Prudential regulation in New Zealand: Time to review the Reserve Bank of New Zealand Act 1989

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While New Zealand managed to avoid any failures of registered banks, the Global Financial Crisis (GFC) nevertheless had a significant impact here. Like many other countries, we experienced a recession.[1] We also experienced the highly destructive consequences of poor financial regulation with the substantial failures in the finance company sector. These failures impacted most seriously on investors, who suffered losses of more than $3billion,[2] and on taxpayers, because the government was forced to pay out approximately $2billion under its retail deposit insurance scheme.[3]

The world's major economies have accepted that poor financial regulation in general, and poor prudential regulation in particular, were significant contributors to the GFC[4]. New Zealand's experience exemplifies that view because the finance company sector was not subject to prudential regulation and supervision until 2008 and the regulatory regime in place at the time failed to identify and address the risks inherent in that sector.

There is now a general recognition that sustainable, prosperous markets require strong effective supervisory and regulatory frameworks.[5] As a result, New Zealand has undertaken wide-ranging reforms and has purported to adopt the Twin Peaks model of financial regulation. This model divides regulation into two functions: (1) market conduct integrity and consumer protection and (2) prudential supervision and financial system stability. It regulates each separately and independently, hence "twin" peaks. However, purporting to adopt Twin Peaks does not, in itself, provide a complete answer to our past regulatory failings. Effective use of the model is dependent on the proper, detailed construction of each peak regulator. It is questionable whether the reforms undertaken to date in New Zealand amount to a complete adoption of the model or, alternatively, fully optimise it.

Reform measures

When New Zealand purported to adopted Twin Peaks markedly different approaches were taken in creating each "peak" regulator. In relation to market conduct, an entirely new regulatory scheme was designed and there was wholesale structural and legislative reform, with a new regulator, the Financial Markets Authority, established.[6] In comparison, reform of prudential regulation was much more circumscribed. Only piecemeal adjustments were made to the regulatory regime already in place and the Reserve Bank of New Zealand (RBNZ) continued in its role as prudential regulator but with an extended mandate. Undertaking reform in this fragmented way is precarious because it risks failing to identify deficiencies in the existing regime. It also risks failing to ensure that the regime is wholly suitable for contemporary market conditions. Arguably, there are aspects of the Reserve Bank of New Zealand Act 1989 (1989 Act), the principal statute governing prudential regulation, that are

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[1] The recession started in early 2008 and contracted for five quarters. Treasure states that "[t]he initial phase of recession was before the global recession, driven by domestic factors" see<http://www.treasury.govt.nz/economy/mei/nov13/03.htm>

[2] Commerce Commission *Inquiry into finance company failures* (October 2011) at 10.

[3] Finance and Expenditure Committee, *Report from the Controller and Auditor-General, The Treasury: Implementing and managing the Crown Retail Deposit Guarantee Scheme* at 2.

[4] G20 "London Summit – Leaders' Statement" (2 April 2009) [G20].

[5] G20, above n 4, at [3], [13], [14] and [21].

[6] Financial Markets Authority Act 2011, sch 1.

out-of-date, fail to recognise advances in prudential regulation triggered by the GFC and fail to optimise Twin Peaks.

Deficiencies in the 1989 Act

(a) Decision-making

The 1989 Act uses a single decision-maker model[7] under which the Governor alone carries statutory responsibility for the RBNZ's various functions. The RBNZ operates as a "full service" central bank. It is responsible for monetary policy, prudential regulation of banks, non-bank deposit takers and insurers[8], payment systems and settlement systems (jointly with the FMA),[9] holds crisis management powers over banks and insurers,[10] acts as lender of last resort[11] and carries responsibilities in relation to anti-money laundering and countering financing of terrorism legislation.[12] Accordingly, there is an enormous concentration of regulatory power in the hands on one unelected official. This arrangement is unlike many other regulatory authorities which have greater checks and balances in decision-making and wider accountability. Indeed, the RBNZ itself appears to recognise vulnerabilities with this model. Since 2013, it has utilised an informal committee, known as the Governing Committee, to make major decisions.

Having an appropriate governance structure is as important for a regulator as it is for companies. Governance arrangements are important because they are likely to have an effect on a regulator's "effectiveness and efficiency [as well as its] public credibility",[13] because regulatory agencies have considerable power for which they need to be accountable, and because they have considerable discretion in the way that powers are used.

It is questionable whether the single decision-maker model is adequate to meet the demands of a modern prudential regulatory regime. This is because the decision-making process is internalised and involves only RBNZ staff. There is no formal structure enabling outsiders (of the RBNZ or government) to contribute to debate or challenge RBNZ thinking. This makes the RBNZ susceptible to "group-think" a form of defective decision-making which arises particularly where group members have similar backgrounds and are insulated from outside opinions. When, after the GFC, the United Kingdom adopted Twin Peaks, it created statutory committees with significant numbers of independent members to undertake prudential regulation in order to ensure that "thinking and expertise in addition to that gained inside the Bank of England [was] considered".[14] For example, the Prudential Regulation Committee, which is responsible for micro-prudential regulation and supervision, has a majority of independent members. In Australia, prudential regulation has been separate from the central bank since 1998 and is undertaken by an independent agency.[15] Although the RBNZ consults with industry and other stakeholders, it is questionable whether this provides sufficient challenge to RBNZ thinking and adequately guards against group-think. This is because the RBNZ oversees and controls the consultation process.

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[7] (12 December 1989) 504 NZPD 340; Reserve Bank of New Zealand Act 1989, s 41.
[8] Non-Bank Deposit Takers Act 2013, ss 3 and 7 and Insurance (Prudential Supervision) Act 2010, ss 3, 4 and 12.
[9] Reserve Bank of New Zealand Act 1989, pts 5, 5B and 5C.
[10] Reserve Bank of New Zealand Act 1989, pt 5, Insurance (Prudential Supervision) Act 2010, pt 4.
[11] Reserve Bank of New Zealand Act 1989, s 31.
[12] Anti-Money Laundering and Countering Financing of Terrorism Act 2009, s 130.
[13] David T Llewellyn "Institutional Structure of Financial Regulation and Supervision: The Basic Issues" (paper presented to the World Bank seminar, Washington DC, 6 and 7 June 2006) at 39-41.
[14] Bank of England "Inside the Bank of England" (3March 2017) www.bankofengland.co.uk at 2.
[15] The Australian Prudential Regulation Authority which was established under the Australian Prudential Regulation Authority Act 1998. See also Australian National Audit Office *Bank Prudential Supervision: Australian Prudential Regulation Authority*, (The Auditor-General Audit Report No.42 2000–2001 Performance Audit, 30 May 2001) at 25.

Perhaps the most significant indicator that reform of the 1989 Act and its decision-making structure would be prudent, is the result of the 2017 International Monetary Fund (IMF) review of New Zealand's financial markets regulation.[16] The IMF expressed significant concerns about the supervisory philosophy, approach and method utilised by the RBNZ in undertaking its prudential role. It stated that the RBNZ has developed a "hands-off supervisory philosophy that departs from conventional, more resource-intensive supervisory practices".[17] Essentially, it considers that supervision is too light-handed and that more should be done to tailor supervision to the characteristics of New Zealand's banking industry.[18] In particular, the RBNZ does not conduct detailed on-site inspections[19] and its light-handed approach makes it difficult for the RBNZ to develop expertise on bank operations, hampering the effectiveness of the RBNZ's analysis and policy development.[20]

The fact that the IMF has identified clear regulatory gaps in spite of the post-GFC reforms is disconcerting. It suggests that the piecemeal reform of prudential regulation may not have been adequate. Further, the IMF's concern about the effectiveness of the RBNZ's supervisory role and the need for the RBNZ to deepen its understanding of banking operations and risks[21] raises questions about the RBNZ's governance structure because of the association between governance and effectiveness. A recent report commissioned by New Zealand Treasury has also expressed concerns about the RBNZ's governance structure and advocates having separate committees for monetary, macroprudential and microprudential policy.[22] This follows the model created in the United Kingdom when it adopted Twin Peaks. Finally, the fact that the RBNZ is responsible for administering the 1989 Act is unusual in New Zealand and, given the limitation of its resources, could also explain why a full review of the RBNZ has not been a priority for the RBNZ.

(b) Statutory objectives and clear responsibilities

Under the 1989 Act, the RBNZ's prudential supervisory powers must be exercised for the purposes of promoting the maintenance of a sound and efficient financial system or avoiding significant damage to the financial system that could result from the failure of a registered bank.[23] These are high level objectives which may be interpreted as meaning that supervisory powers should only be exercised for matters that could have a significant or systemic effect on the financial system.[24] These high level objectives, which were drafted thirty years ago in an era of light-handed regulation, help explain why the RBNZ has been able to adopt an unconventional "hands-off" supervisory approach and not conduct detailed on-site inspections.[25]

Other prudential regulators in comparable jurisdictions have objectives that specifically require the promotion of the safety and soundness of individual institutions but, in advancing that

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[16] International Monetary Fund *New Zealand Financial Sector Assessment Program, Financial System Stability Assessment* (IMF Country Report 17/110, May 2017) [IMF 2017].
[17] IMF 2017, above n 15, at 31 and 59.
[18] Ibid, at 60.
[19] IMF 2017, above n 15, at 59 and International Monetary Fund, *New Zealand Financial Sector Assessment Program Detailed Assessment of Observance-Basel Core Principles for Effective Banking Supervision* (IMF Country Report 17/120, May 2017)[IMF 17/120] at 5 and [3].
[20] IMF 2017, above n 15, at 58.
[21] Ibid, at 71.
[22] Treasury Report: *Summary of Iain Rennie Report on Decisionmaking and Governance – RBNZ* (10 November 201, Report No: T2017/2456) at 3
[23] Reserve Bank of New Zealand Act 1989, ss 1A and 68.
[24] In practice it is arguable that many of the RBNZ's policies, typically imposed on banks through conditions of registration go further than is necessary to meet those objectives. While consistent with international practice and important in ensuring the soundness of individual financial institutions, many such policies probably deliver only minor benefits to the soundness of the financial system, especially when applied to smaller banks.
[25] IMF 2017, above n 15, at 59.

objective, adverse impacts to the financial system, which depend largely on the size and nature of individual regulated entities, may be taken into account.[26]

The RBNZ's second objective of avoiding significant damage to the financial system from bank failure is also problematic. Arguably, it focuses overly on ensuring that the RBNZ has a well-equipped ambulance at the bottom of the cliff after a bank has failed, rather than looking to prevent failure in the first place. Early prevention is a matter that is emphasised in the 2012 Core Principles developed by the Basel Committee on Banking Supervision.[27]

Depositor protection

The 1989 Act does not require the RBNZ to consider the interests of depositors when it is prudentially supervising banks. Again, this is in contrast to other comparable jurisdictions which specifically recognise the critical position of depositors.[28] New Zealand is one of few countries in the world not to have some form of depositor insurance to protect small depositors from loss due to bank failure. The RBNZ's traditional justification for refusing to introduce deposit insurance is that it would weaken self-discipline by banks and market discipline by depositors.[29] The RBNZ has stated that it intends to seek Cabinet approval to consult on a *de minimis* model where depositors might receive an exemption of $10,000 from application of the Open Bank Resolution policy.[30] However, this level of protection leaves the bulk by value of deposits at risk.[31] It also pales virtually into insignificance when compared to the protection available in other comparable jurisdictions.[32] It will be interesting to see the RBNZ's final justifications for its atypical stance and an explanation as to why New Zealanders do not merit the same level of protection as that provided in other developed nations.

Relationship with monetary policy

It is common among jurisdictions that have adopted Twin Peaks to house prudential regulation within a central bank. One of the perceived disadvantages of Twin Peaks is that this could lead to a mismatching of priorities so that monetary policy is prioritised, and prudential regulation is underemphasised.[33] With the single decision-maker model, this is a risk because decisions on monetary policy and prudential regulation are made by one entity (either the Governor or the Governing Committee). Moreover, it would be very difficult to ascertain if this were happening because decision-making is internalised.

Further, it is arguable that monetary policy is given priority under the 1989 Act because, under s 8, monetary policy is the RBNZ's primary function and because s 13 restricts the ability to change this primary function.

Summary

The changes made to New Zealand's financial regulation after the GFC have significantly improved our regulatory regime. We have specifically designed a new legislative regime for market conduct regulation and created a new regulator to take advantage of the Twin Peaks

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[26] Eg Financial Services and Markets Act 2000 (UK), s 2B (as amended by s 6 of the Financial Services Act (UK)) and the Australian Prudential Regulation Authority Act 1998 (Cth), s 8.
[27] Basel Committee on Banking Supervision *Core Principles for Effective Banking Supervision* (Bank for International Settlements, September 2012), principle 8, at 29.
[28] Banking Act 1959, s 12 (Cth), s 12 and Banking Act 2009 (UK), s 4(7).
[29] Geof Mortlock "How safe are your deposits if a bank fails?" *Stuff* (New Zealand, 8 April 2016).
[30] Briefing to the Incoming Minister on Reserve Bank of New Zealand – October 2017 (published 7 December 2017) at 36.
[31] IMF 2017, above n 15, at 37.
[32] Australian Financial Claims Scheme – AUD250,000; United Kingdom Financial Services Compensation Scheme – GBP 85,000; Canada Deposit Insurance Corporation – CAD 100,000.
[33] Andrew Godwin, Guo Li and Ian Ramsay *Is Australia's "Twin Peaks" System of Financial Regulation a Model for China?* (Centre for International Finance and Regulation, University of Melbourne, Working Paper 102/2016, Project E018, April 2016) at 37.

model. However, in relation to prudential regulation, the adoption of Twin Peaks is incomplete and the 1989 Act fails to optimise some of the advantages this model can provide.

Dr Jeffrey Carmichael, former Chairman of the Australian Prudential Regulatory Authority, has stated that:[34]

> New structures do not guarantee better regulation … Any country that thinks that tinkering with the structures of agencies will, by itself, fix past shortcomings is doomed to relive its past crises.

If New Zealand genuinely wishes to fix the shortcomings of the past, the only prudent way forward is to conduct a full review of the legislative and structural framework for prudential regulation. This would require two things: open, informed debate and a willingness from government to redraft the 1989 Act from scratch.

[34] Jeffrey Carmichael, Alexander Fleming and David Llewellyn (eds) *Aligning Financial Supervisory Structures with Country Needs* (World Bank Institute, Washington DC, 2004) at 95-96.