Memorandum for Phase 2 Panel Members

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Title: **Material for Panel Workshop**

Author: **Bernard Hodgetts, Director, Phase 2 Review Team**

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1. We would like to extend a warm welcome to panel members participating in the Panel session on 3 - 4 September. An agenda has been included with the material for the session.

2. In order to help frame the session, the Review Team has prepared a series of power-point presentations structured around five key topics that are expected to form the basis of a public consultation paper that will be released in November. The slides are intended to stimulate discussion about the issue in question along with options for consultation. We will speak to these slides briefly at the beginning of each topic.

3. Below is a brief summary of the contents of each slide-pack along with some draft questions for the consultation paper. We would appreciate feedback from the Panel during the session on (i) how you would answer those questions, and (ii) whether they are the right ones to be asking during consultation.

Overview slides

4. In order to set the scene for the panel's discussion (and help frame the introductory chapter of the consultation paper), we have prepared some scene-setting slides (peer reviewed by colleagues at FMA) which:

   - Describe New Zealand's 'twin peaks' financial regulatory system
   - Explain the role of the Reserve Bank and Financial Markets Authority.
   - Explain how the regulators within the system coordinate and their relationships to other government institutions.
   - Summarise international coordination mechanisms
   - Review the key dimensions of financial regulation
   - Identify potential gaps within the New Zealand regulatory system
   - Summarise criticisms of the current Reserve Bank role and structure
   - Notes the key topics for consultation – the Reserve Bank's objectives, governance, regulatory perimeter, the separation issue and depositor protection – that need to be considered in the context of New Zealand's broader financial sector landscape.

   Possible Questions for consultation

   (i) Is the description of New Zealand's system of financial regulation a reasonable summary of current arrangements? Are there any features missing?

   (ii) Is the gaps analysis fair?

High Level Financial Policy Objectives

5. The Objectives slide pack begins by highlighting the importance of the Bank's high-level financial policy objectives in terms of clarifying the Bank's purpose and teeing up the Bank's lower level objectives (such as regulatory principles or considerations). On the problem identification front, it raises a number of potential issues with the existing high level 'soundness' and 'efficiency' objectives relating to their: relevance, coverage, relative weighting and specificity. The slide pack mainly seeks to address the first two of these issues (relevance and coverage) by asking whether soundness and efficiency are still appropriate and considering whether the Bank should be given other objectives to help plug gaps in New Zealand's broader financial regulation (related to competition, consumer protection and public confidence).

6. In each case, the slide pack runs through the case for amending the existing objectives or adding new ones, and poses some potential questions to consult the public on. The slide pack also tees up a discussion of the mechanisms that could be used to provide additional clarity about how to weight objectives and specify them (such as a government risk appetite statement) but largely leaves that discussion for Consultation 2. We would appreciate the Panel's views on the following:

   (i) Does the overall problem identification (slide 4 and elsewhere) seem reasonable?

   (ii) Does the Panel agree that the 5 objectives considered (soundness, efficiency, competition, consumer protection, and public confidence) cover the appropriate range of options?

   (iii) Does the Panel agree with the potential questions for public consultation (slide 9)?

Governance

7. The governance slide pack reviews the current governance structure of the Bank, whereby (under the current Act) the Governor is the Bank's 'governing body' (responsible for virtually all decisions) while the board performs the role as a monitoring body on behalf of the Minister of Finance (and hence is unlike a conventional corporate board). The slides note some of the arguments that have been put forward for changing the governance model and provide some criteria against which governance models can be evaluated.

8. Two key options for consideration are 1) changing the role of the Board to that of a conventional corporate Board, with the governor largely assuming a traditional chief executive role; and/or 2) the possible creation of a Financial Policy Committee with responsibilities for all (or part) of financial regulation and supervision.

Possible Questions for consultation

(i) What shortcomings (if any) do you see in the Reserve Bank's current governance arrangements?

(ii) What should be the key objectives for the Reserve Bank's governance framework?

(iii) Are the criteria used to assess the models of governance – legitimacy, effectiveness, efficiency, simplicity, consistency, accountability and transparency – appropriate?

(iv) Should the Bank's Board become its governing body (i.e. a conventional corporate board) or should it continue to act as a performance monitor?

(v) What case do you see for the establishment of a Financial Policy Committee? What role could it play? What would be the main trade-offs?

(vi) What should be the extent of the Reserve Bank's operational independence? What governance role should be played by the Minister of Finance?

The Case for and against Institutional Separation

9. The slide-pack on institutional separation notes that various stakeholders raised the possibility of separation in the initial scoping of phase 2 and briefly summarises the various concerns that have led to some stakeholders arguing in favour of a change to current institutional arrangements. It summarises the arguments for and against allocating a set of prudential functions to the Reserve Bank. It provides some international statistics on the allocation of prudential supervision for banking and insurance inside and outside the central bank and reviews post GFC trends (which mostly go in favour of an enhanced prudential role for the central bank). The slides present three possible options for the consultation – keeping the status quo (albeit one enhanced with possible changes from other parts of Phase 2), creating a New Zealand version of APRA or integrating prudential and conduct regulation into a New Zealand version of the UK's former FSA. The slides posit some evaluative criteria for assessing these options.

Possible Questions for consultation

(i) Of the arguments for and against separation, which do you find most compelling and why?

(ii) On balance, which of the options discussed do you favour?

(iii) Are the evaluative criteria reasonable and have we applied these fairly against the three options considered?

The Regulatory Perimeter

10. This slide-pack defines what is meant by the 'regulatory perimeter' and why it matters and describes the current regulatory perimeter as it relates to banks and non-banks. This is an important issue particular given its relevance to depositor protection. The slides briefly cover the international approach to the regulatory perimeter, noting many countries have an activities- based approach, such as the Authorised Deposit Taking Institution (ADI) framework in Australia. It notes that New Zealand's approach appears complex and has other limitations (such as the difficulty of applying macro-prudential tools beyond the banks).

11. We go on to consider the case for changing the perimeter noting that there may be benefits in terms of future proofing. But we also ask whether there is a problem worth solving given that the current approach has been made to work and doesn't appear to be causing major dislocations.

Possible Questions for consultation

(i) How compelling is the case for reviewing the perimeter for financial regulation?

(ii) What are your views on the costs of moving away from the current regulatory perimeter to an ADI type framework?

(iii) Taking into account the potential transition costs of redefining the perimeter, is this an issue that is worth pursuing?

The Case for and against Depositor Protection

12. This slide-pack focuses on the case for reviewing New Zealand's depositor protection framework. It defines what is meant by depositor protection, which covers a range of mechanisms to redistribute losses associated with a bank failure away from depositors. Protection may take the form of depositor preference (where the risk of loss is formally shifted to other creditors of the failed firm), an insurance scheme (where deposits are guaranteed to some limit) or a combination of the two. New Zealand does not currently employ these mechanisms, although Open Bank Resolution (OBR) offers some protection against loss of access to a portion of deposits and essential banking services in the event of a bank failure. The use of a *de minimis* under OBR would also provide some protection for smaller depositors.

13. The slides set out various public policy objectives that might motivate deposit protection, the reasons why a move away from existing arrangements to formal depositor protection might be seen as desirable, as well as the reasons why it might not be. We make several key points, which will be important to emphasise in the consultation. First, depositor protection/insurance will redistribute costs and losses amongst financial market participants. If losses are shifted away from depositors, someone must bear them, just as someone must pay for a bank bailout or bear the losses allocated under an OBR. The costs facing some financial market participants in the event of a bank failure are likely to rise as a result of deposit protection. Second, the design details of an insurance scheme can matter greatly in terms of the costs and benefit realisation (eg insurance fees, coverage and preference all matter in terms of moral hazard risk).

Possible Questions for consultation

(i) Have we correctly identified the key benefits and consequences of the 'status quo' in New Zealand (i.e. no depositor protection) and each of the alternative depositor protection schemes examined?

(ii) Overall, do the arguments lead you to favour protecting deposits or remaining with the status quo? If yes, which type of protection do you favour?

(iii) For the status quo and the three alternative options, are there design features or complementary policies that you feel would lead to improved outcomes under that option?

(iv) As a bank depositor, what would you be prepared to pay for deposit insurance (eg 0.1% of the account balance per year)?