THE TREASURY
Kaitohutohu Kaupapa Rawa

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Safeguarding the future of our financial system:

Phase 2 of the Reserve Bank Act Review

Consultation 1: Separation

Panel Presentation: 4 September 2018

Context

- The institutional location of prudential regulation & supervision is being considered in Phase 2 of the *Review*
- Expert Panel and officials did not recommend this topic be within scope
- However, a number of stakeholders raised this issue in the scoping phase of the ToR
- MoF preference for status quo, but wants rationale fully considered in *Review* (and consulted on early)
- Out of scope for the *Review*
  - Institutional arrangements for anti-money laundering function
  - Consideration of any fundamental change in home-host relationship with Australia (e.g., APRA as sole regulator/supervisor of Australian-owned banks operating in New Zealand)
  - Note, opportunities for enhancing cooperation and coordination with Australian authorities will be considered elsewhere in the *Review*

Our approach has been to:

- Summarise stakeholder arguments that have motivated institutional separation as a solution
- Identify international models and trends over time
- Summarise the standard arguments for and against allocating prudential supervision to the central bank
- Situate within a NZ context and link to previous work: e.g. regulatory framework recommendations from the mid-2000s 'Review of Financial Products & Providers' (RFPP) & 'Domestic Institutional Arrangements' (DIA) discussions
- Outline 3 alternative options to status quo

Substantive *Issues* paper to support consultation material – indicative content

Part 1: Context & stakeholder feedback

Part 2: Institutional arrangements & preconditions for effective regulation

Part 3: Institutional models for financial sector regulation

Part 4: Evaluating different models – some high-level criteria

Part 5: Pros & cons of an enhanced role for the central bank

Part 6: Pros & cons of the 'mega-regulator' model

Part 7: Separating prudential regulation from supervision

Part 8: The NZ 'twin peaks' model & role of the Reserve Bank

Part 9: Options analysis

Appendix 1: The development of NZ's town peaks model
Appendix 2: Financial sector institutional arrangements in Australia
Appendix 3: The UK model during the GFC

Stakeholder feedback during scoping phase

- A number of stakeholders identified ‘separation’ as solution to various ‘problems’ with the current regulatory framework

- Specific concerns varied, but included:

  - Vague objectives & lack of focus
  - Conflicts between policy functions & objectives
  - Lack of resourcing for prudential function (‘poor cousin’ argument)
  - Internal culture of the RBNZ & approach to regulation

- Nature of the ‘separation’ solution also varied:

  - APRA-style separate prudential authority
  - Give RBNZ’s prudential functions to FMA
  - Split prudential policy function from compliance (supervision & enforcement)

Institutional models for financial sector regulation

- Any regulatory system needs to identify & assign financial system functions & objectives to an agency (or set of agencies) that cover the main types of market participants, or sectors

- 3 models (BIS 2018): sectoral, integrated, partially integrated

  - Sectoral: specialist agencies by sector (banks, insurers, securities firms), combining prudential & conduct functions [central bank often the banking supervisor]
  - Integrated: single agency combining prudential & conduct functions [sometimes integrated within central bank]
  - Partially integrated: hybrid models, e.g. 'twin peaks' where prudential is split from conduct [central bank may have responsibility for the 'solvency peak']

Model	Number	Percent
Sectoral	39	50
Integrated – separate agency	14	18
Integrated – central bank	9	11
Partially Integrated – Twin peaks	8	10
Partially integrated – 2-agency model	9	11
	79	**100**

Source: BIS (2018).

Post GFC trends: enhancing the role of the central bank (BIS survey, 2018)

- The central bank figures large in any set of arrangements:
  - Traditional financial system oversight and monitoring function tied to provision of emergency liquidity, and payments role
  - Banking supervision often located in central bank (in 2/3s of cases – BIS survey)
- 11 cases of changes to institutional arrangements in sample post-GFC, generally involving an enhanced role for the central bank
  - Banking & insurance prudential supervision shifting to central bank
  - Formalisation of macro-prudential role for the central bank
  - Clarity of resolution role for the central bank
- For example, 7 cases of changes to specific location of banking supervision
  - 5 from separate agency to central bank
  - 1 from government department to central bank
  - 1 from central bank to separate agency

Arguments for an enhanced role for the central bank

- Central banks have a 'natural interest' in financial stability
  - Financial stability a precondition for monetary policy transmission
  - Realisation of systemic risk poses balance sheet & reputational risk for a central bank
- Synergies between 'lender of last resort' (LoLR) role & prudential supervision
  - GFC illustrated the premium for acting quickly & decisively
- Synergies between monetary & (micro/macro) prudential policy
  - Plus benefits for prudential function from cloak of central bank independence
- Synergies between systemic oversight & macro-prudential policy
- Central bank gets to internalise any potential trade-offs across 3 policy domains (micro, macro-prudential & monetary policy), resulting in more optimal outcomes

Arguments against an enhanced role for the central bank

- Potential conflict of objectives between prudential and monetary policy
  - E.g., inflation forecasts suggest lower interest rates, while financial vulnerabilities building
- Reputational risks to monetary policy from failure of supervised entities
  - Competence of decision-makers questioned
- Threats to monetary policy independence if financial policy function becomes politicised
- Potential conflict between prudential and LoLR
  - Central bank uses emergency liquidity to cover supervisory failures ('bureaucratic gambling')
  - Moral hazard arising from individual institutions become less risk adverse
- Management distraction & prioritisation of functions
- Large concentration of power in a single organisation

New Zealand context

- NZ has a 'twin peaks' model
  - RBNZ: single integrated prudential authority
  - FMA: market conduct authority
- Model developed out of mid-2000s discussions (RFPP & DIA). Recommendations:
  - Strong synergies between the Reserve Bank's prudential role for the banking sector and its systemic oversight functions
  - Significant benefits from consolidating prudential regulation/supervision across individual sectors (banks, insurers and NBDTs)
  - No significant synergies or economies of scale would arise from co-locating prudential regulation and market conduct
  - Co-location of expanded set of prudential responsibilities requires enhanced set of accountability requirements, in part to preserve the operational independence of monetary policy
- 2008 changes to the Act, expanding RBNZ role & including enhanced accountability requirements

Consultation options

- Consider 3 alternative options relative to baseline (status quo)
- Options
  - Separate prudential authority
  - Integrated prudential & conduct authority
  - ‘Enhanced’ status quo
- Evaluative criteria
  - Focus
  - Synergies
  - Conflict of interests
  - Overall costs of regulation, including transition costs
- Not considering policy/supervision split within the prudential function
  - Matter for governance work-stream to consider (roles & responsibilities)

Options defined

- Baseline
  - Status quo (in absence of Phase 2)
- 'New Zealand Prudential Regulation Authority' (NZPRA)
  - APRA-style separate agency for prudential regulation & supervision
  - Still a 'twin peaks' model for financial sector regulation
- 'New Zealand Financial Services Authority' (NZFSA)
  - Separate agency integrating prudential & conduct mandates
- 'Enhanced status quo'
  - No changes to current 'twin peaks' model
  - Assumes some potential changes from Phase 2 for Reserve Bank (e.g., objectives, governance & accountability, resourcing etc.). These changes could address some of the concerns of stakeholders who have advocated for separation

Evaluative criteria

- Focus

  - Nature of emphasis given to an agency's various functions or objectives (their mandates)
  - Linked to number (and clarity) of mandates assigned & degree of attention paid to each (relative resourcing & internal governance)

- Synergies

  - Nature of interactions between an agency's mandates: policy & operational dimensions
  - Policy: benefits from sharing data, analytical perspectives & insights
  - Operational: capability of workforce from cross-fertilisation of skillsets & development opportunities

- Conflicts of interest

  - Nature of any trade-offs between policy mandates & how they are managed

- Costs

  - Overall regulatory costs for the system as a whole, plus transition costs (set-up & productivity)

Baseline: current arrangements

Criteria	Status quo
Focus	▪ Wide number of responsibilities: monetary, prudential, currency, etc. ▪ Increased focus on financial system responsibilities overtime, particularly post-GFC (new responsibilities & accountability arrangements in 2008-10, more resourcing, new macro-financial department created in 2014) ▪ High-level statutory purpose – soundness & efficiency – potentially vague and open to interpretation. Some public confusion on relationship between macro-prudential and monetary policy
Synergies	▪ Synergies associated with cross-sectoral approach to prudential regulation, and that between policy development and supervision/enforcement ▪ Synergies between prudential, monetary policy, & systemic oversight roles ▪ Human resources capability: cross-fertilisation of skills and varied career opportunities ▪ On-going efforts to exploit potential synergies via cross-department collaboration, rotations, secondments etc. Occasional internal organisational restructuring.
Conflicts of interest	▪ Internal department structure broadly aligned with policy functions ▪ Internal committee structure to support single decision-maker, with overlapping membership ▪ RBNZ internalises outcomes across 3 policy areas: micro & macro-prudential, & monetary policy ▪ External coordination with FMA & Treasury via MoUs, and via CoFR
Costs	▪ While resourcing for prudential function has increased overtime, still low by international standards, driven by 3-pillar approach

NZ Prudential Regulation Authority (NZPRA)

Criteria	NZPRA
Focus	▪ Narrower set of responsibilities for both agencies by design, less potential for 'management distraction' at both NZPRA & RBNZ. Potential to develop distinct organisational culture. ▪ NZPRA will still need to decide relative focus across the sectors it is responsible for ▪ Mandates potentially clearer (unless NZPRA and RBNZ both given financial stability objective creating some confusion for stakeholders) ▪ Not clear where macro-prudential policy or oversight of payments system would sit in this model
Synergies	▪ Retain synergies associated with cross-sectoral approach to prudential regulation, and that between policy and supervision/enforcement ▪ Lose synergies between prudential, & monetary policy & systemic oversight roles of RBNZ ▪ Less varied staff development opportunities for staff in NZPRA & RBNZ
Conflicts of interest	▪ Internal RBNZ conflicts reduced by design ▪ Managing policy trade-offs will require establishment of external coordination mechanisms with RBNZ, FMA & Treasury
Costs	▪ High: from loss of economies of scale and transition costs (setting up the new agency) ▪ Some increase in costs could come from generally better resourcing of prudential function that comes with greater focus, relative to the baseline

NZ Financial Services Authority (NZFSA)

Criteria	NZFSA
Focus	▪ Narrower focus for RBNZ, broad focus for NZFSA. Potential for management distraction within NZFSA across its prudential & conduct mandates ▪ Less scope for regulatory underlap across prudential and conduct functions ▪ Depending on specification, mandate could blur prudential and conduct ▪ Not clear where macro-prudential policy or oversight of payments system would sit in this model
Synergies	▪ Retain synergies associated with cross-sectoral approach to prudential regulation, and that between policy and supervision/enforcement ▪ Lose synergies with monetary policy, systemic oversight role of RBNZ ▪ Exploit synergies for any complementarities between prudential and conduct roles ▪ Reduced development opportunities for RBNZ staff, but enhanced for NZFSA staff
Conflicts of interest	▪ Internal RBNZ conflicts reduced by design ▪ Potentially new conflicts created between prudential and conduct (e.g., confidentiality v transparency) ▪ Need for external coordination with RBNZ & Treasury
Costs	▪ Steady state costs for regulatory system not clear ▪ Transition costs very high: disruptive to both RBNZ and FMA

Enhanced status quo

Criteria	Status quo +
Focus	▪ Potential for mandate clarity through re-specification of high-level statutory objectives ▪ Any additional financial sector objectives might require a potential refocus of regulatory & supervisory approach ▪ General focus on financial system responsibilities could be enhanced by increased funding, and/or governance changes (e.g., a financial policy committee)
Synergies	▪ Pre-existing synergies across 3 policy domains (micro/macro-prudential & monetary policy) preserved ▪ Additional funding and some internal organisational changes could help to further exploit potential benefits from co-locating these function
Conflicts of interest	▪ RBNZ still gets to internalise outcomes across 3 policy domains ▪ Separate formal decision-making bodies potential mitigant against any perverse outcomes, while preserving benefits of coordination via overlapping membership
Costs	▪ Could increase from increased resourcing of prudential function; servicing the collective decision-making bodies; or more intensive approach to supervision