

# Safeguarding the future of our financial system

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

*Summary of Submissions – first consultation*

Phase 2 of the Reserve Bank Act Review

February 2019



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# Introduction

This document summarises the first public submissions concerning Phase 2 of the Review of the Reserve Bank Act 1989. The New Zealand Treasury and the Reserve Bank of New Zealand (the Reserve Bank) published the consultation document *Reserve Bank Act Review: Safeguarding the future of our financial system* on 1 November 2018. The first round of public consultation closed on 25 January 2019.

The first round of public consultation asked submitters to respond to detailed questions regarding:

- the Reserve Bank's financial policy objectives
- the regulatory perimeter of the Reserve Bank
- depositor protection in New Zealand
- the separation of prudential regulation from the Reserve Bank, and
- the governance of the Reserve Bank.

The Review team received 67 written submissions during this consultation period. By type of submitter, the Review team received:

- 20 submissions from individuals. The individuals included three former Reserve Bank Governors and several academics
- 14 submissions from individual regulated entities, including banks, non-bank deposit takers (NBDTs) and insurers
- 17 from industry or advocacy bodies including the New Zealand Bankers' Association (NZBA), the Insurance Council of New Zealand (ICNZ), and Consumer NZ
- 10 from other submitters including various consultancy and law firms, and
- 4 anonymous and 2 confidential submissions.

This document summarises the written responses from these submissions by subject and provides an analysis of whether the submitters support or reject each of the proposals contained in the consultation paper; the reasons why certain submitters support or reject these proposals; and submitter opinions on the quality of analysis in the consultation document. As a broad overview, submitters have shown support for:

- a small number of specific financial policy objectives
- a flexible, authorised deposit-taking institution (ADI) framework that regulates both banks and non-bank deposit takers
- improving depositor protection in New Zealand
- keeping prudential regulation within the Reserve Bank, and
- a group decision making governance model for the Reserve Bank.

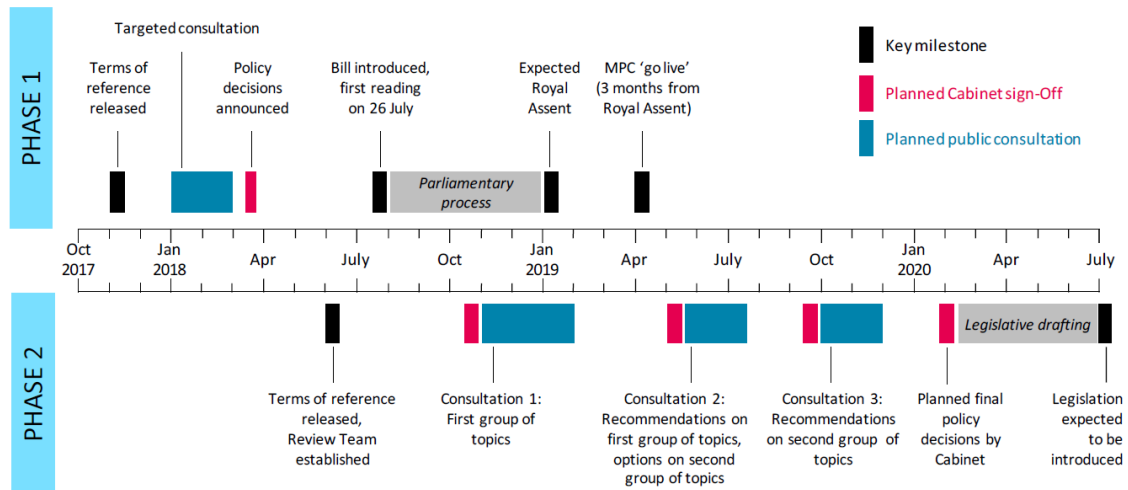
During the submission process, the review team also interviewed a range of stakeholders, usually under the Chatham House Rule. In many cases the feedback from these discussions was consistent with the written submissions. In some cases below we mention additional ideas gained from the

interviews, particularly in the section on governance, on which we undertook a longer and more structured series of interviews.

## What happens next

The first round of consultations as summarised by this document will be used to inform the ongoing review of the Reserve Bank and New Zealand’s prudential policy framework. The second stage of consultation regarding Phase 2 of the Review of the Reserve Bank Act is expected to take place in mid-2019 (figure A).

Figure A: Illustrative timeline of the Review



## Where to find more information

A series of papers related to the review can be found on the Treasury [website](#). We have published the individual submissions underpinning this summary there (subject to some redactions made at the request of submitters).

# Summary of key submission themes

The written submissions made to the Review team have provided a broad range of analysis and opinion on the Reserve Bank's financial system responsibilities. The following sections summarise these submissions by topic and provide a detailed break-down of responses. This analysis has been categorised according to the depth of discussion provided by the submitters. Accordingly, some questions have been 'grouped' within each section for brevity.

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

Submitters were asked to give their views on whether the Reserve Bank's existing soundness and efficiency objectives are still appropriate, and whether the Reserve Bank should be given other objectives (such as promoting competition, protecting consumers, or enhancing public trust). Of the 67 submissions received, around 75% included some commentary on objectives. These submitters were asked eight questions regarding their views on the Reserve Bank's objectives. The responses to these questions are summarised below.

### Key points:

- Two thirds of submissions support replacing 'soundness' with 'stability'. An overwhelming majority are in favour of retaining either 'soundness' or 'stability' as a high-level objective.
- Submissions support a narrow mandate of regulatory efficiency in scope, with a slight majority in favour of including competition in the objective set. There is a small, but notable minority in favour of 'dynamic' efficiency, and general opposition to a broad mandate of allocative efficiency.
- Submissions show an even split on 'efficiency' as a high-level and low-tier objective.
- Most submissions are in favour limiting the number of high-level objectives to a maximum of two, or ideally to one sole objective.
- A significant majority of submissions oppose including 'competition' as a high-level objective, but a slight majority are in favour of inclusion at a lower tier.
- Just under two thirds of submissions oppose including consumer protection in the objective set. The minority who support its inclusion, prefer 'consumer protection' as a lower-tier objective.
- Submissions show an even split on adding public confidence as an objective.
- Other objectives:
  - Several submissions suggest function-specific objectives for different financial policy areas (macro-prudential policy, micro-prudential policy, lender of last resort, and crisis management)

- A small group of submissions support a system-wide objective that applies to all financial regulators (e.g. the Financial Markets Authority (FMA) and Reserve Bank) and/or secondary objectives to support the actions of other domestic regulators to encourage policy coordination
- A small group of submissions recommend the Reserve Bank's financial policy objectives should have regard to the Reserve Bank's monetary policy objectives, and
- A small group of NBDTs suggest that the Reserve Bank should play a role in supporting the development and growth of domestic financial institutions.
- A number of submissions additionally comment that they prefer any high-level objectives be further specified in a secondary legislative instrument, similar to the Policy Targets Agreement for monetary policy.

## Existing high-level financial policy objectives

### **'Soundness' or 'financial stability' as a key objective**

There is almost unanimous support among stakeholders for retaining a soundness or stability objective as a high-level financial policy objective of the Reserve Bank. Many stakeholders link this objective to the core purpose of prudential regulation, which they define as strengthening the risk management and governance practices of financial firms so as to reduce the risk of costly financial failure. Submitter views are divided on whether soundness or stability is the preferable term, but around two-thirds of responders favour a switch to 'stability'.

Those favouring a switch (which includes two former Reserve Bank Governors, several law firms, banks and private citizens) argue that the breadth of a financial stability objective captures not just the resilience of the financial sector itself (soundness), but also the ability of the sector to impact the real economy. A 'sound' system could still have characteristics that contribute to macro-instability. Stability is therefore a more challenging objective, and consistent with the Reserve Bank's macro-financial oversight role. This group argues that 'stability' is a clearer concept than 'soundness'. Several submitters note that financial stability is already the de facto objective of the Reserve Bank and is akin to the existing soundness and efficiency objectives combined.

A sizeable minority of submissions favour retaining the existing soundness objective. This group, which includes a number of NBDTs and financial sector advocacy groups, argues that since the Reserve Bank had performed its prudential role well over the years there is little need to change the status quo. A small number of submitters within this group actively oppose switching to a financial stability objective, arguing that it could create inconsistencies with the insurance sector's regulation (the insurance legislation refers to 'soundness and efficiency') and could risk broadening the Reserve Bank's mandate too far. In the extreme, these submitters suggest that this broader mandate could incentivise the Reserve Bank to take on a more active role in managing the financial cycle, which would undermine market forces.

Several submissions recommend that (regardless of which term was used) the government should consider issuing a Policy Statement, Risk Appetite Statement or Remit (similar in scope to the Policy Targets Agreement (PTA) for monetary policy) that further outlines the definitions of any objectives and any metrics that will be used to hold the Reserve Bank to account, in order to provide further objective clarity. Several submitters also note that it would be difficult to write down a numerical

target (similar to the inflation target for monetary policy), but that this should not stop qualitative guidance being issued to guide the Reserve Bank on how to operationalise its objective.

### **‘Efficiency’ as a narrow or broad mandate**

A number of submissions recognise that the scope of the Reserve Bank’s existing efficiency objective was unclear and needed clarifying. However, there are a range of views as to which aspects of efficiency should be included in the objective’s definition.

Around half of respondents believe that regulatory efficiency (ensuring that the costs of prudential regulation are proportionate to the benefits in terms of financial stability) should be the main focus of the Reserve Bank’s role in supporting efficiency. Those who favour a fairly narrow focus on regulatory efficiency, including a former Reserve Bank Governor, several law firms, some banks, financial sector experts and private citizens, tend to argue that the Reserve Bank has limited powers to support efficiency beyond ensuring that its own regulatory actions are implemented in a cost effective and not-overly burdensome manner. This group also notes that too broad an efficiency mandate could make it more difficult to hold the Reserve Bank to account and could threaten the Reserve Bank’s credibility, if it were perceived to be tasked with elements of efficiency outside its control. Some stakeholders in this group also note that the Non-bank Deposit Takers Act 2013 (NBDT Act) and the Insurance (Prudential Supervision) Act 2010 (IPSA) already include a regulatory principle that specifies regulatory efficiency, which could be applied to the Reserve Bank’s prudential actions more broadly.

A slight majority of submissions support including competitive efficiency as well as regulatory efficiency in the objective set. This is further discussed in the section below regarding the competition objective.

A number of submitters support the way the Reserve Bank has interpreted its efficiency objective over time, with a focus on regulatory efficiency but with forays into other areas (such as helping to improve dynamic efficiency via capital market development).

A minority of submissions suggest that efficiency should be interpreted more widely. A small but significant group favour incorporating a more explicit role for the Reserve Bank in developing New Zealand’s capital markets and supporting financial innovation. An even smaller group argue that the Reserve Bank should have a broad efficiency mandate that incorporates allocative efficiency and other elements of ‘economic efficiency’. However, this latter view is actively opposed by a number of submissions, given the accountability deficit and overlap with the government’s broader role.

### **‘Efficiency’ as a high-level or low-tier objective**

Around half of responders support retaining efficiency as a high-level objective. Many in this group, including several NBDTs and business advocacy groups, have a general preference for the status quo, as they believe that the Reserve Bank’s existing financial objectives have served New Zealand well. Others in this group, including several banks, argue that efficiency needs to be retained at a high-level as it is an important moderator to stability. The NZ Initiative goes further, arguing that efficiency shouldn’t just be one of the Reserve Bank’s high-level objective, it should be the Reserve Bank’s primary objective and sit at the top of legislative hierarchy above soundness/stability.

Around a third of responders support retaining efficiency somewhere in the objective set, but at a lower tier or subordinate to financial stability/soundness. This group, which includes two former Reserve Bank Governors, several law firms, several banks and international consultancies, argues that the Reserve Bank only has limited powers to promote efficiency (beyond ensuring regulatory efficiency) and so the objective should mainly be retained to ensure that regulatory actions aimed at supporting stability do not unduly harm financial system efficiency. Several in this group also favour including a definition of efficiency that includes a competition component.

Around a fifth of responders support dropping efficiency from the objective set entirely. This group, which includes a former Reserve Bank Governor, a trade union body and some private citizens, suggests that efficiency is already covered by the Reserve Bank's new overarching purpose statement, that it would be covered by a new financial stability objective, or that the efficiency objective should be dropped on the basis that free markets will deliver efficient outcomes without regulatory intervention.

## **Additional high-level financial policy objectives**

### **Number of high-level objectives**

Many submissions caution against giving the Reserve Bank too many high-level objectives as this risks the Reserve Bank losing focus and its role overlapping with the responsibilities of other agencies, which could generate confusion and lead to regulatory arbitrage. One submission also notes that as the Reserve Bank is given more objectives, the mechanism for deciding how to weigh those objectives becomes more important. If this is left up to one individual (the Governor or the Minister), this could increase the risk that the objective weighting varies over time as new Governors or Ministers are appointed.

Just under half of the relevant submissions favour having a single high-level objective, and the vast majority of submissions support having no more than two high-level objectives (as is the case in the status quo). Indeed, one submission with a legal background, notes that it is better not to think of objectives in tiers or levels, but instead as part of an objectives regime – where one broad objective sets the basis of the regime and all other considerations are keyed off that (e.g. if financial stability is the high level objective, the role of an efficiency objective is defined in relation to that financial stability objective).

### **'Competition' as a high-level or low-tier objective**

A significant majority of submitters do not support including competition as a high-level objective of the Reserve Bank, but a slight majority are in favour of including it at a lower tier.

Those against including competition as a high-level objective argue that a competition objective could:

- conflict with the Reserve Bank's soundness/stability objective
- overlap with the role of the Commerce Commission and create confusion and opportunities for regulatory arbitrage, and/or
- overload the Reserve Bank with objectives and dilute focus away from soundness/stability.

A small minority of stakeholders argue a competition objective is unnecessary as the banking sector is already highly competitive.



Those in favour of including a competition objective (at a lower tier) argue that competition is an important ingredient for innovation and dynamic efficiency, and that it should be included because it already featured as a regulatory principle that the Reserve Bank must have regard to when setting prudential regulations for the NBDT and insurance sectors.

One submitter also notes the Bank of England's Prudential Regulation Authority (PRA) and the Australian Prudential Regulation Authority (APRA) have both had some success in boosting competition in the financial sector since they were given an explicit objective to promote competition. Another submission notes that greater competition could also support financial stability by reducing the number of firms that are 'too big to fail'.

Another submission notes that a competition objective would need to be carefully specified so that the Reserve Bank only promotes competition provided that financial stability is not threatened.

### **'Consumer protection' as an objective**

Of the respondents who expressed a view, around three fifths believe that consumer protection should not be included in the Reserve Bank's objective set. This group argues that including such an objective could:

- blur the lines between the Reserve Bank and FMA's existing conduct role
- cause the Reserve Bank to lose focus on its prudential responsibilities, and
- raise the risk of moral hazard.

The minority that support including a consumer protection objective, argue it should be a limited role and feature at a lower tier in the legislation. Most submissions in this group link the objective to the Reserve Bank's crisis management function, arguing that the interests of unsophisticated depositors and insurance policyholders should be a consideration when deciding how best to resolve a failing firm. Some submissions also note that the case for including this narrowly defined consumer protection objective would be stronger if New Zealand pursued some form of depositor protection.

### **'Public confidence' (or 'trust') as a high-level objective**

Submission views are evenly split between those in favour of including a public confidence objective in the Reserve Bank's objective set and those opposed to it.

A significant group of those in favour of a public confidence objective believe that it should feature as a high-level objective. This group notes that confidence in the financial system is a necessary condition for stability and argue that it was implicit in the Reserve Bank Act but should be made explicit. A high-level reference to public confidence would reinforce the need for a strong communications function, close collaboration with the FMA and other regulators, and could increase emphasis on improving public understanding of the financial system which is low in New Zealand. Those in favour of including public confidence, but at a lower tier in the objective hierarchy, note that this would match the Reserve Bank's existing legislation for regulating insurers which already requires the Reserve Bank to take confidence into account.

Those against including a public confidence objective argue that this objective:

- is an outcome of policy, not an objective in its own right
- would be implicitly covered by a financial stability objective
- would be difficult to hold the Reserve Bank to account for, and
- could risk generating unintended consequences if it were included (e.g. if policymakers encourage over-confidence in the financial system, leading to excessive risk taking).

## Other objectives

Submitters raise a number of other potential objectives that could be included in the Reserve Bank's objective set, including:

- **Function-specific objectives.** A number of prominent submitters advocate including specific objectives for the Reserve Bank's core financial policy functions.
  - Oliver Wyman (financial sector consultancy) suggests there should be specific objectives for three core financial functions: **macro-prudential policy**, **micro-prudential policy** and **resolution policy**.
  - Geof Mortlock (financial sector expert<sup>1</sup>) recommends various policy objectives that should be taken into account, including ensuring **prudent risk management** in financial firms, and **minimising fiscal risk** when a firm fails.
  - Grant Spencer (former Governor) notes the Reserve Bank's **lender of last resort** function should be given a clear objective and more prominence in the Reserve Bank Act.
- **Coordination with other regulators.** A couple of submissions argue that the Reserve Bank should play a supporting role in delivering the objectives of other regulators (namely the FMA and Commerce Commission) and vice versa. Primary responsibility for a particular regulatory area would still rest with a particular agency, to avoid reducing accountability, but including a supporting objective should encourage coordination and help bridge regulatory gaps.
- **A system-wide objective for all regulators.** A couple of stakeholders with legal expertise recommend introducing an overarching objective that applies to all of New Zealand's financial regulators (RBNZ, FMA and potentially the Treasury and the Ministry of Business, Innovation and Employment (MBIE)). This would help facilitate a coordinated jurisdiction-wide approach to regulation and minimise regulatory gaps over time.
- **Objectives of monetary policy.** A number of submissions believe that the Reserve Bank's financial policy objectives should also support the objectives of monetary policy, namely price stability and maximum sustainable employment.
- **Climate change.** Two stakeholders note the pressing risk of climate change to New Zealand's economy and financial system. These stakeholders welcomed the launch of the Reserve Bank's recent climate change strategy but believe that the Reserve Bank should be mandated to take account of climate risks as part of its legislative mandate.

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<sup>1</sup> This was not a formal submission, but can be found [here](#).

- **Encouraging the growth of domestic financial firms.** A number of NBDTs believe the Reserve Bank should play a more active role in facilitating the growth of New Zealand-owned financial firms, and recognise the value they add to local communities.
- **Other:**
  - giving the Reserve Bank a role in reducing inequality
  - maintaining a stable exchange rate
  - an explicit house price inflation target
  - a role in promoting financial literacy, and
  - supporting the economic objectives of the Maori community, including taking account of Treaty of Waitangi obligations.

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

Submitters were asked to give their views on two questions:

- the costs and benefits of moving from the Reserve Bank’s current regulatory perimeter to a single licensed deposit-taking framework, and
- whether it was desirable to consider non-legislative mechanisms to add flexibility to the regulatory perimeter. These mechanisms would be used to help future proof the regulatory system.

Of the 67 submissions received, 35 responded to the question relating to the licensed deposit-taking framework, while 22 responded to the question relating to perimeter flexibility. The responses to these questions are summarised below.

### Key points

- 26 submitters support a shift to a licensed deposit-taking framework, with 2 submitters opposed. A further group make a broader set of observation about perimeter design, or the appropriate treatment of certain sectors, such as wholesale-funded lenders.
- 18 submitters support increased perimeter flexibility. In addition, a section of submitters saw potential value in providing either the Minister of the Reserve Bank with additional tools, but expressed the view that there were risks around the design of any tools, such as specifying when it might be used, or providing appropriate governance and safeguards.

### A single licensed deposit-taking framework

Among the 28 submitters that have expressed a view on this topic, there is almost universal support for a single licensed deposit-taking framework. This includes a broad cross-section of large and mid-size banks, NBDTs, consultancy and law firms, former Governors, and private individuals. Submitters discuss three key advantages of making the shift:

- The difference between bank and NBDT regulation had occurred for historical reasons, rather than by design. Submitters do not consider there is any obvious reason why banks and NBDTs should be subject to a different regulatory framework, and therefore these submitters are in support of shifting to a single licensed deposit-taking framework. These differences are seen as having an impact on regulatory neutrality. NBDTs in particular (such as WBC, Baywide and Credit Union South) note concern about the relative level of regulatory burden in their sector. Co-Op Money consider that the current restrictions on the use of words such as “banking” by NBDTs was problematic, given the lack of alternative terms.
- Having a single framework that applies to all regulated financial institutions (such as the Australian ADI regime) makes it easier to create and manage a graduated prudential regulation regime to take account the individual circumstances of the entities subject to the regime. It may also allow for innovation.
- Shifting to an ADI framework would allow the regime to fit more closely with, and empower other features of, the regulatory framework. For example, if it was decided to proceed with a deposit protection regime, then we would expect that the entities receiving the benefit of such

deposit protection regime (irrespective of how they were structured, name or operated) would be subject to some level of prudential supervision based on a standardised set of prudential requirements.

Submissions emphasise the need for any framework to allow for differences in both regulation and intensity of supervision between firms. Stakeholders consider there is a need to support tailored approaches for firms of different scale or with specific business models. Several NBDTs considered that this issue was linked to the Reserve Bank's objectives, and could be recognised through an objective to encourage the growth of domestic financial firms.

Two submitters oppose a single licensed deposit-taker framework. One submission supports retaining current supervisory arrangements, on the basis that it is desirable to retain a split between regulation and supervision, and that trustees have the flexibility in supervisory approach necessary in the NBDT sector. The second submission, from a former Governor, raises the argument that deposit takers that are not systemically important should not be regulated by the Reserve Bank.

### **Submissions from the non-deposit-taking lending Institutions (NDLIs) sector**

The November consultation paper noted that the application of the NBDT regime was currently defined by reference to an offer to retail investors. The consultation paper noted that one possible option was an activities-based definition that did not explicitly exclude wholesale-funded deposit-takers (even if these wholesale-funded firms were subsequently exempted from coverage).

Submissions were received from two law firms, one submission from an industry body, and one submission from a group of NDLIs who are concerned about the potential capture of NDLIs in the regulatory perimeter. Submitters broadly note that:

- NDLIs provide a valuable source of funding diversity. Some of the risks in the New Zealand financial system come from the limited number of funding options.
- Extending the perimeter beyond retail deposit-taking institutions (as would occur under an ADI-type framework) goes further than is required to meet the Reserve Bank's mandate, whether the mandate be soundness or stability.

### **Flexibility of the regulatory perimeter**

There is general support among the submitters for increased flexibility concerning the prudential perimeter (in other words, providing scope to expand the regulatory perimeter without needing to amend legislation, for example through regulation). Several submitters (such as the NZBA and the barrister Michael Webb) note the existing model in the Financial Markets Conduct Act for designations. Submitters mention that enhanced tools are required to efficiently protect against potentially systemically important sectors (for example, the non-bank deposit-taking lending sector) rapidly growing or evolving and thereby exposing the financial system to risk, as well as offering flexibility and 'future proofing' the regime. These submitters suggest that compliance requirements should be aligned with the risk associated with, and scale of, the entity or activity; these requirements would not therefore necessarily reflect the risk and scale of existing participants.

A number of submitters note the need to test any proposals for perimeter flexibility against the attributes and indicators of best-practice regulation. These submitters included the law firms

Chapman Tripp and Mayne Wetherell. These submitters emphasise that there should be a relatively high threshold for activation. They therefore consider it inappropriate that any extension to the prudential perimeter should be left to the sole decision of the Reserve Bank, unless these decisions are triggered by the need to take urgent action due to situation that has an impact on financial stability.

Several submitters note the desirability of increased monitoring of entities outside the perimeter. Without appropriate monitoring, submitters note that there is a risk that regulatory decisions could be made without adequate information. Several submitters, including INFINZ and several NDIs, note that increased data collection would help ensure any changes to the perimeter remained proportional.

### 3. Should there be depositor protection in New Zealand?

Submitters were asked to express their views on the depositor protection considerations and options that were identified in the November consultation paper. Deposit protection was an important issue for many consultation respondents with nearly three quarters of submissions (49 of the 67) addressing the issue. Submitter responses to the five relevant questions are summarised below.

#### Key points

- Two in three submitters support strengthening the depositor protection framework in New Zealand.
- The remaining third are evenly split across opposing enhanced depositor protections or preferring alternative protection mechanisms not suggested in the consultation.

This breakdown across written submissions roughly accords with a survey of 1,000 New Zealanders commissioned as part of the Review team's engagement process.<sup>2</sup> Separately, a targeted stakeholder engagement programme found very strong support for enhanced depositor protections amongst lawyers, investors, academics, and special interest groups, who generally viewed stronger protections as 'overdue'. Non-financial corporates (and their representative bodies) were a notable exception, preferring the status quo, a stance also reflected in their written submissions to the consultation.

#### Support for depositor protection in New Zealand

Of the 32 submitters that support the enhanced depositor protection options proposed in the consultation, around half favour deposit insurance, including several deposit-takers (KiwiBank, Westpac, ASB); one in three favour both insurance and preference; and one in six favour a standalone preference. Lawyers, insolvency practitioners, and the deposit takers who are in favour of depositor protection are strong in their opposition to a legal preference as a standalone mechanism to protect depositors, noting that it would add complexity to insolvency processes without accelerating payout speeds or providing certainty around depositor outcomes. These respondents prefer insurance.

Submitters are split on why they support stronger depositor protection, across:

- protecting vulnerable depositors from loss and promoting access to the critical banking services that depositors need to participate in the modern economy
- addressing information asymmetries faced by less-sophisticated consumers<sup>3</sup> who have limited tools to manage deposit risks

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<sup>2</sup> Once deposit protection was explained, half of all survey participants supported deposit insurance up to a guaranteed limit, a quarter favoured a depositor preference, while one in ten preferred the status quo. The rest were unsure.

<sup>3</sup> Less than investors and supervisors.

- supporting fairness, trust and confidence in the financial sector ('if supervisors couldn't see the risks, why should depositors be blamed?')
- promoting clear and predictable outcomes for depositors that are politically sustainable
- promoting consistency with international practices, and
- mitigating the risk of disorderly runs and contagion to the financial system.

Almost all submitters in favour of depositor protection agree that it could provide a mechanism to protect depositors from hardship and to address information asymmetries. There is doubt amongst some written submitters about whether or not deposit protection could really help to support confidence and mitigate bank runs and contagion. On the other hand, most stakeholders we spoke to as part of our targeted engagement programme see strong 'financial stability' grounds for protecting depositors. Submitters who are opposed to depositor protection overall sometimes note that insurance would usefully mitigate the risk of bank runs, but were typically strongly opposed to 'hardship' and 'information asymmetry' justifications.

## Opposition to depositor protection in New Zealand

Within the 17 written submissions that oppose formal depositor protection in New Zealand, eight prefer the status quo, while nine provide alternative options that were not presented in the consultation document.

Submitters that opposed formal deposit protection gave reasons including:

- capital and other regulatory requirements that reduce the probability and severity of failures provide depositors with sufficient protection against the risk of loss (this included the Financial Services Federation, Federated Farmers, and several deposit takers, most notably ANZ and BNZ), and
- individual incentives to manage risks prudently are well-supported by aligned private costs and benefits (this group included Business NZ).

Alternative options proposed by submitters include a case-by-case approach to guaranteeing failed institutions, or protecting depositors through 'risk free' narrow banking (requiring deposit takers to match deposit holdings with safe and liquid assets). A few (including Graeme Wheeler, a previous Governor of the Reserve Bank) prefer a formal *de minimis* limit as part of the Reserve Bank's open bank resolution (OBR) policy.

In general, there is broad scepticism (amongst the public, financial corporates, lawyers, and academics) about relying solely on OBR as a mechanism to handle failures or to protect depositors. Of note, Grant Spencer describes existing OBR protections as 'not satisfactory' because 'depositors are not protected in a systematic or politically sustainable way', calling for more explicit protections that are not dependent on the form of failure resolution.



## Other comments

Most submitters agree that the assessment of the benefits of the status quo and the depositor protection options presented in the consultation paper are reasonable, although several, including Grant Spencer, are unconvinced of any 'financial stability' benefits from deposit insurance (whilst still being in favour of it). They see insurance as a definite cost to system stability due to the potential for moral hazard to encourage a build-up of risks.

In general, there is a good understanding that formal deposit protection would come with costs. A diverse range of stakeholders (including consultancy firms, consumer and special interest groups, lawyers, insolvency practitioners, and banks) believe that the moral hazard of formal insurance should not be overstated, given depositors' limited ability to discipline banks as well as the distortions already present under the status quo (given what some submitters saw as an existing implicit guarantee for deposits, and/or the risk that another retail Crown Deposit Guarantee Scheme-style scheme would have to be put in place in another crisis).

The consultation, by intention, did not delve into design specifics. Many submitters agree the scheme's design would have to be carefully considered to avoid unintended consequences and costs. Various submitters specifically comment on coverage limits, with preferences here often shaped by where submitters fell on the primary objectives of deposit protection. Some who want alignment with international practices see Australia's \$250,000 limit as appropriate; those who believe depositor protection could help support financial system stability (including Westpac, ASB and Kiwi Bank) tend to favour a lower, but still 'meaningful', limit; while those who prefer to focus protections on preventing hardship tend to favour a low limit in the order of \$10,000-20,000 (including former Governors Graeme Wheeler and Grant Spencer).

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

Submitters were asked to express their views on whether prudential regulation and supervision should be separated out from the Reserve Bank. Of the 67 total submissions received by the Review team, 41 responded to the questions on separation. The responses to these questions have been summarised below.

### Key points

- 32 of the 41 relevant submissions support the status quo proposition that prudential regulation and supervision remain within the Reserve Bank.
- The majority of these supportive submitters also prefer enhancing the status quo through increased resourcing, clearer objectives and enhanced governance arrangements.
- Four of the 41 submissions prefer separation.
- The remaining 5 submissions express no firm view either way.<sup>4</sup>

### Support for the status quo

Close to 80% of submissions support the status quo, where prudential regulation and supervision remain within the Reserve Bank.<sup>5</sup> However, almost all of these submissions note that there are improvements that could be made to the status quo that would improve the focus and effectiveness of financial policy made by the Reserve Bank.

Those in favour of current institutional settings are not persuaded that any potential benefits from separation would outweigh the costs. One consistent argument in support of the status quo is that for a small country like New Zealand the **direct costs** of setting up a separate agency and the associated duplication of functions such as various corporate-related functions, IT and data/information infrastructure, are potentially prohibitive. Disruption to current institutional arrangements is also seen as a factor (large **transition costs**), compounding this overall cost argument. In short, submitters believe that New Zealand does not have the scale or capacity to support two separate agencies tasked, in their own way, with ensuring financial stability.

Another key argument put forward by those supporting the status quo is an observation that there is some natural ‘complementarity’ between prudential regulation and supervision, and a central bank’s other functions such as monetary policy, providing liquidity in times of stress (the ‘lender of last resort’ role), and systemic risk monitoring. By housing these functions under one roof, these policy functions can be **better coordinated**, and underlying **synergies** be exploited (e.g. the cross-fertilisation of ideas from interactions across those involved in different policy areas). A number of

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<sup>4</sup> Of the 5 ‘on the fence’ submissions, two were from industry bodies (FINSIA and the NZBA) and therefore their reluctance to affirm a clear position likely reflects some diversity of views among their membership.

<sup>5</sup> Note, while 26 submissions don’t explicitly reference the separation issue, they nevertheless address other consultation questions focusing on potential changes to current arrangements within the Reserve Bank (e.g., what objectives the Reserve Bank should have, or governance and accountability arrangements). One might infer that many of these submitters are likely to have an ‘enhanced status quo’ as their default position.

submitters note in particular, the benefits from co-locating knowledge about individual institutions and the ability to provide emergency liquidity in times of stress. Separation, by contrast, would require robust external coordination mechanisms between any separate financial regulator and the Reserve Bank as the lender of the last resort. Some submissions see the risk of such arrangements not working adequately in times of severe financial system stress (pointing to the failings of the pre-crisis tripartite arrangement in the UK), or ‘turf wars’ between agencies.

Two individual submitters qualify their support for current arrangements by suggesting that the prudential regulation and supervision of the *insurance sector* might better sit with another agency – with the Reserve Bank maintaining responsibility for other sectors.<sup>6</sup> They note that the sector was not as systemically important to the New Zealand financial system compared to banks, and that the culture and business of insurance is sufficiently distinct from credit intermediaries to warrant oversight from another agency. That said, the two insurance bodies that submitted on the separation issue – the Insurance Council of New Zealand (ICNZ) and the Financial Services Council – do not support this proposition, despite acknowledging that there are less potential synergies between insurance supervision and the Reserve Bank’s other non-prudential functions such as monetary policy. However, the ICNZ notes that there are sufficient synergies and overlap between banking and insurance to keep these sectors together under the Reserve Bank’s prudential roof.

### **Enhancements to the status quo**

Almost all submitters in favour of the status quo recognise that improvements to the current prudential framework are necessary. Several submitters are explicit that their support for the enhanced status quo option, as laid out in the consultation document, is contingent on the efficacy of any changes arising out of the Review – that is, if the Review does not ‘deliver’ as expected, they reserve the right to re-evaluate the merits of separation. Some believe that a degree of internal ‘cultural resistance’ within the Reserve Bank to embedding change could be a pragmatic reason for separation.

The main concern underpinning various enhancements to current arrangements rests around the notion that there is not the appropriate degree of focus being placed on prudential regulation and supervision by the Reserve Bank (including the perception from some that the Reserve Bank focuses on monetary policy at the expense of its financial policy related responsibilities). An almost universal solution suggested by submitters to address this problem within current arrangements is **greater resourcing**. More funding would underpin a more capable and responsive prudential regulator, with many submitters tying this greater funding to a desire to see the Reserve Bank become a more orthodox supervisor (in recognition that the Reserve Bank is an outlier in how it undertakes its prudential responsibilities relative to the rest of the world).

Other key enhancements to the status quo identified by proponents include changes to **governance arrangements**, whereby a dedicated group decision-making body would provide the necessary focus for financial policy. In addition, a number of submitters believe that clearer statutory objectives would also support a more focused approach to the Reserve Bank’s prudential responsibilities.

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<sup>6</sup> The one licensed insurer that submitted – Tower Insurance – supports the full separation of the Reserve Bank’s prudential responsibilities.

Other enhancements to the status quo suggested by submitters include:

- Improvements to current accountability arrangements, including review rights for regulated entities, regular independent reviews of Reserve Bank legislation, and independent assessments of the effectiveness of the Reserve Bank as a prudential regulator.
- Improvements in the supervisory 'culture' at the Reserve Bank, tied to greater transparency around Reserve Bank decisions and better communication with regulated entities, including more clearly articulated expectations and/or guidance for industry of Reserve Bank policies.
- Formalising the cooperation between the Reserve Bank and the FMA (the two peaks of the 'twin peaks' regulatory model) through legislation.
- Various changes to how NBDTs are regulated and supervised.

## Support for separation

A small number of submitters (4 out of 41) argue that the creation of a new agency is the only way to fundamentally change the current approach to prudential supervision. Two of the four are from individuals who merely state their preference for separation without specific supporting arguments. The other two proponents of separation are Westpac and Tower Insurance.<sup>7</sup>

Both Westpac and Tower support the New Zealand Prudential Regulation Authority (**NZPRA**) **option**. Westpac argues that there is little or no synergy between the Reserve Bank's prudential mandate and its other functions. They also believe that co-location significantly complicates the construction of optimal governance arrangements for the Reserve Bank. A separate NZPRA effectively solves this governance question, while creating an agency whose sole focus is on its prudential role, staffed and resourced accordingly. Additional costs for the regulatory system could be recovered by an industry-funding model for the NZPRA. Westpac qualifies its support for the NZPRA option by suggesting greater structural separation of prudential regulation and supervision within the Reserve Bank could be an alternative to separation. This second-best solution would involve the creation of a financial policy committee, supported by a separate mandate and greater resourcing for the prudential function.

Tower believes that the current approach to prudential regulation and supervision is fundamentally flawed and in need of an urgent overhaul. They submitted that the light-touch Reserve Bank approach is out of step with international norms, there is a lack of focus on the prudential function, and that Reserve Bank supervisors are under-resourced and lacking in capability and capacity. An NZPRA model would afford a greater focus on the insurance sector and a more focused organisational culture appropriate for a prudential regulator.

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<sup>7</sup> Note, the Review team also received support for separation from several individuals that were engaged through stakeholder meetings following publication of the C1 consultation document in November. They have not however, followed up with formal submissions. That said, many of the arguments the Review heard from these individuals align with those presented by Westpac and Tower.

## 5. How should the Reserve Bank be governed?

Submitters were asked to express their views on how the Reserve Bank should be governed. In particular, views were sought on the following areas:

- The governance structure of the Reserve Bank including whether the governing body should be a single-decision maker or a board, and whether a financial policy committee should be established;
- The scope of the Reserve Bank's operational independence including the role of the Minister of Finance and responsibility for legislative stewardship; and
- How the Reserve Bank should be monitored and held to account.

Of the 67 submissions received by the Review team, just under half provided substantive comments on governance. The NZBA made a submission covering governance, and seven other submissions covering governance were from registered banks including the four largest banks. Three former Governors of the Reserve Bank made written submissions on this topic.

In addition to receiving feedback on governance via formal submissions, the Review team conducted a series of interviews with a selection of individuals with governance expertise in the public, private and regulatory sectors in New Zealand and internationally. The interviewees include experienced directors and senior governors (past and present) at the Bank of England, the United States Federal Reserve, APRA and the FMA. The interviews were conducted on a confidential basis and on the understanding that the views would be used to inform our analysis but not attributed to an individual. In many cases the feedback from these discussions was consistent with the written submissions. In some cases below, we mention additional ideas gained from these interviews.

The written responses to the relevant questions on Reserve Bank governance have been summarised below.

### Key points

- 15 submitters favour a policy board model whereby a governance board would be established with responsibility for all corporate, operational and financial policy responsibilities of the Reserve Bank (Policy Board model). These submitters include the NZBA and all banks (with the exception of Westpac).
- 10 submitters favour the establishment of a statutory financial policy committee (FPC) with responsibility for financial policy and the establishment of a governance board with responsibility corporate, operational and other policy matters.
- 5 submitters favour moving from a single decision maker but expressed no firm preference for a Policy Board model or an FPC model.
- 3 submitters favour the single decision-maker model.
- 17 submitters favour the Treasury acting as external monitor and 14 submitter favoured the Treasury administering legislation. These submissions include NZBA and nearly all of the bank submissions.

## Support for group decision making

The more substantive submissions favouring a move to group decision making point to the lack of checks and balances, the concentration of power and a lack of accountability in the single decision-maker model. The advantages of different perspectives, the involvement of externals and the independent challenge inherent in a group decision-maker model are seen as key reasons for moving to group decision making. A number of submitters suggest the monitoring role played by the current board is ineffective. Some submitters emphasise the benefits that externals could bring to group decision making. Some submitters note the costs of moving to group decision making, but see the benefits as outweighing these costs.

Nearly all submitters favouring group decision making see value in a governance board being established. The advantages of a governance board include robust accountability provided by the split of governance and management roles, and the ability of directors to hold management to account. A number of these submitters note that there would need to be appropriate transparency requirements to ensure external accountability. Some submitters note the importance of a balanced board and a robust appointment process.

## The Policy Board and FPC models

### Policy Board model

While most submitters support the establishment of a governance board, there is a difference of view on what its responsibilities should be. The majority of submitters are in favour of the Policy Board model. These submissions tend to focus on the board as a conventional group decision-making structure with robust internal accountability. Some submissions note the flexibility inherent in a board model including the use of delegations and internal committees. While most submissions favouring a Policy Board did not argue against the FPC model, those that did tended to focus on the increased complexity, novelty and inflexibility associated with the FPC model.

### FPC model

Ten submitters expressed a preference or interest in the FPC model for governance of the Reserve Bank's financial policy responsibilities. Those submitters favouring the FPC model tend to note the complexity associated with financial policy suggesting that decisions on financial policy would benefit from focused expertise. Some reasons given in support of an FPC were that it would better embed external expertise, give financial policy more prominence and be consistent with phase 1 decisions.

### Importance of delegations

A number of the submissions note the importance of the governing body and the Governor operating at the right levels with the governing body having a more strategic and oversight role with most day to day operational matters being handled by the CEO. These submissions suggest that an effective delegations framework will be required as part of the governance structure. Some submissions view crisis management decisions as needing to be dealt with under a separate process due to the need to act quickly.

## Governance interviews

Participants in the governance interviews raised views similar to those in the written submissions. Both models are generally seen as a move to a more robust governance structure although there was divided opinion on what model is optimal. There was an even split of views, often reflecting a participant's background with different governance structures. Some additional matters raised by participants included:

- Supervision and enforcement: a number of participants thought that the Policy Board or FPC should have responsibility for supervisory and enforcement decisions but that most of these decisions would be delegated by the board or FPC to the Governor.
- Crisis management: some participants thought crisis management was a difficult area to address. Crisis management decisions are hard to deal with at a board or committee level as crisis management is too fast-moving and operational. Externals can be ill-suited to crisis management and conflicts become more problematic. A different process may be needed.
- No separation of macro-prudential and micro-prudential responsibilities: participants who favoured an FPC model generally agreed it was not necessary, particularly in a small concentrated financial system like New Zealand, to have separate statutory micro-prudential and macro-prudential committees.

## Operational independence

There was generally strong support from submitters for the Reserve Bank's operational independence for prudential policy. However, a number of submitters note the broadness of the Reserve Bank's financial policy objectives and that there may be benefit in clarifying the Reserve Bank's financial policy mandate. There were a range of views submitted on these matters including the following:

- Some submitters state that there is a need to better define the Reserve Bank's financial policy objectives and that the Minister should have a role in clarifying these objectives. Some ideas for clarifying the financial policy objectives included a ministerial remit or government policy statement.
- Other submitters are concerned that ministerial involvement in clarifying objectives could undermine operational independence and preferred legislative mechanisms to the extent clarification is required. One submitter notes that ministers may be inclined to assess and define the Reserve Bank's financial policy objectives by reference to shorter time horizons and cycles than may be appropriate given the nature of prudential management.
- There was generally strong support for the removal of the requirement for ministerial consent for most direction powers provided there were sufficient checks and balances in place on the use of direction powers.
- A number of submitters note that there would need to be an increased level of ministerial involvement for financial policy matters involving distributional effects.

## Monitoring, accountability and administration of legislation

There is strong support for the Treasury to act as the external monitor and have responsibility for the administration of the Reserve Bank's legislation. 17 submitters favour the Treasury acting as external monitor and 14 submitters favour the Treasury administering legislation.

Submissions that favour moving administration of legislation to the Treasury tend to note that it would enhance the operational independence of the Reserve Bank by removing a conflict of interest. Some note that an agency administering its own legislation is unusual.

A number of submissions on external monitoring note that the current arrangements with the existing board acting as monitor could not continue if a new governance board was established. Some submitters note that with the increased internal accountability in a governance board, there is less of a need for intensive external monitoring. A couple of submitters suggest that a different approach to external monitoring is needed and that an independent supervisor with its own resources should be established to monitor the Reserve Bank.

A number of submitters note the Reserve Bank's exclusion from performance audits by the Office of the Auditor General should be removed. Other submitters suggest that existing transparency and accountability requirements should be formalised.



# Appendix 1: List of submitters

Submitter
ANZ Bank New Zealand Limited
ASB Bank Limited
Avanti Finance Limited, Bluestone Group, Flexigroup New Zealand, Latitude Financial Services, Motor Trade Finance, Resimac, Toyota Finance
Australian Securitisation Forum
Bank of New Zealand
Ben Thirkell-White
Bill Foster
Bruce White
Business New Zealand
Chapman Tripp
Chris Gregory
Cody Cooper
Consumer NZ
Co-op Money NZ
Credit Union Baywide and Credit Union South
David Tripe
Don Brash
Federated Farmers
Financial Services Council
Financial Services Federation
FINSA Financial Services Institution of Australasia
Graeme Wheeler
Grant Spencer
Heartland Bank
IAG New Zealand Ltd
Iain Parker
Insurance Council of New Zealand
Institute of Directors
Institute of Finance Professionals New Zealand Inc (INFINZ)
Kerry McDonald
Kiwibank Limited
Leigh Kenna
Lord Anubis

<b>Submitter</b>
Marion Stewart
Martien Lubberink
Martin Taylor
Mayne Wetherell
Michael Webb
Murray Jackson
Mutual Credit Finance Limited
NZ Bankers' Association
NZ Council of Trade Unions
NZ Initiative
NZX Limited
John Ryan (Office of Auditor General)
Oliver Wyman
Pat Vincent
Richard Darlow
RITANZ
Robbie Cullen
Roger C Lowry
Ross Edney
Sarah Mead
Social Credit
Tower Insurance
Transparency International New Zealand
The Cooperative Bank Limited, SBS Bank and TSB Bank Limited
Trustee Corporations Association of New Zealand
Wairarapa Building Society
Wellington Chamber of Commerce
Westpac New Zealand Limited

There were two submissions made on a confidential basis and four anonymous submissions.