. In considering the matters that should be investigated in phase 2 of the Review, the Panel followed a robust process of considering material from the Treasury and the Reserve Bank, reports and critiques from major institutions and independent commentators, and a comprehensive stakeholder engagement process. The Panel has recommended to you a list of topics and matters for investigation in a draft Terms of Reference for phase 2.

The Reserve Bank and the financial stability regulatory framework play a central role in the New Zealand economy and in raising and protecting living standards

6. The Reserve Bank holds a central position in the institutional architecture of the New Zealand economy. It oversees two of the three pillars of New Zealand's macro-economic framework: stable prices delivered by monetary policy and a stable financial system (a sustainable fiscal policy being the third pillar). It is essential that, as one of New Zealand's principal regulators, the Reserve Bank is afforded the soundest of legislative footings to operate at an appropriate degree of arm's length separation from government with the powers necessary to discharge its responsibilities.

7. It is similarly essential that the wider financial stability regulatory framework is robust and fit for purpose. A well-functioning and efficient financial system is important for improving the well-being and living standards of New Zealanders. The regulatory framework is a key driver in the performance of the financial system.

8. Prudential regulation is a key plank in the financial system's regulatory framework. At its most simple level, prudential regulation is a set of requirements for regulated institutions to manage risks and support market and self-discipline. For banks, these requirements include adequate capital and liquidity buffers so that they can withstand

shocks, and disclosure obligations so that stakeholders can make well-informed decisions. For the regulator/resolution authority, prudential enforcement powers are also complemented with crisis management powers. Prudential supervision monitors institutions' compliance with prudential requirements and helps them to remain strong so that they do not pose a risk to the stability of the financial system. Where threats do arise, effective supervision also helps to ensure that authorities are informed as early as possible and have the information available to take appropriate action to manage the distress of individual institutions, thereby minimising any damage to the wider financial system. Choices around prudential policies and supervision have an impact on how much confidence one can have in the financial system and the level of risk to which the Crown and, ultimately, taxpayers are exposed. It is not possible to eliminate that risk completely and there are often trade-offs to be made between financial stability and financial efficiency.

A quality regulatory framework helps to deliver a high-performing regime

9. A strong and clear regulatory framework is therefore essential for providing the conditions in which the financial system can perform well and for managing risk to government finances and the wider economy. Getting it right matters. As the Productivity Commission noted in its 2014 report on *Regulatory Institutions and Practices,* the 'price' of regulation in general may often be invisible, but the costs of poor regulation can be all too clear (as evidenced by, for example, the events of the 2007-2008 global financial crisis).

10. The global financial crisis highlighted that financial crises can impose large and prolonged costs on economies and governments. Although having had only a moderate impact on the banking sector in New Zealand unlike in other jurisdictions like the UK and USA, it demonstrated that the approach taken to financial regulation has to provide long term stability, be consistent through time, and give effect to the government's objectives and its desired level of risk mitigation. Trust and confidence in the financial system are essential in a modern, advanced economy. Institutional arrangements and accountability mechanisms support the necessary buy-in from the public and industry and broad political support.

11. The Productivity Commission noted that the institutional arrangements and regulatory practices that constitute the architecture of regulatory regimes shape how regulators and those regulated behave, the quality of decision-making, and ultimately the success of regulatory regimes in achieving desired outcomes. Ensuring that the regulatory regime is fit for purpose not only means the objectives of regulation will more likely be achieved but, importantly, it builds legitimacy and trust in the regulator and regulatory regime.

12. Internationally, the International Monetary Fund (IMF) provides guidance as to what constitutes best practice financial regulation and institutional arrangements. Uppermost for the IMF is the notion that a prudential regulator should be independent and operate at arm's length from government. For the IMF there are four dimensions to this independence: institutional, regulatory, supervisory, and budgetary. Institutional independence refers to the status of the regulator outside the executive government and the legislature. Regulatory independence defines the ability of the regulator to autonomously set prudential rules and regulations within the parameters set by the relevant legislation. Supervisory independence is the ability of the agency to exercise judgement on matters pertaining to individual institutions such as licensing, how these institutions are monitored and supervised, as well as the ability to undertake enforcement actions. Budgetary independence refers to the nature of the agency's

funding arrangements and the extent to which such arrangements act to reduce the risk of arbitrary political interference.

13. A strong regulatory regime that is based on the delegation of powers to an independent regulator requires robust accountability arrangements. Well-designed accountability arrangements provide for robust public oversight, maintain and enhance the legitimacy of the regulator, and improve the overall performance of the regulator.

A review of the Act is good regulatory stewardship

14. The *Government Expectations for Good Regulatory Practice* (April 2017) set out expectations for regulatory stewardship. These expectations include:

    - reviewing a regulatory system at appropriate intervals to determine whether it is still fit-for-purpose and likely to remain so in the medium to longer term
    - testing existing operating assumptions, and considering the perspective and experience of regulated parties and others directly affected by the regulatory system's rules and practices, when undertaking review work, and
    - periodically looking at similar regulatory systems, in New Zealand and other jurisdictions, for possible trends, threats, linkages, opportunities for alignment, economies of scale and scope, and examples of innovation and good practice.

15. These expectations respond to the findings and recommendations of the Productivity Commission, which noted that in-depth reviews of regulatory regimes in New Zealand often followed a crisis rather than a systematic and strategic approach to review. The Commission also noted the importance of periodic review and endorsed clearly articulated review processes that combine both breadth and depth to keep regulatory regimes up to date.

16. Parts of the Reserve Bank Act are nearly thirty years old. In 2008, a number of targeted reforms were made to provide additional accountability requirements on the Reserve Bank, in part to address its additional functions for the non-bank deposit taker and insurance sectors. Much has changed in the international financial environment and with financial system regulatory frameworks around the world since then. Reviewing the Act now is good regulatory stewardship, is consistent with the *Government Expectations for Good Regulatory Practice*, and offers an opportunity to take account of the findings of the Productivity Commission where relevant.

Report of the Independent Expert Advisory Panel on the scope of phase 2 and its recommended Terms of Reference

17. To ensure the Act continues to support the operation of the Reserve Bank, the Panel has recommended that phase 2 of the Review consider the following:

    - Objectives, objective setting processes, and alignment with government policy and risk appetite
    - Statutory functions and powers
    - Role clarity for the Minister of Finance, Board and Governor, including the allocation and coordination of powers, functions, and tools
    - Accountabilities

- The strengths of current legislation, including its flexibility
- The balance between primary, secondary, and tertiary legislation, including in respect of setting policy
- Co-ordination across government, including pre-existing forums such as the Council of Financial Regulators (CoFR)
- Alignment with the domestic regulatory management system
- Procedural approaches, fairness, and safeguards
- International experience and best practice.

18. In considering these matters, the Panel has recommended that the Review be organised around the following key topics:
    (1) Overarching objectives and the scope, coverage, and coherence of the legislation
    (2) Institutional governance, and decision-making
    (3) Trans-Tasman co-ordination
    (4) Prudential regulation
    (5) Supervision and enforcement
    (6) Resolution and crisis management
    (7) Macro-prudential policy
    (8) Resourcing and funding
    (9) Miscellaneous issues

19. The following areas are recommended to be **out of scope** of phase 2:
    - Separation of the Bank's prudential function into a separate entity
    - Fundamental change to the New Zealand-Australian home-host relationship, whereby APRA becomes the sole regulator and supervisor of Australian banks operating in New Zealand
    - The Insurance (Prudential Supervision) Act 2010, Non-Bank Deposit Takers Act 2013, or the proposed Financial Markets Infrastructures Bill, except where consequential changes are necessary or could encourage alignment
    - Covered bonds or netting, except to the extent that any issues requiring change are identified during the review process (for example, if work on crisis management or depositor protection created the need to also look at how encumbrance limits are set)
    - Clearing[1], payment, and settlement systems and the regulation of Financial Market Infrastructures
    - Anti-money laundering (AML) functions (to be reviewed in 2019 as part of the Financial Action Task Force (FATF)/Countering Financing of Terrorism (CFT) review)

[1] The Panel's proposed Terms of Reference mistakenly referred to 'currency' instead of 'clearing'. We have corrected this to 'clearing' in this report and the attached Terms of Reference.

- Other financial system functions within the Reserve Bank such as market operations, other than those that are relevant to the areas for phase 2.

Cabinet decision on inclusion of deposit insurance

20. In its recent consideration of the proposed response to foreign margin requirements for over-the-counter (OTC) derivatives, the Cabinet Economic Development Committee discussed the potential implications for depositors. In agreeing to the proposals, the Committee “invited the Minister of Finance to include work on depositor insurance as part of phase 2 of the review of the Reserve Bank of New Zealand Act 1989.” [DEV-18-MIN-0031, 28 March 2018]

21. The Committee’s decision is consistent with the Panel’s recommended scope of phase 2. Officials envisage deposit insurance being considered as part of the ‘resolution and crisis management’ topic.

Agency perspectives on the Panel’s advice and proposed Terms of Reference

22. The Treasury and the Reserve Bank endorse both the Panel’s recommendation for a broadly-scoped, comprehensive review and the Panel’s proposed Terms of Reference for phase 2. In the Treasury’s view, the matters raised by stakeholders and others support the Terms of Reference, and the Terms of Reference covers the concerns that the Treasury brought to your attention in its briefing to you as incoming Minister of 1 November 2017. The Reserve Bank welcomes the opportunity that the Review provides to modernise aspects of the Act.

23. Officials worked closely with the Panel in arriving at the proposed scope and the list of topic areas. The process followed by the Panel was to establish a well-founded set of questions and considerations that should be included in the Review, without forming a view as to whether change is required. The approach taken by the Panel was robust and the Panel’s findings provide the flexibility required to consider the range of issues identified by officials, the IMF, industry practitioners, expert commentators, and stakeholders.

24. More specifically, the proposed scope would enable the Review to consider whether the features of the Act remain fit for purpose and aligned with what the government considers will provide a strong, flexible, and enduring regulatory framework that enjoys broad public and industry support. These features might include:

    - ensuring a well-resourced and empowered regulator
    - an appropriate role for government, with clarity as to the role of the government in setting objectives
    - an appropriate degree of operational independence of the regulator, recognising that there is widespread support for regulation being undertaken by independent regulators to protect the impartiality of decision-making, to create a stable and predictable regulatory environment, to ensure that a long-term view for prudential regulation is taken, and to maintain public confidence
    - an appropriate role for Parliament in overseeing the process around the setting of prudential rules for banks, and

- ensuring the Act retains sufficient flexibility to deal with unknowable future changes in the financial system.

Addressing the IMF FSAP recommendations

25. As noted in the Panel's report, the IMF's 2017 Financial Sector Assessment Programme (FSAP) report on New Zealand provides a starting point for several aspects of the Review. Officials have yet to provide comprehensive advice to Ministers on the IMF recommendations. The IMF commended the record of the Reserve Bank and its staff in many areas and challenged the Bank, and the government, in others. A number of the IMF's key recommendations raise questions that touch on fundamental tenets of the financial stability regulatory framework. These questions include statutory objectives for the Act and operational objectives of the Reserve Bank, resourcing of the Reserve Bank, and the government's interest in the Bank's approach to prudential supervision while protecting the Bank's operational independence (see paragraph 12 above) as a major financial sector regulator.

26. The IMF also made a number of recommendations around New Zealand's crisis management framework such as depositor protection, clarity of roles, responsibilities, and Ministerial powers (including removing the requirement for Ministerial consent when issuing directions in cases not involving systemic implications).

27. A comprehensive review of the Act is an appropriate approach for addressing these topics.

Expert and industry perspectives

28. In addition to the Panel's own relevant expertise, the Panel was provided with a number of other expert and stakeholder views, including a report from James Every-Palmer QC on the Reserve Bank's prudential regulation of banks. James Every-Palmer noted that prudential regulation has become broader in scope and more prescriptive in the three decades since the Act came into force. He suggested that the accountability framework provided by the Act was now out of step with the nature of prudential regulation today. However, the report also emphasises the need for regulatory certainty and the importance of technical expertise and concludes that the Reserve Bank should continue to have a high degree of autonomy when setting prudential regulations.

29. The Panel's expert material also included an article on prudential regulation authored by Auckland University of Technology Senior Law Lecturer Helen Dervan and Buddle Findlay Partner Simon Jensen.[2] Dervan and Jensen argue that there are a wide range of shortcomings with the current Act and suggest there should be a full review of the legislative and structural framework for prudential regulation. Dervan and Jensen also note that the quality of regulation and supervision is not purely a function of the legislative framework; any desire to improve the quality of supervision in particular will require the government to adequately resource the Reserve Bank.

30. In their recent review of regulator performance,[3] Roger Partridge and Amy Thomasson point to short-comings in the Reserve Bank's governance framework for the Bank's

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[2] The full Dervan and Jenson article is due to be published in the New Zealand Business Law Quarterly in April, but a summary is able to be released publicly along with other phase 2 scoping papers following announcements of the government's decision on the scope of phase 2.

[3] Roger Partridge and Amy Thomasson, 'Who Guards the Guards? Regulatory Performance in New Zealand', *Draft - February 2018.*

regulatory function and its lack of safeguards as a root cause of concerns raised by a number of industry participants surveyed by the authors. In particular, Partridge and Thomasson identify the limited powers of the Reserve Bank Board in providing suitable checks and balances on the single decision-making model. They also point to limited accountability and external oversight and lack of a merits review afforded by the Act given the high degree of discretionary regulatory decision-making power vested in the Governor.

The proposed scope also aligns with stakeholder concerns

31. You have received under a separate Treasury Report (T2018/721, 21 March 2018) a summary of the stakeholder engagement on the scoping of phase 2 of the Review. The Panel was provided with a draft of this summary and a member of the Panel attended a number of the stakeholder meetings.

32. Our view is that the proposed scope for phase 2 does justice to the range of issues that surfaced in the stakeholder engagement process. As noted in the Treasury's summary report (and as reflected also in the Panel's report), 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.

Not in scope: separation of the Reserve Bank's prudential function

33. One thematic area raised by some stakeholders was the separation of the Reserve Bank's prudential function into a separate entity. The Panel has recommended not including the question of separation in phase 2 of the Review. Officials support this view.

34. There are a range of arguments both for and against institutional separation. Separation would be a major undertaking and would create significant uncertainty for the Reserve Bank and its staff. Officials and the Panel are of the view that including the question of separation in the Review's scope would increase the complexity of the Review when there are a wide range of other options that the Review could consider to address the concerns raised by stakeholders.

Prioritisation, sequencing, and timeframes

35. The issues covered in the phase 2 Terms of Reference are interconnected. They need to be planned and executed together. For example, questions about roles, responsibilities, functions and powers sit at the head level of the Act, but also within individual functions; Trans-Tasman co-ordination issues sit across all of the functional areas identified for review; and changes to the role of the board need to integrate with the introduction of any new committees for decision-making.

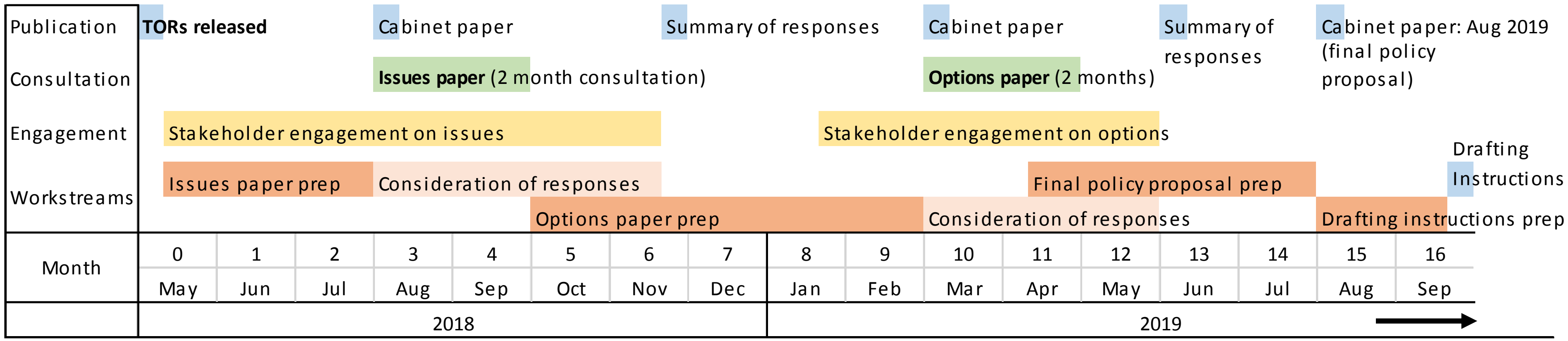
36. Policy-making of this significance needs a robust process for sector and public participation. The Review will need to create an environment that supports the contribution of views from a wide range of interested and affected parties, and that fosters debate and discussion to inform iterative development of policy. Prior to the introduction of legislation, for each key topic the agencies envisage at least three rounds of consultation, one to help define the issues (issues paper), a second to gather feedback on specific options (options paper) and a third to test draft legislation (exposure draft). A programme of ongoing stakeholder engagement, run in parallel to

the formal consultation process, will assist in the swift preparation of final policy proposals. The select committee process would provide a final opportunity for input.

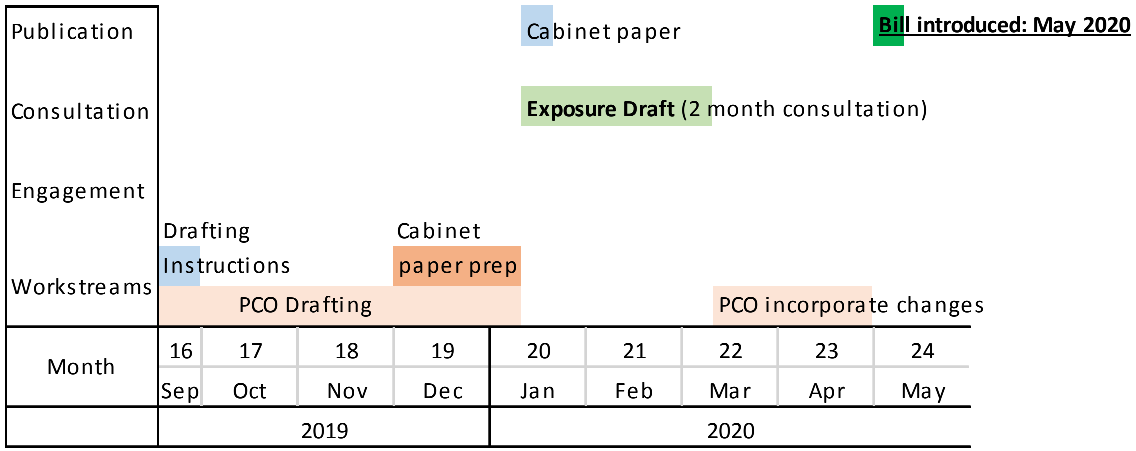
37. The workplan will of course be prioritised and broken into individual streams and these are unlikely all to proceed on exactly the same timetable. However, if the Review were to progress the entire Terms of Reference as a bundle using the three stage process outlined above, the agencies anticipate being ready to introduce legislation no earlier than the first half of 2020. This is represented in a simplified, stylised timeline below, which deals with the policy and drafting process up to the introduction of legislation.

38. Officials note that this timetable has little room for slippage.

Stylised timeframe: 16 months for policy development



Stylised timeframe cont: 8 months for Bill development



39. There will be a range of choices to progress certain aspects of the Terms of Reference faster than this, and if passage of legislation in this term of Parliament is a priority, the agencies think that this can be achieved for a subset of issues. For example, the Review team could focus in the first instance on overarching objectives and governance changes for introduction in an initial Bill, with a further Bill or Bills to pick up functional areas such as crisis governance.

40. Timeframes for phase 2 will be particularly sensitive to decisions around the following key areas:

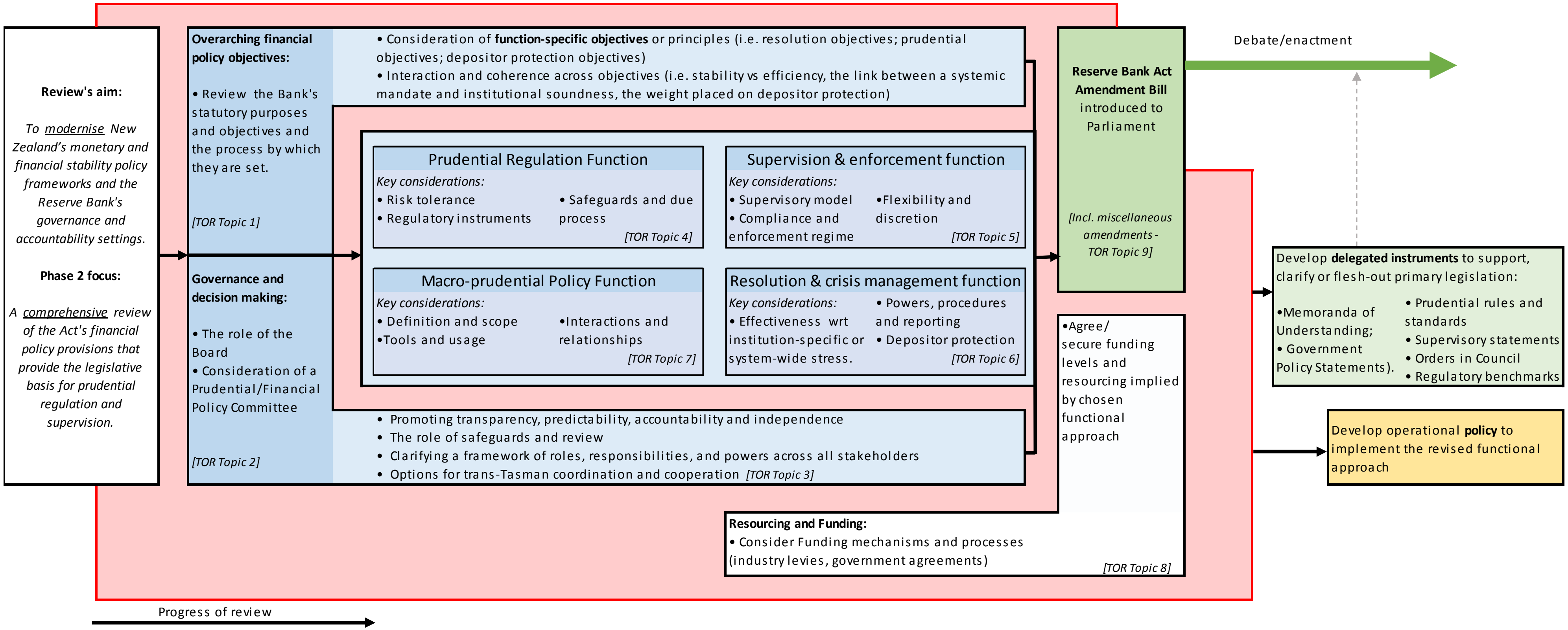
- Statutory purposes for prudential regulation and whether the Act includes depositor protection as a specific objective. This point is separate from deposit insurance or a minimum depositor preference (*de minimis*) (see below) and, if adopted, where this objective sits within the overall framework will potentially affect the intensity of supervision, the conservatism of policy settings and the crisis management framework

- Who the Act applies to. Currently the Act is 'opt in' in nature and if the Act becomes activity-based then this will have implications for the perimeter of regulation (e.g. the Non-bank Depositors Act) which will have potential flow through effects on macro-prudential policy, crisis management framework and any new depositor protection mandate

- Deposit insurance and/or depositor preference. The nature of government policy decisions here may affect the scope and scale of the review, for example whether non-bank depositors are impacted.

41. These choices require further work. The agencies recommend this work should be an initial priority for the Review team, which should report back early in its process with a detailed work programme. It is important that a sequenced approach does not limit the Review's scope. This is sensitive to stakeholder feedback, and to the Panel's recommendations, which concluded that the Review topics are interconnected and many issues are cross-cutting. It is an approach that will allow trade-offs to be made without losing interconnections.

42. A stylised picture of how the topics identified in the proposed Terms of Reference can be thought about for the purposes of planning is presented below. Time is on the horizontal access from left to right. The red box depicts the reform of primary legislation. The two boxes to the right (green and yellow) depict consequential processes to develop secondary legislation and make operational changes that could be significant, but sit outside the scope and timeframe for the Review. As shown in the blue L-shaped boxes, significant questions of overarching objectives and governance and decision making need to be addressed first as they will substantially set the direction for some or all of the functional workstreams; these issues will also need to be kept under review as the functional workstreams progress. The functional workstreams in the centre will be progressed in parallel to some degree and could have staggered start and end dates. Funding mechanisms and levels should be considered in light of the chosen functional approaches so appear in the white L-shaped box at the bottom right.



43. Under this approach, the government has choices as to what it would announce in respect of timing when it releases the Terms of Reference. One option is to indicate that a major package of reforms is expected to be introduced in 2020. Another would be to set the expectation that a more targeted reform Bill could be passed before the next election, with further Bills to follow. In both instances, officials should be asked to provide a more detailed plan for communication to the public in the first few months of the process.

44. The agencies are seeking early feedback on the considerations that will inform your views on timing.

Delivery of Phase 2

Principles

45. In considering how to organise resources to deliver phase 2 of the Review, a number of principles are critical: the Review should contain deep expertise but also a diversity of perspectives, and work collaboratively to ensure it develops the best possible advice; it should be empowered to be effective through a clear mandate, clear accountability and strong leadership; it should minimise conflicts of interest and model best practice, which will in turn render it credible externally and encourage full sector participation; and it should operate transparently and allow contestable views to be heard.

A co-located team

46. Expert and diverse input into development of policy will be critical to a successful review. Officials recommend a co-located team that is drawn from both Treasury and Reserve Bank staff. This could be supplemented by secondments from other parts of the public sector (e.g. MBIE, FMA, or IRD) or private sector (provided that conflicts can be managed), and by contractors or fixed term staff. In addition, expert consulting advice could be sought on particular issues, as necessary.

47. Our sense is that the Review will require around 15 people. As a review of the Act involves the design of the framework, the principal skills are policy advice and expertise in public sector governance and regulatory management frameworks. Knowledge of financial sector issues will be important throughout the Review, but detailed financial sector expertise is more important with respect to design of detailed regulatory requirements rather than with respect to the statutory framework itself. Legal advice will also be essential, not only to inform policy advice, but also when the Review moves into drafting, and a review of this complexity and public profile will also require professional project management and communications support.

48. The team's responsibilities would include:

- Developing the workplan
- Delivering the workplan, including
  - Policy development
  - Stakeholder consultation
  - Advice to Ministers and Cabinet
  - Preparation of legislation
  - Advising the select committee

- Supporting the joint steering committee (see below)
- Supporting the Independent Expert Advisory Panel (see below)

Joint steering committee

49. The principles of expert and diverse input should be applied to the governance of the Review. Officials recommend that the review team is overseen by a joint steering committee co-chaired by the Treasury and the Reserve Bank and comprised of senior officials from the Treasury and the Reserve Bank, and possibly external members drawn from, for example, MBIE, the FMA, and IRD, to capture other public sector expertise in regulation of financial markets.

50. The joint steering committee would meet on a regular basis with a focus on:

    - Ensuring the team has developed a comprehensive, integrated workplan for the Review
    - Monitoring delivery against the workplan
    - Identifying and mitigating risks
    - Ensuring the review team has sufficient resource and capability, including by accessing resource from home agencies where appropriate
    - Guidance on key issues, and issue resolution (see below)

Lead agency

Treasury view (paragraphs 51-55)

51. The Treasury considers that it should have formal accountability for, and be the lead agency for, the Review, as it has for the monetary policy changes in phase 1. The Bank is significantly conflicted in respect of advising on its own role, meaning a Bank lead would risk the development of impartial advice. A Treasury lead would create a clear, single point of accountability for advice and implementation (the Secretary to the Treasury) and would be in line with best practice elsewhere in the public sector where departments take responsibility for the legislation that governs independent entities.

52. The alternative to a Treasury lead is a joint lead with accountability resting with both the Secretary to the Treasury and the Governor of the Reserve Bank (as proposed by the Bank). There are some advantages to a joint lead: in particular the Bank has greater depth of understanding of the regime than Treasury, and a joint lead may support deployment of greater Bank capability inside the co-located team.

53. The Treasury considers that any advantages of a joint lead are outweighed by the disadvantages. With a policy initiative of this significance, it is critical that Minsters receive free and frank advice. Joint responsibility has the effect of providing each organisation with a veto over the views of the other, which can lead to advice that does not surface key issues with sufficient clarity or allow Ministers to consider the range of perspectives on an issue. The key consideration here is that the regulator's perspective is sought, considered, and adopted where possible (as it has been with phase 1) but that advice can move forward in a timely manner, which requires a single point of accountability. Under Treasury's proposed structure, the regulator's perspective will be provided by staff in the co-located team and by the joint steering committee and further bolstered by the review team consulting with the Bank on key issues and through the Governor's ability to give contestable advice to Ministers. Public consultation will also ensure a rigorous testing of the Review team's ideas and proposals.

54. Finally, joint accountability (or a Bank lead) will not secure confidence from the sector that the Review will thoroughly consider the issues identified in the Terms of Reference, which will create risks that affected parties will not participate fully, thereby diminishing the quality of the policy development process.

55. The Treasury's recommended approach would enable the team working on implementation of phase 1 decisions to be folded into an overall review team, providing co-ordination benefits across the two work programmes, particularly in respect of governance arrangements that will affect the whole of the Bank. The Treasury's proposed review structure is depicted in Figure 1 at the end of this report.

Reserve Bank view (paragraphs 56-64)

56. The Reserve Bank believes that it will need to play a significant part in phase 2, similar to the role it had in the more limited review of the Act in the lead up to the 2007/08 changes. This would ensure that its expertise and experience of working with the existing legislation is fully harnessed. It is also in line with its role as the Minister's "lead advisor on matters related to the formulation and implementation of monetary policy, prudential supervision, macro-prudential policy, and financial markets (including payment systems, liquidity management, and foreign reserves management)" (paragraph 10, *Memorandum of Understanding on Information Exchange and Collaboration: Reserve Bank and Treasury*, 2012).

57. The Reserve Bank acknowledges, however, the somewhat conflicted nature of its involvement in such a fundamental review of the legislative basis for prudential regulation and supervision, and the uncomfortable optics this would present to external stakeholders if the Reserve Bank were to be the sole lead of phase 2. The Bank accepts Treasury's point that the Reserve Bank has a conflict of interest that needs to be managed.

58. However, the Reserve Bank notes that the Treasury is similarly conflicted given its relationship with the Minister, the potential for phase 2 to redefine Treasury's role within the current framework, and that Treasury has already articulated strong positions on some of the key topics the Review will consider.

59. There is also nothing exceptional about the Reserve Bank advising or preparing advice on its own legislation. Inland Revenue, MPI and many other agencies do this, reflecting their specific knowledge and expertise, with the Cabinet Legislation Committee agreeing recommended legislative changes. Making full use of the Reserve Bank's expertise in administering legislation is also likely to enhance the efficiency of the legislative drafting process, which should be an important consideration given the tight timeframe envisaged for the Review and the expectation of delivering concrete outcomes within this legislative term.

60. What is important is that the best policy advice and options are put before the Minister and Cabinet for decision. The Reserve Bank believes that, given the respective expertise and conflicts of the two agencies, phase 2 would be best lead jointly by both the Treasury and the Reserve Bank – in light of the absence of any other agencies with the requisite expertise in the prudential framework to lead such a broad ranging review.

61. A sole leadership role given to Treasury, by contrast, immediately places the Reserve Bank in an adversarial (contrary advice) role. This is counter-productive. Moreover, having Reserve Bank staff working under Treasury line-management places them in an uncomfortable conflict of interest mode. They have two masters.

62. To navigate potential tensions between the two organisations the Reserve Bank considers that a neutral project director provides the best means of ensuring objective, high quality advice to senior officials and ministers, with issues for decision objectively identified rather than presented positionally. In addition, for working level officials, participating in a joint project team under a neutral project director will maximise project allegiance and minimise conflicts. The importance of strong and independent project management cannot be understated given the breadth of phase 2.

63. The Reserve Bank also considers that joint Treasury-Reserve Bank responsibility for phase 2, supported by a neutral project management role, will be the most effective and efficient model for achieving and delivering the outcomes expected by the Minister – particularly where recommendations put forward to the Minister are more likely to reflect an agreed position between the two organisations under a joint model, compared to one where Treasury is the lead agency. Moreover, collaboration is expected in policy making, and senior officials should be held accountable for working collaboratively. This is joint sponsorship like many public sector activities. Further, public consultation will also ensure a rigorous testing of the Review team's ideas and proposals.

64. The Reserve Bank's model for the governance of phase 2 is described in figure 2 at the end of this report.

Role of the Panel

65. The Panel has played an important role in landing close to unanimous advice on the key issues in phase 1 and making critical judgements on the scope of phase 2. The diverse and well informed perspectives of the Panel members, and a focus on building consensus, have provided considerable assurance to the Minister on the quality of the solutions proposed. The Panel has brought independence and legitimacy to the process. It has given effect to these outcomes by providing comprehensive written advice, with considerable support from officials.

66. The work programme for phase 2 will be much larger than for either exercise to date and contain a wide range of interconnected issues that need to be prioritised and sequenced. Officials will need to meet with Ministers on a regular basis for direction setting decisions which will need to be taken quickly, and that policy development will be iterative.

67. In this environment, officials consider that the Panel would find it extremely challenging to provide the same comprehensive written advice as this would take considerable time (close to full time roles) and require operating at a level of detail that is not realistic to expect.

68. Officials therefore recommend that the Panel provides advice to the review team, and where requested, directly to Ministers. The review team would consult with the Panel at key stages on policy issues and documents, including prior to and after major stakeholder engagements and reflect the Panel's views in advice to Ministers. The review team would also refer significant issues to the Panel for resolution where the joint steering committee is not able to agree (see issue resolution below).

69. The review team would not support the Panel to provide comprehensive, detailed, written advice to the Minister.

70. Officials will provide separate advice on the composition of the Panel for phase 2, noting that additional specialist expertise is likely to be required.

Issue resolution

71. The Review will emphasise giving agreed, joined-up advice to Ministers wherever possible. Where there are differences of view in the co-located review team, or between the team and the Bank, resolution will first be sought from the joint steering committee and then if necessary from the Panel. Under the Treasury's proposed approach, final decision rights on advice sit with the Treasury Secretary. Under the Reserve Bank's proposed approach, final decision rights on advice sit with the Reserve Bank Governor and the Treasury Secretary jointly. Where officials still decide to give alternative advice to Ministers, advice will be supported by a recommendation from the Panel wherever possible.

Figure 1: Treasury's preferred governance model for Phase 2

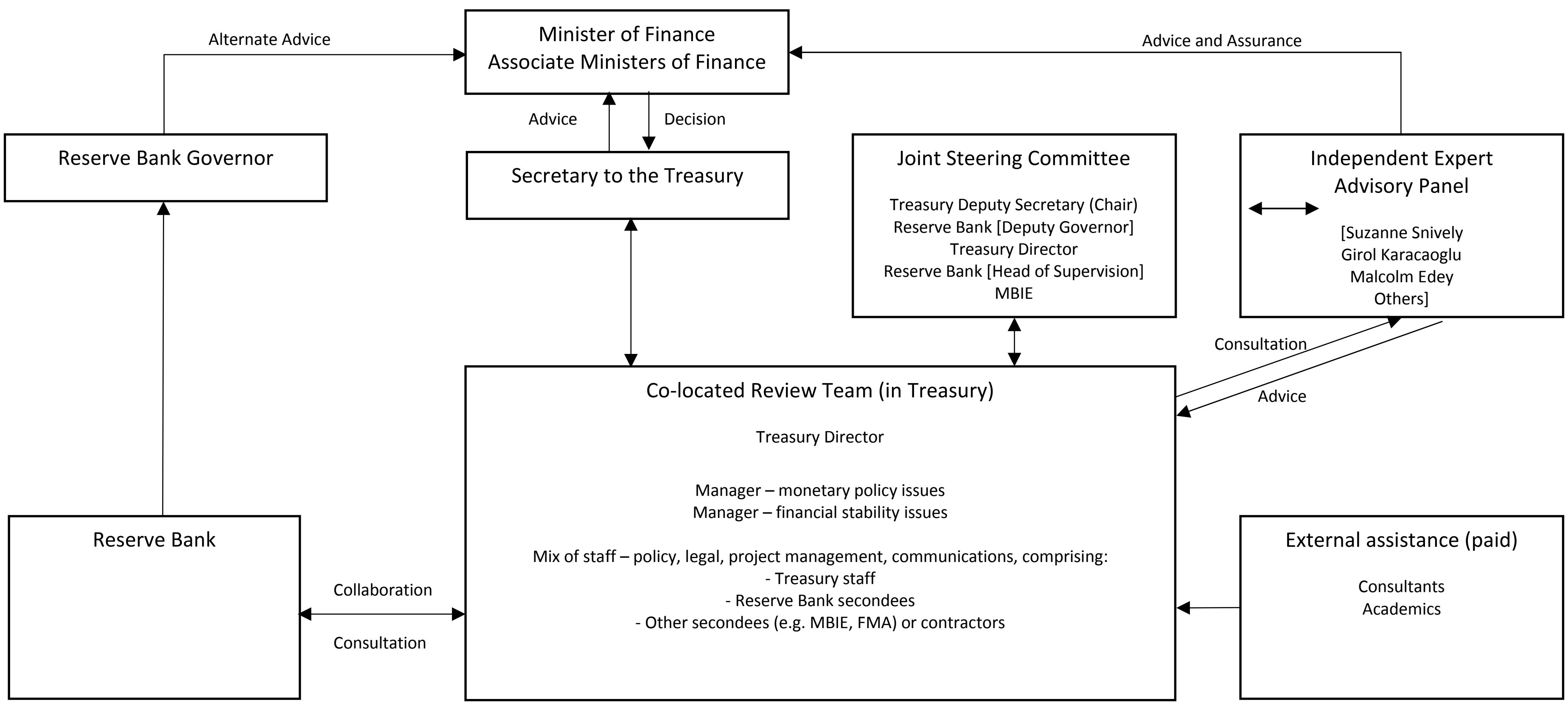


Figure 2: Reserve Bank's preferred governance model for Phase 2