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THE TREASURY

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Safeguarding the future of our financial system

Executive summary: In-principle decisions and follow-up questions on: The role of the Reserve Bank and how it should be governed

Consultation Document 2A

Phase 2 of the Reserve Bank Act Review

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Executive summary

This document, 'Consultation Document 2A', is one of two documents being released as part of the second round of consultation on Phase 2 of the Review of the Reserve Bank of New Zealand Act 1989 (the Reserve Bank Act).[1] It is being released alongside Consultation Document 2B – 'The Reserve Bank's role in financial policy: tools, powers, and approach'.

A glossary accompanying this document explains many of the technical terms used in this document.

Consultation Document 2A is a follow-up to Consultation Document 1: The role of the Reserve Bank and how it should be governed, which sought feedback on questions about:

- what the Reserve Bank's objectives, governance arrangements, and regulatory perimeter (the boundary between regulated and unregulated firms) should be
- whether New Zealand should have depositor protection
- whether responsibility for prudential regulation should stay with the Reserve Bank.

This document:

- reports back on in-principle decisions that the Minister of Finance has made on the issues covered in Consultation Document 1
- seeks feedback on more detailed elements of these issues in light of the Minister's in-principle decisions.

Your views are welcome on these important in-principle decisions and related follow-ups. The deadline for submissions is 5pm on **16 August 2019**.

1. Should prudential regulation remain with the Reserve Bank?

The Minister has made an in-principle decision to keep the responsibility for prudential regulation with the Reserve Bank.

Keeping responsibility for prudential regulation with the Reserve Bank:

- will maximise synergies between the Reserve Bank's prudential regulation function and the Reserve Bank's other functions
- will avoid the transition costs of setting up a new prudential agency
- is a cost-effective regulatory model given New Zealand's size.

The decision is consistent with trends internationally since the global financial crisis (GFC), with jurisdictions shifting responsibility for prudential regulation to central banks. This decision was also supported by the majority of stakeholders in the first round of consultation, and by the Independent Expert Advisory Panel.

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[1] Phase 1 of the Review of the Reserve Bank Act began the task of modernising New Zealand's central bank legislation, focusing on reforms to the framework for monetary policy.

The 2018 scoping process for Phase 2 revealed that some stakeholders were concerned about issues such as a lack of focus from the Reserve Bank on its prudential role and a lack of capacity to deliver it, poor relationships with regulated entities, and potential conflicts in different policy functions. However, only a minority of respondents to Consultation Document 1 were concerned about these issues, and these issues are expected to be addressed through wider initiatives in this Review which:

- clarify the Reserve Bank's focus on prudential regulation by establishing a clearer set of financial policy objectives (see Chapter 2)
- embed group decision-making in the financial policy process (see Chapter 3)
- potentially increase funding and resourcing for the Reserve Bank's prudential function (see Chapter 3 in Consultation Document 2B).

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

The Minister has made an in-principle decision to replace the Reserve Bank's existing 'soundness and efficiency' financial policy objectives with a single high-level objective to 'protect and enhance financial stability'.

'Financial stability' is seen as a clearer, more modern, internationally accepted term that is more relevant to the Reserve Bank's broad role in safeguarding the financial system. It provides direction for all of the Reserve Bank's financial policy functions, from prudential regulation to crisis management. It also encapsulates the most relevant aspects of soundness and efficiency in a singular objective, removing ambiguity over how to weight objectives, and providing clarity of focus.

Most stakeholders supported this change while recognising that the high-level financial stability objective should be complemented by a fuller 'objective set' to guide the Reserve Bank in undertaking its various financial policy functions. In particular, stakeholders noted that it would be important to retain and clarify the Reserve Bank's role in supporting 'financial system efficiency' when developing the broader objective set.

In light of this decision, Chapter 2 of this document provides some objectives that could be added to the objective set, including those that cover:

- specific elements of financial stability, such as enhancing the resilience of the financial system or ensuring the continuity of critical financial services in a crisis
- specific elements of financial system efficiency, such as minimising the regulatory burden on financial firms or facilitating effective competition in the financial sector
- protections for certain groups in society, such as depositors, clients, firm owners or public funds in the event of a bank failure
- behavioural goals for the Reserve Bank, such as acting transparently and coordinating with other regulatory agencies
- other economic objectives such as promoting sustainable economic growth and the economic objectives of government.

The emphasis the Reserve Bank places on these additional objectives will depend on the form they take in legislation, including whether they are specified as 'secondary objectives' or 'lower-tier considerations' that the Reserve Bank must have regard to. Chapter 2 discusses how legislative structure can affect the Reserve Bank's objective set. The chapter also provides and seeks feedback on an illustrative example of how the complete objective set could be specified.

3. How should the Reserve Bank be governed?

Consultation Document 1 considered whether:

- the Reserve Bank's governance arrangements should move from a single-decision-maker model (the status quo) to a more typical board structure
- a statutory Financial Policy Committee (FPC) should be established with responsibility for prudential policy
- the responsibility for external monitoring of the Reserve Bank should move from the current Reserve Bank Board to the Minister's policy department (the Treasury).

The Minister has made the following in-principle decisions:

- A new governance board will be established with statutory responsibility for all the Reserve Bank's decisions (except those reserved for the Monetary Policy Committee[2]). It will replace the single-decision-maker model, under which the Governor has this responsibility.
- No statutory FPC will be established; the new governance board will be responsible for all prudential policy decisions.
- The Treasury will be responsible for assessing the Reserve Bank's performance, replacing the existing Reserve Bank Board as monitoring agent.

Through the new governance board, group decision-making will be embedded at the highest level of the Reserve Bank. This will help to bring diverse perspectives and experiences to key decisions and protect against individual biases and preferences. It will also enable more robust accountability for decisions by creating a clearer split between the governance and management functions (with the latter being the Governor's responsibility).

The board governance model is already used by all New Zealand Crown entities (including the Financial Markets Authority [FMA]), is well understood domestically and internationally, and is underpinned by robust legal and corporate governance frameworks. In contrast, the statutory FPC structure is little used for prudential policy, with the Bank of England (BoE) being a notable exception.

The Reserve Bank's governance board will need to be designed carefully to ensure it can manage its broad mandate, particularly details such as its composition, appointment/removal and decision-making processes. In addition, given that the board model and monitoring arrangements share common features with Crown entities' governance arrangements, there may be merit in reclassifying the Reserve Bank as a Crown entity.

Chapter 3 provides further detail on the governance structure, options for key design features, and asks for your feedback on the proposed governance package.

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[2] The Monetary Policy Committee was established in Phase 1. It is responsible for formulating monetary policy.

4. How should the regulatory perimeter be set?

The Minister has made an in-principle decision to unite the two currently separate regulatory regimes for banks and non-bank deposit takers (NBDTs) – institutions that are not registered banks, such as finance companies and building societies – into a single 'licensed deposit taker' framework. Stakeholders almost universally supported this decision.

This move to a single regime will more clearly align regulatory activities with the Reserve Bank's financial stability objective, and also support good regulatory outcomes through greater regulatory efficiency (minimising duplication across regimes) and neutrality (treating similar activities in the same way).

The new framework will continue to be risk-based, allowing it to be growth compatible and support innovation.[3] It will also be more flexible and adaptable, and enable new entrants and business models to be accommodated where appropriate (this was a strong theme in stakeholder feedback). A model that supports competitive regulatory neutrality will also be important in enabling a comprehensive depositor protection scheme in New Zealand.

In light of this in-principle decision, Chapter 4 addresses design issues relating to the perimeter in more detail, including the potential definition of a deposit taker. The chapter also considers three proposals for supporting an adaptable and flexible perimeter: enhanced perimeter monitoring, a designation regime, and a distinct macro-prudential perimeter.

5. Should there be depositor protection in New Zealand?

The Minister has made an in-principle decision to start developing a scheme that will protect New Zealand depositors if the institutions that hold their deposits fail.

New Zealand's depositor protection scheme will protect eligible depositors' savings in failed deposit-taking institutions (for simplicity, 'banks') up to an insured limit, proposed to be in the range of $30,000-$50,000 per depositor. The scheme will protect, with certainty and consistency, ordinary New Zealanders from the risk of losing their savings in the bank – and in doing so contribute to public confidence and the stability of New Zealand's financial system.

The first consultation showed that a broad cross-section of stakeholders are in favour of protecting New Zealand depositors in some way. Those in favour included a significant majority of the general public, industry practitioners and experts, special interest groups, past governors of the Reserve Bank, and three of the five largest banks in New Zealand.

Stakeholders generally agreed that an insurance scheme would be the best way to protect New Zealand depositors, possibly supported by a depositor preference (which puts protected depositors in failed banks higher in the creditor hierarchy so closer to the front of the queue to be repaid). Stakeholders had mixed views on the objectives of depositor protection, however, and many – including the Independent Expert Advisory Panel – asked for more information on where depositor protection might fit within New Zealand's broader prudential framework, and on the economic consequences of protecting depositors.

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[3] A risk-based approach focuses resources according to the risk profile of regulated entities.

Chapter 5 follows up on these issues in more detail. It shows that depositor protection is one of the five key elements of the 'financial safety net', which supports the smooth functioning of the financial system in good times, and protects society from damage when things go wrong. The other four elements of the net are prudential rules and regulatory requirements, supervision and monitoring, liquidity, and resolution. Although the net's five elements overlap, all are needed for it be effective in protecting the financial system from shocks or unexpected events that can cause banks to fail, and giving governments credible tools to stop banking failures, if and when they occur, from becoming damaging crises. Introducing depositor protection to New Zealand will make the current safety net more comprehensive, and the financial system and economy more resilient.

However, there are economic costs associated with depositor protection:

- Protected depositors might take less care when choosing their banks, and banks might in turn take less care with depositors' money. This is called 'moral hazard', which can make the system more, not less, risky - unless it is carefully managed by good scheme design.
- The depositor protection scheme will need to be funded, most likely by a levy imposed on members and supported by temporary (repayable) support from the government.

Although these costs could be significant, deposit protection should be a net benefit for society provided it is designed well.

Within the parameters set by the Minister's in-principle decisions, the design of New Zealand's depositor protection scheme will require significant further work and consultation to ensure that it is the best for New Zealand. Some of the things that the programme of work will have to address include the mechanisms for protection that best advance the public policy objectives chosen for the scheme, and how those mechanisms should be calibrated and put into practice.

Chapter 5 seeks preliminary feedback on these issues. Final decisions towards the implementation of a New Zealand deposit protection scheme will be made later in the Review process, and in the context of other decisions on New Zealand's wider prudential framework.