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RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Safeguarding the future of our financial system

Executive summary: The role of the Reserve Bank and how it should be governed

Phase 2 of the Reserve Bank Act Review

November 2018

New Zealand Government

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Executive Summary

This consultation document is seeking views on the role the Reserve Bank should have in safeguarding New Zealand's financial system, and how the Reserve Bank should be governed. You are invited to provide your views on these important issues. Submissions on the consultation document and the questions it asks are welcome by 25 January 2019. An easy-access guide to this consultation has been prepared and is available at https://treasury.govt.nz/rbnz-act-review.

Last year the Government announced that it would undertake a review of the Reserve Bank of New Zealand Act 1989 (the 'Review'), with the aim of modernising the Reserve Bank's monetary and financial policy frameworks and its governance and accountability arrangements.

The Review is one of the Government's initiatives to "grow and share New Zealand's prosperity more fairly". It supports the development of a productive, sustainable, and inclusive economy.

Phase 1 of the Review (which is largely complete) focused on improving the Reserve Bank's monetary policy framework, and led to Cabinet announcing agreed policy changes in March 2018.

Phase 2 (the subject of this consultation document) focuses on the Reserve Bank's financial policy framework. This framework underpins the Reserve Bank's role in prudential regulation and supervision, which aims to ensure that financial institutions adequately manage their own financial risks and the risks they collectively pose to the financial system. Phase 2 also considers other matters, such as how the Reserve Bank is governed.

The terms of reference for Phase 2 are broad and comprehensive, so the consultation has been split into three rounds. This first round focuses on five key topics that are important in shaping the Review outcomes. They are summarised below.

1. What high-level financial policy objectives should the Reserve Bank have?

The Reserve Bank's high-level financial policy objective is to **promote the maintenance of a sound and efficient financial system**. This objective:

- defines the Reserve Bank's purpose as a regulatory authority
- provides the focus for the work of Reserve Bank staff
- provides the context for other lower-level objectives directed at specific financial sectors, such as banks, non-bank deposit takers (NBDTs), and insurers
- provides a benchmark for holding the Reserve Bank to account for the performance of its financial system responsibilities.

A sound and efficient financial system is a critical foundation for a sustainable and productive economy. While the Reserve Bank's current financial policy decisions are focused on safeguarding our financial system, they also affect the everyday lives of New Zealanders in a multitude of ways – from influencing the cost of borrowing and the returns to saving, to affecting the availability of credit for households to buy homes and businesses to invest. The Reserve Bank's legislative objectives guide all of these policy decisions – deciding what these objectives should be is a key focus of this review.

Chapter 2 asks whether 'soundness' and 'efficiency' are still appropriate goals for the Reserve Bank's financial system role, and whether they need to be clarified. They are not defined in legislation and can be widely interpreted – and the relationship between them is not clear. Do they work together or conflict with one another? If there are trade-offs, how should the Reserve Bank prioritise one over the other?

In parallel with this, the consultation document asks whether the Reserve Bank should be given more high-level objectives, such as in the areas of competition, consumer protection, and promoting public trust and confidence.

Chapter 2 examines the pros and cons of five potential high-level objectives: financial soundness; efficiency; competition; consumer protection; and public confidence. It evaluates the potential definition of each term, as well as its ideal place in the legislative hierarchy (as a high-level objective, as a lower tier objective, or excluded from the Reserve Bank's legislation).

2. Who does the Reserve Bank regulate and how should the regulatory perimeter be set?

The 'perimeter' for prudential regulation is the boundary between entities required to operate according to certain prudential rules and requirements, and those that are not. This consultation round asks whether the current perimeter is appropriately targeted and capable of adapting to emerging risks.

The Reserve Bank currently regulates three sectors – banks, NBDTs, and insurers – and each has its own prudential regime. In addition, a process is currently underway to enhance the oversight regime for financial market infrastructures (FMIs). Banks and NBDTs are both regulated to address the risks from borrowing and lending, and Chapter 3 asks whether it may be more efficient to integrate them into one regime. This is the more common approach in other countries.

In the wake of the 2007/08 global financial crisis, there has been growing recognition of the risks to financial stability of entities that do not fit neatly into existing regimes, such as 'shadow banks' and FinTech. Regulators are also using macro-prudential tools that can potentially be applied beyond the traditional prudential perimeter. Chapter 3 therefore asks whether it would be desirable to provide greater flexibility for the perimeter to adjust or develop over time.

3. Should there be depositor protection in New Zealand?

Unlike almost all other advanced countries, New Zealand does not have a formal system for protecting depositors against the risk of losing their deposits if a registered bank or NBDT fails.

Instead, those making deposits are encouraged to do so responsibly, as neither the deposit-taking institutions nor the government promise to protect them from the consequences of their actions. This approach also incentivises institutions taking deposits to act responsibly in managing their risks.

While these disciplines may help support financial stability, some form of special treatment of depositors could help to meet public policy objectives – especially given that ordinary depositors may be less aware than others of the risks of placing their money in a bank or NBDT, and deposit accounts provide essential transactional services that make it easy for people and organisations to buy and sell goods and services.

Depositor protection could also support financial stability by reducing the risk of a 'bank run', while helping to underpin depositor confidence and trust in the financial system. However, in keeping depositors 'safe' through some form of protection, someone else will have to bear the losses if a deposit-taking institution fails.

With these potential objectives and costs in mind, Chapter 4 considers three options:

- The **status quo** – this would leave New Zealand with no formal depositor protection mechanism. However, the Reserve Bank does have an Open Bank Resolution policy, which when used can protect depositors from a small amount of loss when a bank gets into difficulty.
- Depositor **preference** – this involves ranking the claims of ordinary depositors within the legal framework ahead of other general creditors if a deposit-taking institution is liquidated. Depositors with a preference would be less likely to lose money (and more likely to be repaid) than general creditors, but would still not be immune from loss.
- A deposit **insurance scheme** (sometimes called a guarantee or compensation scheme) – this would pay eligible depositors up to a pre-set maximum amount or 'coverage limit'.

4. Should prudential regulation and supervision be separated from the Reserve Bank?

Under New Zealand's current financial regulation model, the Reserve Bank is responsible for prudential regulation and supervision, and the Financial Markets Authority is the 'conduct' authority with an objective to promote and facilitate the development of fair, efficient, and transparent financial markets. Belgium, the Netherlands, and the United Kingdom use a similar model, but in other countries with similar models (e.g. Australia and Canada) the prudential authority is separate from the central bank.

Chapter 5 looks at the pros and cons of the central bank having a prudential mandate. The arguments in favour typically focus on the coordination benefits of grouping functions that are complementary to a degree (e.g. prudential regulation, lender of last resort, and monetary policy) and where synergies can be exploited. Arguments in favour of separation tend to focus on some tension or trade-off between monetary policy and prudential regulation.

The variety of institutional models around the world suggests there is no 'best' regulatory arrangement. Instead, they tend to reflect the size and nature of each financial system, experiences in dealing with past financial crises, and a broad range of legal, historical, cultural, and political factors. All models have advantages and disadvantages and all involve trade-offs.

Since the global financial crisis, arguments have tended to be more in favour of assigning a prudential mandate to the central bank. Today, in close to two-thirds of all countries, the central banks have prudential authority for the banking systems.

Chapter 5 discusses three options for New Zealand:

- An '**enhanced status quo**' based on potential changes to the Reserve Bank's objectives, governance, or funding as a result of this Review
- A separate '**New Zealand Prudential Regulation Authority**' (similar to Australia's)
- A separate '**New Zealand Financial Services Authority**', which would be responsible for prudential regulation and financial market conduct regulation. For example, Germany, Switzerland, and the Nordic countries use this model.

Each option's strengths and weaknesses are assessed against four general criteria: focus, synergies, conflicts of interests, and cost.

5. How should the Reserve Bank be governed?

Governance encompasses the way an organisation is controlled and operates, the mechanisms by which it and its people are held to account, and the people who make particular decision types.

As a public sector organisation – to which Parliament delegates specific functions and responsibilities – the Reserve Bank's governance regime is different from that of private sector organisations. As well as having the above characteristics, it involves the allocation of responsibilities between elected officials and the Reserve Bank, and how elected officials oversee the Reserve Bank's performance.

Currently, the 'governing body' of the Reserve Bank is the **Governor** (the 'single decision-maker'). The Governor also serves as the Reserve Bank's Chief Executive Officer (CEO). The **Reserve Bank Board** is the principal monitor of the Governor's performance on behalf of the Minister of Finance. The Board is not a 'board' in the conventional sense, as it is not the governing body.

This arrangement will change as a result of Phase 1 of the Review, which led to the establishment of a **Monetary Policy Committee** (MPC). The group of four internal Reserve Bank officials (of whom one is the Governor) and three external members will take responsibility for monetary policy decisions away from the exclusive domain of the Governor.

Chapters 6-9 examine whether the scope of the Reserve Bank's operational independence in financial policy needs to be defined more clearly, and whether further changes to the Reserve Bank's governance arrangements are desirable.

The scope of operational independence

The terms of reference for Phase 2 note the importance of the Reserve Bank's operational independence and the need to ensure that it is protected. Chapter 7 examines three issues relating to that independence:

- The Minister's role in clarifying the Reserve Bank's financial policy objectives
- The Minister's role in approving various policies and decisions
- Who should be the 'steward' of primary legislation.

Changes to governance arrangements

Chapter 8 considers the pros and cons of the Reserve Bank's governance arrangements moving away from a single-decision-maker model to a more typical board structure. This would see a board take formal responsibility for all the Reserve Bank's functions except monetary policy, which will be covered by the MPC.

The board would be responsible for the oversight of the Reserve Bank's performance, strategic guidance, risk and audit, operational policy, and important decisions relating to financial policy. It would typically delegate corporate functions to the Governor as CEO, and financial policy functions to the Governor, senior staff and internal committees. This model is consistent with the structure of State sector organisations set up as Crown entities.

In addition, a **Financial Policy Committee** could be established, with formal responsibility for financial policy decisions (just as the MPC will be responsible for monetary policy decisions). This consultation round looks at the merits of such a committee against criteria including the complexity of financial policy decisions, the breadth and depth of these decisions, and flexibility required in times of crisis.

Accountability

Alongside changes to governance arrangements, the Review considers how the Reserve Bank should be held to account, including who should monitor its performance. It examines the pros and cons of a dedicated **supervisory council** (similar in concept to the Reserve Bank Board), and compares this to shifting the monitoring role to a Crown-entity-style **monitoring department** (e.g. the Treasury).