TE TAI ŌHANGA
THE TREASURY

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Safeguarding the future of our financial system

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

June 2019

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Ministerial foreword

This document and the companion paper – 'The Reserve Bank's role in financial policy: tools, powers, and approach' – form the basis for the second consultation for Phase 2 of the Reserve Bank Act Review, which has been underway since June 2018.

Phase 2 of the Review is focusing on the Reserve Bank's role in the regulatory framework, which is critical to ensuring a high-functioning, resilient, and efficient financial system. Enhancing this framework will contribute to the Government's economic plan to improve the wellbeing and living standards of all New Zealanders by building a productive, sustainable, and inclusive economy.

This paper outlines a number of in-principle decisions that I have taken following the first public consultation for the Review that began in November last year. These include:

- keeping responsibility for all prudential regulation functions with the Reserve Bank
- replacing the Reserve Bank's existing 'soundness' and 'efficiency' financial policy objectives with a single overarching 'financial stability' objective
- establishing a new governance board, which will be given statutory authority over all Reserve Bank decisions (other than those reserved for the Monetary Policy Committee)
- establishing the Treasury as the Reserve Bank's monitoring agent
- combining the separate regulatory regimes for banks and non-bank deposit takers (institutions that are not registered banks, such as finance companies and building societies) into a single 'licensed deposit taker' perimeter
- developing a formal depositor protection scheme that will protect depositors' savings up to an insured limit, currently proposed within a range of $30,000-50,000.

The accompanying consultation paper explores all the remaining issues in the Review's terms of reference that were not considered in the first consultation. These include the Reserve Bank's regulatory powers, supervision and enforcement roles, the macro-prudential policy framework, and crisis management and resolution. The paper also considers models for the funding of the Reserve Bank.

As with the first consultation, I would urge all stakeholders to offer their views to assist the Review team and the Independent Expert Panel in providing the Government with recommendations.

A third and final consultation will take place later in 2019 before the Review team delivers final recommendations on remaining issues to me. A particular focus will be on ensuring the proposed changes to the Reserve Bank's legislative framework work effectively as a package and continue to protect its operational independence consistent with the Review's terms of reference.

I look forward to further progress on the Review over the months ahead.

Hon Grant Robertson, Minister of Finance

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.

Questions for consultation

Chapter 1: Should prudential regulation remain with the Reserve Bank?

No follow-up questions.

Chapter 2: What financial policy objectives should the Reserve Bank have?

2.A What other objectives should the Reserve Bank have?

- Which of the objectives discussed in Chapter 2 should feature in the Reserve Bank Act, and why?
- Are there any other objectives not covered in Chapter 2 that should be considered?

2.B Should the Reserve Bank be given a more explicit climate change objective? If so, what would be your preferred mechanism for achieving this?

2.C Where in the legislative hierarchy should any additional objectives sit – as 'secondary objectives', or as 'considerations' that the Reserve Bank must look at?

2.D How should the Reserve Bank's objectives be specified? Do you see a role for a 'financial policy remit'? If so, what should it include?

2.E What is your view on creating a new 'Deposit Takers Act' that combines material from the NBDT Act with the Reserve Bank Act's banking regulation material?

2.F Looking at the example of the Reserve Bank's objective set, which elements do you support and which would you change, and why?

Chapter 3: How should the Reserve Bank be governed?

3.A What factors are most important for achieving the establishment of an effective governance board with responsibility for all the Reserve Bank's decisions outside of monetary policy?

3.B What is the appropriate degree of delegation from the board to the Governor? Are there any decisions that should be reserved for the board?

3.C What approach should the Treasury adopt in monitoring the Reserve Bank? What should the Treasury's monitoring responsibilities be? Should the Treasury's monitoring responsibilities be different for the MPC?

3.D Do you think there is merit in reclassifying the Reserve Bank as an independent Crown entity?

3.E For the new governance board:

- what should the split of executive and non-executive members be?
- what skills and expertise should non-executive members have? Is there merit in having representation from the FMA and/or the Treasury?
- how should members be appointed and removed? Should the board be able to appoint the Governor as CEO?

3.F Are there any aspects of the board's operation would benefit from legislative clarity or guidance?

Chapter 4: How should the regulatory perimeter be set?

4.A What is the appropriate definition of 'deposit taker'? Do you agree that the definition should be framed around entities that take retail 'deposits' and lend? If not, what approach do you consider would be preferable?

4.B Should the Reserve Bank's ability to monitor non-licensed entities be enhanced, for example through increased data reporting requirements? What do you consider would be the costs and benefits of such an approach?

4.C Should the Reserve Bank be given discretion to extend the perimeter within clearly specified parameters to avoid regulatory arbitrage (such as designating in entities with business models economically similar to deposit takers)? Do you agree that changes that are more significant may be more suited to legislative change, supported by pre-positioning?

4.D Should tools that are not linked to licensing have a different perimeter? For example, it is common internationally for non-bank lending institutions to be subject to macro-prudential lending tools, even though they do not take deposits.

Chapter 5: Should there be depositor protection in New Zealand?

5.A Are the interactions between depositor protection and the other parts of the financial safety net set out in Part I of Section 2 described appropriately?

5.B What objectives should the depositor protection regime in New Zealand have? Should its objectives be:

- to protect depositors from loss?
- to contribute to public confidence and financial stability?
- both of these?
- something else?

5.C The Minister has made an in-principle decision that the depositor protection regime should have a limit in the range of $30,000-$50,000. Given your answer to 5.B, what coverage level would be best within this range?

5.D How would your preferred limit affect depositor wellbeing, public confidence, and depositors' responsibilities for their financial choices?

5.E Do you think the New Zealand depositor protection regime should be supported by a preference for insured depositors? How would this affect the costs and benefits of a depositor protection regime in New Zealand?

Background to this consultation document

In November 2017 the Government announced a review of the Reserve Bank of New Zealand Act 1989 (the Reserve Bank Act) with the aim of ensuring that the Reserve Bank's monetary and financial policy frameworks are the most efficient and effective for New Zealand.

In December 2017 the Minister of Finance established an Independent Expert Advisory Panel to support and advise the officials undertaking the Review.

What does the Review involve?

The Review has two phases:

- Phase 1 (which is now complete) focused on improving the Reserve Bank's **monetary policy framework**. Final Cabinet decisions were announced on 26 March 2018. These included a decision to add 'maximum sustainable employment' to 'price stability' as an objective of monetary policy. In addition, Phase 1 established a Monetary Policy Committee (MPC), which formally commenced its role on 1 April 2019. The Committee is based in the Reserve Bank and is responsible for formulating monetary policy.
- Phase 2 (the subject of this document) focuses mainly on the Reserve Bank's **financial policy framework**, which provides the basis for prudential regulation and supervision. Phase 2 also deals with the Reserve Bank's governance arrangements. The Minister of Finance released the terms of reference for this phase on 7 June 2018 and the result of a first consultation was published in November 2018.

Phase 2 is being carried out by a Review team comprising members of both the Treasury and the Reserve Bank, and is overseen by a Steering Committee that makes policy recommendations to the Minister of Finance as the Review progresses. In addition, the Independent Expert Advisory Panel contributes to and challenges the Review team's work.[4] The Chair of the Independent Expert Advisory Panel is also a member of the Steering Committee.

Where do you fit in?

Phase 2 has three rounds of public consultation, in which you and other stakeholders are invited to take part (see Figure A below). The first round is complete, and this consultation document is one of two released for the second round. It reports back on in-principle decisions that the Minister has made on issues covered in Consultation Document 1 and seeks feedback on more detailed elements of these issues, including:

[4] The Independent Expert Advisory Panel for Phase 2 consists of Suzanne Snively (Chair), Malcolm Edey, Girol Karacaoglu (the original members of the panel), Barbara Chapman, Belinda Moffat, and John Sproat.

- the case for and against separating prudential supervision from the Reserve Bank
- the Reserve Bank's overarching objectives
- the perimeter for prudential regulation
- the case for and against depositor protection
- the Reserve Bank's institutional governance and decision-making framework.

First group of topics

Consultation Document 2B, published alongside this document as part of the second round of consultation, considers the remaining topics covered in the terms of reference, such as:

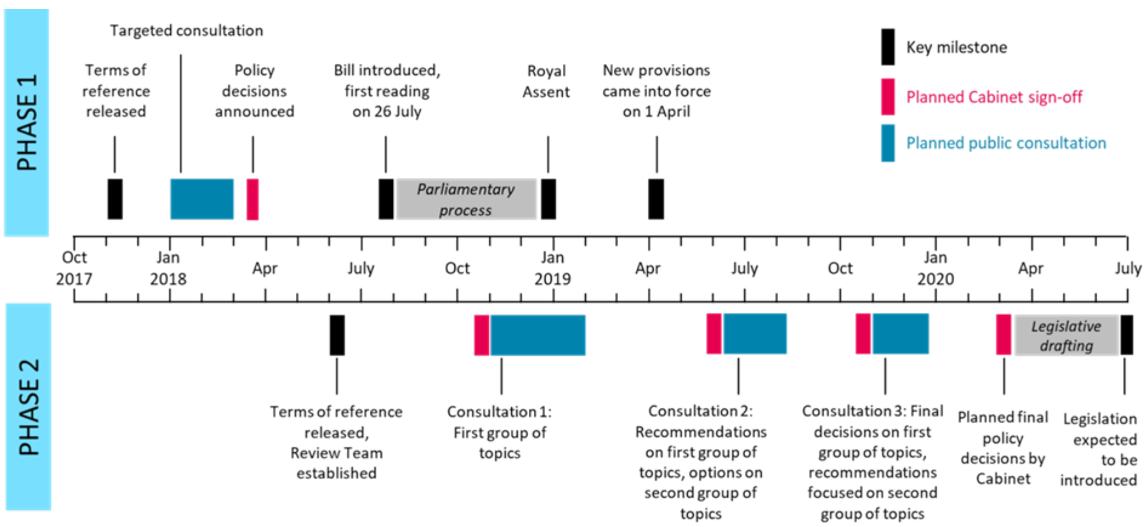
- the legal basis for bank regulation
- macro-prudential policy
- the approach to supervision and enforcement
- crisis management
- coordination with other agencies
- the Reserve Bank's resourcing and funding.

Second group of topics

A third and final consultation will take place later in 2019 before final recommendations on remaining issues are delivered to the Minister of Finance.

Throughout this consultation, comments are invited from everyone who has an interest in the future of New Zealand's financial system, including financial market participants, businesses, and all members of the public. The Review team welcomes your feedback on all topics and the options for change – your views will help to ensure that the Reserve Bank's legislation is fit for the future.

Figure A: Illustrative timeline of the Review



How you can contribute

This public consultation process provides New Zealanders with the opportunity to give their views on the future shape of financial policy in New Zealand, the appropriate role for the Reserve Bank in safeguarding the financial system, and how the Reserve Bank should be governed.

You are encouraged to make your views known on these important issues. An online form to assist you with providing written comments is available on the Treasury's website at http://treasury.govt.nz/rbnz-act-review.

All responses should be emailed to rbnzactreview@treasury.govt.nz. Alternatively, responses can be sent to the address below:

Phase 2 of the Reserve Bank Act Review
The Treasury
PO Box 3724
Wellington 6140

The deadline for submissions is 5pm on **16 August 2019**.

Further information about Phase 2 of the Reserve Bank Act Review can be found on the Treasury's website at http://treasury.govt.nz/rbnz-act-review.

Questions about the consultation process can be sent by email to rbnzactreview@treasury.govt.nz.

Following the consultation process is complete, the intention is to publish all submissions as well as a report summarising the key messages and emerging themes. If you have any objection to your submission or parts of it being published, please state this in your submission. If you wish your submission to be anonymised, please also state this in your submission.

Submissions and the Official Information Act 1982

Submissions received are subject to the Official Information Act 1982 (OIA). Please set out clearly with your submission if you have any objection to any information in the submission being released under the OIA. In particular, clearly state which part(s) you consider should be withheld, and the reason(s) for doing so.

The OIA sets out reasons for withholding information. Reasons could include that the information is commercially sensitive or that you wish personal information – such as names and contact details – to be withheld. An automatic confidentiality disclaimer from your IT system is not a reason to withhold information.

Your objections will be considered when responding to requests under the OIA.

Chapter 1: Should prudential regulation remain with the Reserve Bank?

Overview

This chapter follows up on the question of whether the Reserve Bank's prudential regulation and supervision responsibilities should be separated from the Reserve Bank.

Under New Zealand's current financial regulation model, the Reserve Bank is responsible for prudential regulation and supervision, and the FMA is the conduct authority with an objective to promote and facilitate the development of fair, efficient, and transparent financial markets.

During the scoping of this Review, some stakeholders raised concerns about the Reserve Bank continuing to be responsible for prudential regulation and supervision. These concerns focused on potential conflicts between the Reserve Bank's different policy functions, a lack of focus in its prudential role, and an insufficient capacity to deliver the role. The Review is addressing these concerns as part of considering wider reforms in areas such as the Reserve Bank's governance arrangements, objectives, and resourcing.

Consultation Document 1 considered three options for locating prudential functions:

- Keeping them in the Reserve Bank but making changes as part of this Review that could address some of the concerns raised by stakeholders (this is the 'enhanced status quo' option).
- Moving them to a stand-alone prudential agency.
- Combining them with the functions of the financial market conduct regulator (currently the FMA) into a single regulator.

This chapter describes the Minister of Finance's in-principle decision and its rationale, and reports on the stakeholder feedback received through the first consultation.

Section 1: In-principle decision

Should the prudential regulation function be separated from the Reserve Bank?

The Minister has made an in-principle decision to not separate the prudential regulation and supervision functions from the Reserve Bank. This is the enhanced status quo option outlined in Consultation Document 1.

Rationale for the decision

Retaining the prudential functions within the Reserve Bank would preserve the strong complementarity between a prudential mandate (which includes crisis management) and the Reserve Bank's central bank functions. Co-locating these functions enables synergies to be exploited, and the benefits would be particularly evident in times of financial stress. In addition, since the GFC a number of other jurisdictions have moved closer to New Zealand's model (of combining prudential and central bank functions) rather than away from it.

The enhanced status quo would also keep transition costs to a minimum (since a new agency would not be required) and would not duplicate business functions (such as human resources, IT, and data/information management services).

The option to combine the Reserve Bank's prudential function with the FMA's conduct function would come with additional risks due to the potential conflicts of interest in housing the conduct and prudential regulators in the same institution (as discussed in Consultation Document 1).

While stakeholders have raised potential issues with how the model currently works, these can be addressed through the changes to governance, objectives, and resourcing that are being considered elsewhere in the Review:

- **Establishing clearer financial-system-related objectives** (see Chapter 2) – well-specified objectives are the building block for an organisation's activities, providing a clear focus and a marker for assessing performance. Some stakeholders supporting separation raised concerns that the Reserve Bank's current financial objectives are unclear. The in-principle decision to change the Reserve Bank's current high-level objectives, as well as the options for lower-level objectives set out in Chapter 2, provides for increased clarity and specification of the Reserve Bank's financial policy focus.
- **Shifting to collective decision-making for financial policy** (see Chapter 3) – some stakeholders supporting separation commented on the Reserve Bank's lack of focus on its prudential functions. The in-principle decision to establish a governance board enables more collective decision-making than the current governance arrangements; this can help to strengthen the Reserve Bank's focus on its prudential responsibilities.
- **Greater resourcing for the Reserve Bank's prudential responsibilities** (see Chapter 7 of Consultation Document 2B) – this consultation is also considering whether there are opportunities to improve the current funding model so that the Reserve Bank has the necessary degree of 'budgetary independence' to support a capable and effectively resourced prudential regulator.

The Independent Expert Advisory Panel, the Reserve Bank, and the Treasury all support the in-principle decision to keep the responsibility for prudential regulation and supervision within the Reserve Bank. The Independent Expert Panel also supports potential enhancements to current arrangements that will improve the resourcing and focus of the Reserve Bank's prudential functions.

Feedback from stakeholders

Of the 67 submissions received on the first consultation, 41 commented on separation specifically. The vast majority of stakeholders preferred the enhanced status quo. Out of the 41 submissions that commented on the issue, 32 supported prudential regulation and supervision staying within the Reserve Bank. Five submissions commented on separation but expressed no firm views, while four preferred some form of separation.

The remaining submissions did not mention separation specifically, but overall commented favourably on the proposed changes to governance and objectives that would feature in an enhanced status quo model.

The feedback from stakeholders supporting the enhanced status quo featured two main arguments:

- There is a natural 'complementarity' between the Reserve Bank's prudential mandate and its other functions, as noted earlier. By housing these functions under one roof, these policy functions can be better coordinated and underlying synergies better exploited.
- New Zealand does not have the scale or capacity to support two separate agencies tasked with ensuring financial stability. Stakeholders felt the transition to and the direct costs of setting up a separate agency (and the associated duplication of functions such as human resources, IT, and data/information management) would be potentially prohibitive.

Almost all the submissions supporting the status quo noted that changes could be made to current arrangements to improve the focus and effectiveness of financial policy in the Reserve Bank. The suggested key improvements related to increased resourcing for the Reserve Bank's prudential functions, and changes to the current governance arrangements.

Four submissions preferred to have a new agency rather than maintain the current arrangements – generally to create a stand-alone prudential regulator rather than a joint prudential and conduct regulator. One submission suggested a lack of synergy between the Reserve Bank's prudential mandate and its other functions, while noting that a separate agency would be more effective in addressing concerns on current governance arrangements. Another submission believed the Reserve Bank's light-touch approach to supervision was out of step with international norms, and a shift towards orthodoxy would best be made in a newly created agency.

You can find more details of stakeholder feedback on the first consultation in the Summary of Submissions, published in March 2019, on the Review website.

Other options considered

The two other options considered in the first round of consultation were:

- **A New Zealand Prudential Regulation Authority (NZPRA)** – this option would have been similar to the Australian model, with the Reserve Bank keeping the central bank function and a new agency being established for prudential functions. This option is not being considered further as it would increase the costs of financial sector regulation in New Zealand by creating a separate agency and duplicating some functions with the Reserve Bank (even if the new agency were better resourced than current baseline funding would allow). The transition costs in setting up an NZPRA would also have been significant.
- **A New Zealand Financial Services Authority (NZFSA)** – this option would have established a separate agency with responsibility for the Reserve Bank's prudential role and the FMA's financial market conduct role. This option is not being considered further, as the transition costs would have been significant and would have meant disruption for the Reserve Bank and the FMA (and likely the Ministry of Business, Innovation and Employment [MBIE]). While there would have been some economies of scale from integrating the Reserve Bank's prudential function with that of the FMA, there would likely have been some duplication of effort with the Reserve Bank in some areas. It is unlikely that this option would have addressed some stakeholders' concerns about the Reserve Bank's perceived lack of focus on prudential policy. The NZFSA would have had a broad mandate cutting across prudential and financial market conduct issues.

Chapter 2: What financial policy objectives should the Reserve Bank have?

Overview

This chapter follows up on one of the core topics covered in Consultation Document 1: what high-level financial policy objectives should the Reserve Bank have?

Section 1 provides an answer to that question based on an in-principle decision from the Minister of Finance. Section 2 describes additional objectives that could be included in a full 'objective set' for the Reserve Bank and the form they could take in legislation. It includes an illustration of how the objective set could look and seeks your feedback.

Section 1: In-principle decision

What should the Reserve Bank's high-level objectives be?

In Consultation Document 1 stakeholders were asked whether the Reserve Bank's existing objective to 'promote the maintenance of a sound and efficient financial system' was still appropriate, whether other terms should be used instead (such as 'financial stability'), and whether other objectives (such as promoting competition, protecting consumers or enhancing public confidence) should be added.

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

> "Protect and enhance the stability of New Zealand's financial system".

This 'financial stability' objective will be complemented by lower-tier objectives (including relevant aspects of efficiency) to guide the Reserve Bank's actions – as discussed in Section 2 below. This decision was unanimously supported by the Independent Expert Advisory Panel, the Reserve Bank, and the Treasury.

Rationale for decision

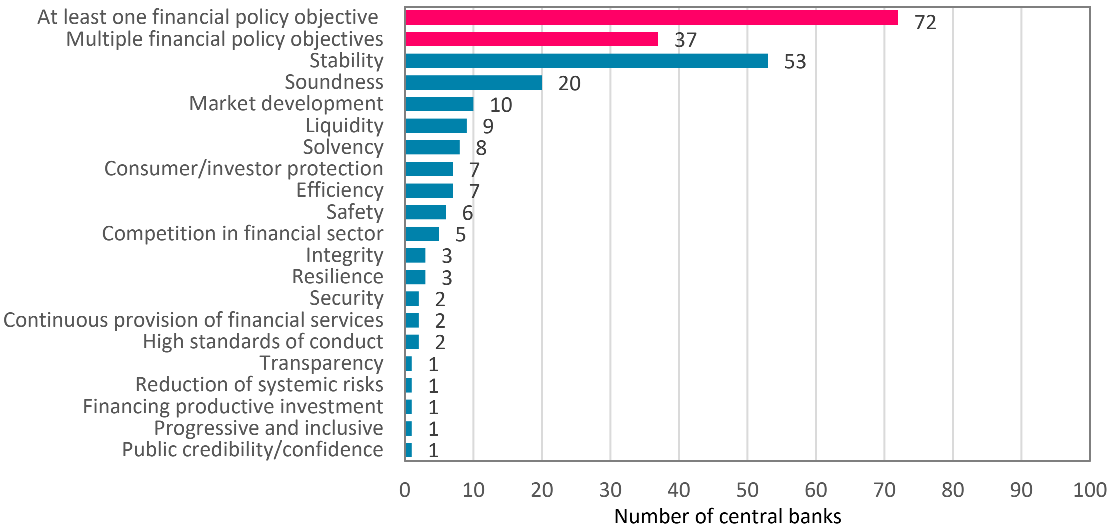
Relevance – as the prudential authority, the Reserve Bank can contribute to the prosperity and wellbeing of New Zealanders by minimising the likelihood and impact of financial crises. This is the defining feature of financial stability and is consistent with the recently amended purpose of the Reserve Bank of New Zealand Act (the Reserve Bank Act): to "promote the prosperity and wellbeing of New Zealanders, and contribute to a sustainable and productive economy".

'Financial stability' relates directly to the purpose of *prudential* regulation and supervision, which is to ensure that financial firms conduct their business in a careful and judicious ('prudent') way. The GFC highlighted how a lack of effective prudential regulation and supervision can lead to financial instability and impose significant economic costs on society.

Switching to an overarching financial stability objective is consistent with the way the Reserve Bank already interprets its responsibilities – it has published a Financial Stability Report (FSR) since 2004. It is also the main goal of prudential authorities overseas, the financial policy focus of international agencies – such as the Financial Stability Board (FSB), International Monetary Fund (IMF), and Bank for International Settlements (BIS) – and has become an internationally accepted term.

A survey of 100 central banks revealed that financial stability is by far the most common financial policy objective in legislation (Figure 2A). Of the 72 central banks that have financial policy objectives, 52 have financial stability objectives, 20 have 'soundness' objectives, and only seven have system-wide 'efficiency' objectives (including New Zealand).

Figure 2A: Financial system policy objectives for 100 central banks



Sources: IMF Central Bank Legislative Database, BIS, national legislation.

Notes: The chart shows the results of a survey of 100 central banks' primary legislation. Any such survey requires a degree of judgement as to what constitutes an 'objective' and may miss some objectives that are specified in sectoral or secondary legislation.

Clarity – 'Financial stability' captures the aspects of soundness and efficiency that are most relevant for prudential authorities, while overcoming some of the drawbacks.

- Soundness is often solely interpreted as meaning the resilience of the financial system. Financial stability encompasses this definition of soundness, but also covers the need to dynamically adjust regulatory settings during the 'financial cycle' and consider how regulatory settings can affect the economy.
- Efficiency is a broad and poorly defined term:
    - It can be interpreted as the dynamic element that soundness lacks. In highly cyclical financial systems, it can be difficult to identify long-term productive investment opportunities from cyclical upswings. This makes it more likely that credit will be misallocated to unproductive uses and asset price booms and busts will occur. The Reserve Bank's efficiency objective encourages it to take action to mitigate excessive variability in the financial cycle. This aspect of efficiency is also captured by 'financial stability'
    - It can be interpreted as a counterweight to soundness so that the Reserve Bank does not stifle economic activity in its pursuit of soundness. This aspect of efficiency is not captured

by 'financial stability', but while it is important, it is more commonly achieved through lower-tier objectives (see Section 2)

- It can also capture concepts that conflict with the Reserve Bank's other objectives. For example, efficiency could be interpreted as giving the Reserve Bank a mandate to direct credit to certain sectors of the economy that are struggling to obtain finance (on the grounds of 'allocative efficiency').[5] This conflicts with the purpose of prudential regulation, which is to underpin, not substitute for, a market-based system of credit allocation. This aspect of efficiency is not covered by 'financial stability' and is debatable whether it should be included in the Reserve Bank's objective set at all (see Section 2).

Weighting – the Reserve Bank's existing soundness and efficiency objectives do not align with the OECD's best-practice guidelines, as there is no clear guidance on how to weight the objectives when they conflict with one another. A single, high-level financial stability objective that is supported by a set of lower-tier objectives will provide a clearer objective hierarchy.

The Reserve Bank will still have to make difficult trade-offs when formulating policy – balancing the need for financial stability with other concerns such as minimising the burden of regulation or facilitating competition in the financial sector. But by having tiered objectives within a carefully defined objective set (as discussed in Section 2), the Reserve Bank will have a clearer sense of how to prioritise over time, which should lead to greater role clarity and a sharper focus.

Coverage – 'financial stability' is a multi-dimensional objective that incorporates a number of intermediate goals, such as protecting the financial system's resilience, maintaining public confidence in the system, and mitigating excessive variability in the financial cycle. It is broad enough to span all the Reserve Bank's financial policy functions, including micro- and macro-prudential policy, and crisis management policy. In contrast, other objectives are less relevant to these policy areas (for example, efficiency concerns are less paramount in a crisis, such as when trying to resolve a failing bank).

Feedback from stakeholders

Stakeholders were nearly unanimous in their support for retaining some form of soundness or 'stability' as a high-level financial policy objective for the Reserve Bank. Two-thirds were in favour of financial stability instead of soundness. Those in favour of 'stability' thought it was a broader, more systemic objective that provided a clear mandate for the use of macro-prudential tools and was already the de facto way the Reserve Bank interpreted its objective.

Around half of stakeholders supported keeping efficiency as a high-level objective, often as part of a general view that the Reserve Bank's existing objectives were working well and did not need changing. However, an equal number supported making efficiency a lower-tier objective at most, arguing that the existing term was too broad and should be clarified to focus mainly on avoiding onerous regulation (regulatory efficiency).

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[5] In a financial context, allocative efficiency refers to the ability of borrowers to obtain funds and lenders to invest their assets in a way that ensures capital is allocated to its most productive use. In New Zealand, allocative efficiency is largely achieved through a market-based system of credit allocation, supported by prudential regulation that seeks to address market failures. Other systems of credit allocation exist, including those where the state takes on a more direct lending role.

Most stakeholders preferred to have one objective (soundness or stability) or at most two high-level objectives. Besides efficiency, there was some support for 'public confidence' as a primary objective on the grounds that it would reinforce the need for a strong communication function, close collaboration with the FMA and other regulators, and a greater emphasis on improving public understanding of the financial system (which is low in New Zealand).

Stakeholders also suggested:

- adding objectives to the Reserve Bank Act for specific functions such as macro-prudential policy and crisis management
- additional secondary objectives to sit below the high-level objectives. Besides efficiency and public confidence, these included promoting financial sector competition (some support) and consumer protection (majority against)
- that legislation should provide for objectives to be specified in more detail (and additional considerations added) via a government policy statement or 'remit' (as discussed in Section 2).[6]

Other options considered

Consultation Document 1 put forward a number of options for the Reserve Bank's high-level objectives, including retaining soundness and efficiency, and adding one or more of 'competition', 'public confidence', and 'protecting consumers'.

Some of these alternatives are important considerations that could be included elsewhere in the Reserve Bank's objective set – as discussed in Section 2 of this chapter. However, they do not feature particularly prominently as objectives of central banks overseas (see Figure 2A). There are also some strong arguments against including these alternative objectives at the highest level of the objective hierarchy, as discussed in Consultation Document 1 (see pages 32-36).

Given the previous arguments, stakeholder feedback, and the desirability of having a single high-level objective to provide role clarity, these alternative objectives will not be considered further as high-level objectives. However, Section 2 considers them as lower-tier objectives.

Section 2: Follow-up questions for consultation

Introducing a new, high-level financial stability objective will help to modernise the Reserve Bank Act by providing a more relevant, focused, and clear goal to guide the Reserve Bank's behaviour and enable the public to hold it to account for its actions. However, having a financial stability objective is not enough on its own to guide the Reserve Bank in its wide range of financial policy functions. Other lower-tier objectives are required to provide further clarity.

This section explores how a full objective set could be specified for the Reserve Bank. It discusses:

- the additional objectives that could be included in the objective set (Part I)
- the ways in which additional objectives could be included in legislation, and how legislative form and terminology affect the intensity with which each objective is pursued (Part II).

It also provides an illustrative example of how the Reserve Bank's full objective set could look (Part III).

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[6] See pages 3-9 of the summary of stakeholder submissions for more detailed feedback.

Part I: What other objectives should the Reserve Bank have?

Based on the survey of 100 central banks, a range of financial policy objectives could be included below 'financial stability' in the Reserve Bank Act. These can be grouped into six broad categories, as summarised in Figure 2B.

Some of these objectives are broad and apply to financial policy in general (such as maintaining public confidence in the financial system). Others are more specific and apply to particular policy areas (such as the need to protect public funds when resolving a failing bank). Still others are less policy goals and more 'behavioural principles' that encourage the Reserve Bank to act in particular ways (such as coordinating with other regulatory agencies).

Figure 2B: Potential objective categories

Elements of financial stability	**A1** Enhance resilience of financial system	**A2** Enhance resilience of regulated entities	**A3** Mitigate excessive variability in financial cycle	**A4** Maintain confidence in financial system	**A5** Ensure continuity of critical fina-ncial services	**A6** Prevent financial contagion	**A7** Maintain market discipline
Elements of financial system efficiency	**B1** Minimise the costs and burden of regulation	**B2** Facilitate competition in the financial sector	**B3** Facilitate development of capital markets	**B4** Facilitate innovation in the financial sector	**B5** Ensure credit is allocated to productive uses		
Safeguards to protect particular groups in society	**C1** Protect public funds	**C2** Protect insured depositors	**C3** Protect client assets and funds	**C4** Protect private creditors and owners			
Behavioural goals to share information and promote understanding	**D1** Foster flow of financial information to public	**D2** Act as transparently as possible	**D3** Promote financial literacy				
Behavioural goals to co-ordinate policy	**E1** Coordinate with other regulatory agencies	**E2** Support objectives of monetary policy					
Other economic objectives	**F1** Support sustainable growth	**F2** Support economic objectives of government					

Each objective has a specific interpretation that can both enhance and complicate the Reserve Bank's objective set. When considering whether to add any of these objectives to the Reserve Bank's legislation, it is important to:

- consider both the merits of the individual objective and whether it would work as part of a coherent package to contribute to financial stability and New Zealand's economic prosperity
- achieve a balance in providing enough detail to guide the Reserve Bank's behaviour (so that its actions reflect society's best interest and it can be held to account for its decisions) and avoiding an overly prescriptive objective set that limits the Reserve Bank's ability to evolve.

The section below discusses each Figure 2B objective: its meaning, how it relates to (or is distinct from) financial stability, and how its inclusion could affect the Reserve Bank's behaviour. This is to enable stakeholders to view the full range of potential objectives before deciding which to prioritise. As noted in Consultation Document 1 (p. 31), it will be important to choose a manageable number of objectives from this full list, to maintain role clarity, to minimise conflicts between objectives, and to ensure that the Reserve Bank can achieve its objectives and be held accountable for doing so.

Category A: Objectives covering specific elements of financial stability

A key criticism of the Reserve Bank's existing soundness and efficiency objectives is that their meanings are not clear. To avoid this criticism applying also to financial stability, the Reserve Bank Act could include specific sub-objectives of financial stability that clarify the Reserve Bank's role in its financial policy functions. These sub-objectives could include some, or all, of the following.

A1. Protecting and enhancing the resilience of the financial system – this objective would require the Reserve Bank to ensure that the financial system is sufficiently robust to withstand shocks without adversely affecting the real economy. It is relevant to all the Reserve Bank's financial functions as it covers:

- acting to remove systemic weaknesses in the financial sector (macro-prudential policy)
- setting prudential requirements to ensure that financial firms behave prudently (micro-prudential regulation)
- supervising and taking enforcement action to ensure compliance with those requirements (supervision and enforcement)
- being the 'lender of last resort' (providing emergency loans to solvent financial institutions that have temporary liquidity problems, to maintain the financial system's soundness)
- ensuring that financial firms can fail without imposing wider costs on society (crisis management).

This objective is similar to the Reserve Bank's existing soundness objective and is a core element of financial stability.

A2. Protecting and enhancing the resilience of Reserve Bank-regulated entities – this objective is common among prudential regulators overseas. It is equivalent to having a 'micro-prudential' objective, which emphasises the importance of supervising individual firms as well as the system as a whole. The objective is not currently part of the Reserve Bank's objective set, and would likely require a more active approach to supervising firms (this is discussed in Chapter 3 of Consultation Document 2B).

Currently the Reserve Bank takes a risk-based approach to supervision and focuses most supervisory resources on the largest, most systemically important banks. However, the GFC showed that if small firms act in similar ways, even they can generate instability (this was seen, albeit in a modest way, in the failure of more than 60 finance companies between 2006 and 2012 in New Zealand). Having a 'micro-prudential' objective in the Reserve Bank Act could incentivise the Reserve Bank to supervise smaller firms more actively. However, it could risk diverting supervisory attention away from the most systemically important banks if the Reserve Bank were given this objective without any increase in supervisory resources.

A3. **Mitigating excessive variability in the financial cycle** – this objective would encourage the Reserve Bank to adjust regulatory settings over time in response to movements in the financial cycle. Past financial crises have demonstrated that credit booms sow the seeds of subsequent credit crunches (see Borio *et al*, 2018). By curbing excessive variability in the financial cycle, regulatory standards that are adjusted dynamically over time can help to reduce both the extent of unsustainable credit booms and the adverse effects on society of the subsequent busts. This objective is closely tied to macro-prudential policy (discussed in Chapter 2 of Consultation Document 2B), and features in the Macro-Prudential Memorandum of Understanding between the Reserve Bank and the Minister of Finance.

A4. **Maintaining public confidence in the financial system** – public confidence was a high-level objective of the Reserve Bank before 1989 and currently features in some of its sector-related legislation (e.g. in the Insurance (Prudential Supervision) Act 2010 [IPSA]). Confidence in the financial system is essential for ensuring financial stability. If included as an objective, it would encourage the Reserve Bank to take a stewardship role over the whole financial system, and could encourage a greater emphasis on communication to ensure that the public understands the rationale for its decisions. Around half of the stakeholders who responded to Consultation Document 1 supported including a public confidence objective in the Reserve Bank Act.

A5. **Ensuring the continuity of critical financial functions in a crisis** – this objective would require the Reserve Bank to act both in advance of and during a financial crisis to ensure that the public could continue to access critical financial services. This objective applies to crisis management policy, which is discussed in more detail in Chapter 5 of Consultation Document 2B.[7]

The objective is not currently part of the Reserve Bank's objective set, but it has been an objective of all European Union (EU) countries' resolution regimes since the introduction of the 'Bank Recovery and Resolution Directive' in 2014. If included, this objective would encourage the Reserve Bank to prepare more actively for financial firm failures, including through developing recovery and resolution plans for individual financial entities.

A6. **Preventing financial contagion** – even healthy financial firms can be affected by market panic. This objective would encourage the Reserve Bank to identify and reduce the risk of structural vulnerabilities in the financial system that could lead to contagion, such as reducing reliance on short-term funding or resolving failing banks in a way that minimises the chance of bank runs.[8]

Again, this objective mainly applies to crisis management policy. It is arguably already covered by the need to promote the resilience of the financial system (objective A1). However, given contagion's potential to amplify financial stress in the GFC, this element of financial stability could be emphasised in primary legislation, as it is in the EU.

A7. **Maintaining market discipline** – market participants can influence the behaviour of financial firms by choosing where to invest their funds and at what price. This can be a powerful incentive for those firms to manage risks effectively – as long as the market participants have the information they need to reach informed judgements, the ability to process that information correctly, the right incentives, and the right mechanisms to exercise discipline.

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[7] This objective also relates to the Reserve Bank's role in overseeing the smooth running of New Zealand's financial market infrastructure (FMI). This role is currently being clarified and formalised via a new piece of FMI legislation.

[8] A bank run happens when a large number of customers of a bank or other financial institution withdraw their deposits simultaneously over concerns about the bank's/institution's solvency.

Market discipline is not an explicit Reserve Bank objective, but it is a key pillar of its regulatory approach (see Fiennes, 2016). Making it an objective in the Reserve Bank Act would reinforce this approach – providing the Reserve Bank with an incentive to take action to ensure that market participants can discipline the market. The main risk of including such an objective is that it over-emphasises market discipline's ability to deliver financial stability at the expense of other regulatory measures, including official intervention.

Category B: Objectives covering elements of financial system efficiency

Although the Reserve Bank's efficiency objective is unclear and unusually high in the legislative hierarchy, efficiency is still a fundamental building block of an effective financial system. In response to Consultation Document 1, most stakeholders thought there was a place for a clarified definition of efficiency in the Reserve Bank's objective set. However, views were mixed about which elements of efficiency should be included. Sub-objectives could include the following:

B1. **Minimising the regulatory burden on firms and using regulatory resources cost-effectively** – this objective would encourage the Reserve Bank to undertake a cost-benefit analysis before introducing any new regulations, to ensure that the benefits of action are worth the compliance costs imposed on regulated entities and the costs of using its regulatory resources. Stakeholders widely supported a 'regulatory efficiency' objective as an important cross-check on the Reserve Bank's financial stability focus.

B2. **Facilitating effective competition in the financial sector** – policy for competition in the financial sector is currently determined by MBIE and regulated by the Commerce Commission. However, the Commerce Commission's competition powers are limited to regulating mergers, natural monopolies, anti-competitive behaviour, and market studies.

The Reserve Bank could have a role in supporting competition in the financial sector either by setting prudential regulations in ways that avoid impeding competition or by developing policies to actively promote competition (such as by lowering the barriers to entry for new financial firms). The main advantage of including a competition objective would be to address a perceived shortfall in competition in the financial sector.

Greater competition could support financial stability by spreading risks across more financial institutions. However, it could also undermine stability by increasing the complexity of the financial system and incentivising financial firms to take more risks. Most stakeholders thought the Reserve Bank should have a more active role in promoting competition in the financial sector, over and above the existing requirement to consider competition concerns when regulating the 'non-bank deposit taker' (NBDT) and insurance sectors.

B3. **Facilitating the development of New Zealand's capital markets** – it is relatively common for central banks, particularly in developing economies, to have some kind of 'dynamic efficiency' objective to develop (or at least not impede the development of) domestic capital markets. This can help support economic growth and financial stability by creating extra sources of finance and enabling greater risk-sharing. Dynamic efficiency can also be tied to broader societal aims, such as promoting green finance to help mitigate the impacts of climate change (as discussed in Box 2A below).

In the past the Reserve Bank has helped to develop New Zealand's capital markets, for example, through initiatives to develop standards for covered bonds. This objective would incentivise more of this behaviour. A minority of stakeholders supported including a capital market development objective in the Reserve Bank Act.

B4. **Facilitating effective innovation in New Zealand's financial sector** – it is rare for central banks to be given explicit objectives to support financial sector innovation. However, regulatory approaches can help with this; for example, some central banks have introduced 'regulatory sandboxes' that enable firms to test new products under a controlled, but less onerous, regulatory regime.

Financial innovation can support financial stability by creating products and services that better match investors with borrowers and enable risk-sharing. However, it can also generate complex financial products that have information asymmetries and lead to excessive risk-taking – as happened during the GFC with mortgage-backed securities and collateralised debt obligations.

B5. **Promoting efficient credit allocation** – an 'allocative efficiency' objective could be interpreted in two ways. Interpreted narrowly, it could encourage the Reserve Bank to ensure that market participants have enough information to make informed decisions – helping to support market discipline and financial stability. Interpreted broadly, it could enable the Reserve Bank to direct credit to particular sectors of the economy if the market were providing inadequate access to finance.

A large majority of stakeholders argued against the broader interpretation on the grounds that it could:

- create distortions in the market (it is similar to the Reserve Bank 'picking winners')
- compromise the Reserve Bank's independence, as any credit allocation decisions include a political judgement
- undermine stability by encouraging lending to areas that the market deems too risky.

Category C: Safeguards to protect particular groups in society

The Reserve Bank makes policy decisions that can affect different groups in society in different ways.

Some central banks around the world have specific objectives that require them to consider the interests of different groups in society before making policy decisions with particularly stark distributional consequences.[9] These 'protection objectives' have become particularly common in crisis management regimes since the GFC, as they encourage the relevant authorities to consider a wide range of interests before deciding how best to resolve a failing financial firm.

A number of these objectives could be added to New Zealand's crisis management regime as a way to support financial stability (for more detail, see Chapter 5 of Consultation Document 2B).

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9 Some central banks have a broad 'consumer protection' objective, which is typically tied to having responsibility for conduct regulation. In New Zealand's twin peaks regulatory model (where financial market conduct and prudential regulation are separated), conduct regulation is the primary responsibility of the FMA. Stakeholder feedback from the first consultation revealed there was a strong aversion to giving the Reserve Bank a broad 'consumer protection' objective to avoid blurring its role with that of the FMA.

C1. **Protect public funds** – this objective is now a common feature of modern resolution regimes such as those in the United Kingdom, the EU, and Hong Kong.

A key lesson from the GFC was that some financial institutions were so large and complex that if they failed they would threaten the stability of the financial system. Being 'too big to fail' meant that they benefited from an implicit government guarantee that they would be bailed out with taxpayer funds if they got into trouble. This implicit guarantee incentivised some large international banks to take excessive risks, which amplified the extent of the GFC.

Including an objective to protect public funds would encourage the Reserve Bank to adopt resolution policies to remove an implicit guarantee and minimise the use of public funds.

C2. **Protect insured depositors to the extent covered by compensation schemes** – this objective would require the Reserve Bank to consider the interests of insured depositors when resolving a failing financial firm. It is tied to whether New Zealand has deposit insurance (see Chapter 5), as this insurance can help to reduce the risk of destabilising bank runs by ensuring that insured depositors can access their funds in a timely way.[10]

C3. **Protect client funds and client assets** – this objective is similar to C2 but applies to a different group of stakeholders. 'Client assets' are securities held by financial institutions (usually for investment purposes) on behalf of their clients. They are particularly important for 'custodian' banks, which are financial institutions that mainly earn revenue by safeguarding financial assets rather than engaging in traditional lending. These banks are a significant feature of large financial centres in the UK, the EU, and Hong Kong and this objective features in all those regimes. However, custodian banks are not a significant part of New Zealand's financial system, so there is a question on whether this objective should be included as a future-proofing measure.

C4. **Protect private creditors and owners of failing financial firms by minimising the cost of resolution and avoiding the unnecessary destruction of value** – this objective would require the Reserve Bank to resolve failing financial firms in ways that minimise the costs of resolution and seek to avoid the unnecessary destruction of value for owners and private creditors.

The objective is often included in resolution regimes that also have built-in 'no creditor worse off' safeguards. These safeguards require the resolution authorities to compare the cost of using their resolution tools with the cost of a standard insolvency, and compensate any creditors that are made worse off by a resolution decision. This supports financial stability by creating investor certainty, but as with depositor protection (see objective C2 above) this objective would need a compensation mechanism or insurance fund to be set up.

[10] In some jurisdictions, this protection objective also extends to insurance policyholders, who are covered up to a guaranteed limit in the event an insurer fails. That option is not explicitly consulted on here, as a review of the Reserve Bank's insurance legislation under IPSA is outside the Review's terms of reference.

Category D: Behavioural goals to promote information-sharing and understanding

Independent central banks have explicit 'transparency' requirements so that the public can hold them to account for their actions. Some central banks also have behavioural principles in their legislation, which encourage them to share more information than they are legally required to.

Behavioural goals to encourage information-sharing could include the following:

D1. **Foster the free flow of financial sector information to the public** – the Non-bank Deposit Takers Act 2013 (NBDT) and IPSA already include a principle that recognises the importance of providing the public with adequate information to enable them to make informed financial decisions. This supports financial stability by helping to address information asymmetries in the financial system and enabling risks to be priced fairly. The principle currently only applies to the NBDT and insurance sectors and largely applies to disclosure requirements, but it could be applied to banks and other regulated financial firms too.

D2. **Act as transparently as possible** – this objective would require the Reserve Bank to put more emphasis on its public communications to ensure that the reasons for its actions are clearly articulated and understood.

The Reserve Bank already scores well internationally on the transparency of its monetary policy decisions (Oikonomou and Spyromitros, 2017), but some stakeholders have criticised the Reserve Bank for being relatively opaque on financial policy. For example, the policy rationale to introduce loan-to-value ratio (LVR) restrictions for home loans in 2013 drew some criticism. Including this objective could support financial stability by promoting public confidence in the Reserve Bank's decision-making.

D3. **Promote financial literacy** – the Reserve Bank could also be tasked with raising public awareness and understanding of financial matters. This is a more active objective than information-sharing, and would require the Reserve Bank to take an educational role.

The Reserve Bank is already active in this area through targeted initiatives, such as the Bank Financial Strength Dashboard, which aim to distil a range of information on banks' strength into easily digestible formats.

This objective would incentivise more of that behaviour. However, achieving a notable improvement in financial literacy might require a significant increase in resources, and could divert resources away from the Reserve Bank's core functions.

Category E: Behaviour goals to coordinate policy

Policy coordination is key to achieving efficient and effective regulatory outcomes – both within the Reserve Bank, to ensure consistency in its own policies (e.g. monetary and financial policy), and between the Reserve Bank and other financial regulatory agencies, to plug regulatory gaps, reduce areas of overlap and ensure regulatory harmony. To help ensure this coordination, the Reserve Bank could be given an explicit coordination objective or behavioural principle to guide its behaviour. This could take two possible forms:

E1. **Subject to achieving financial stability, the Reserve Bank should use its prudential tools and powers to support the objectives of monetary policy** – the Reserve Bank's Monetary Policy Committee (MPC) "shall have regard to the efficiency and soundness of the financial system" when setting monetary policy – but there is no legislation-based requirement for the Reserve Bank to consider the objectives of monetary policy when formulating prudential policy.

This objective would provide that link and help to encourage policy coordination between the MPC and the rest of the Reserve Bank. A number of stakeholders supported this objective in response to Consultation Document 1.

E2. **In pursuing its financial stability objective, the Reserve Bank shall seek to work with other agencies (including the Treasury and the FMA)** – this objective mirrors the wording in the UK legislation for the BoE.

During the GFC, coordination failure was a key issue in the UK and became a focus of the post-crisis reforms. Including this objective in the Reserve Bank Act could encourage a more active approach to policy coordination in New Zealand, helping to reduce regulatory gaps and potentially leading to more effective policy-making over time. The objective could be supported by other mechanisms (see Chapter 6 of Consultation Document 2B).

Category F: Other economic objectives

Most central banks have economic objectives (often secondary objectives) beyond their core monetary and financial policy functions. These typically take two forms:

F1. **Support sustainable economic growth** – the Reserve Bank Act's purpose statement already requires it to set monetary and financial policy in a way that "promotes the prosperity and wellbeing of New Zealanders and contributes to a sustainable and productive economy". A secondary objective to also support sustainable economic growth would go further, requiring the Reserve Bank to support growth as long as it did not conflict with financial or monetary stability.

F2. **Support the Government's economic objectives** – a significant minority of central banks have a secondary objective to support government economic policy. This provides a mechanism for the government of the day to have economic priorities that it would like the central bank to support (as long as they do not conflict with the Reserve Bank's core objectives). For example, some governments require their central banks to develop their country's status as a financial centre.

The key risk is that these government objectives could compromise the Reserve Bank's independence or divert attention away from the Reserve Bank's core functions. There is also a risk that the Reserve Bank would be tasked with achieving objectives that conflict with its main functions, or are unachievable with the tools it has available.

Box 2A: Climate change and the Reserve Bank's objectives

Climate change, and society's response to it, presents financial risks to the economy through two main channels:

- **Physical risks related to the effects of climate change** – climate and weather-related events can lower the value of certain assets, such as beachfront homes at risk from sea-level rise, and farming assets exposed to the effects of droughts and floods.
- **Risks associated with the transition to a lower-carbon economy** – changes in climate policy, technology or market sentiment could prompt a reassessment of the value of a range of assets, such as fossil fuel resources or high-emission agriculture.

While reducing the risks of climate change has traditionally been seen as a government responsibility (via policy), there is growing recognition that financial system participants, including central banks and financial regulators, can have a role in mitigating the financial risks of climate-related factors. There is an open question on whether the Reserve Bank's objectives enable it to take on such a role or whether additional objectives are required.

Internationally, central banks have in recent years become much more active on climate change, and together have established the Network for Greening the Financial System to share best practice – a development that has not required legislative change. The BoE is seen as a frontrunner in this area, and has focused its climate change actions on three broad functions that link to its financial stability mandate (see BoE, 2017):

1) **Surveillance** – as part of its prudential supervisory function, the BoE is developing a deeper understanding of firm-level exposure to climate risk by stress-testing business models to different climate scenarios.
2) **Climate-related financial disclosures** – providing investors with access to information is a key requirement for markets to function efficiently. To support a smooth market transition to a low-carbon economy, the BoE is participating in the G20's Task Force on Climate-related Financial Disclosures to increase the quality and quantity of information available to investors.
3) **Promoting green finance** – the BoE also co-chairs a G20 Green Finance Study Group to identify the barriers to green finance and expand the market for green bonds.

The Reserve Bank's existing soundness and efficiency objectives (and the proposed new financial stability objective) are arguably broad enough to enable the Reserve Bank to be active in all the areas noted above. However, while the current and proposed objectives may permit the Reserve Bank to act on climate change, they do not explicitly require or encourage it to do so. If stakeholders are concerned that the Reserve Bank will not be proactive enough, a number of options are available to ensure that it has a role in this area:

- **Include lower-tier objectives that span the areas of activity where the Reserve Bank could help respond to climate change** – this could include objectives A1 and A3, which would emphasise the role of the Reserve Bank in monitoring and mitigating the risks to financial stability from climate. It could also include objectives B3-B5, which could encourage the Reserve Bank to help develop New Zealand's financial markets to support greener growth.

- **Issue an overarching direction to 'take into account' climate change in the Reserve Bank's activities** – the Reserve Bank Act already gives the Minister of Finance the power to direct the Reserve Bank in certain areas (as discussed in the next section). Such powers could be used to increase the Reserve Bank's focus on climate change issues.
- **Include an explicit climate change objective** – to our knowledge, no central bank has an explicit climate change objective in its legislation. This is partly because climate change is one of many risks that central banks must consider when overseeing the financial system, and including it could risk diverting too much attention from other risks (e.g. cyber risk). Nevertheless, if stakeholders were concerned that the mechanisms above were insufficiently durable to embed climate change in the Reserve Bank's regulatory approach, an explicit climate change objective could be included in the Reserve Bank Act.

Although all these options are available, it is worth noting that the Reserve Bank has already become much more active on climate change on its own initiative, including with the publication of its first Climate Change Strategy in December 2018.

Part II: How should any additional objectives be specified in legislation?

As well as deciding on the objectives the Reserve Bank should have, we need to consider the hierarchy of those objectives, how they will be specified in legislation, and the structure of the legislation. These all affect how the Reserve Bank will strive to achieve the objectives.

The objectives hierarchy

For each potential objective, we need to consider where it should feature in the Reserve Bank's objective set (and therefore how actively the Reserve Bank will pursue the objective). This hierarchy:

- includes both primary and secondary objectives that would likely feature in the Reserve Bank Act, as they would apply to the whole financial sector
- could also include various forms of 'consideration', which could feature in the Reserve Bank Act if they applied to the financial sector as a whole, or in sectoral legislation such as IPSA if they applied more narrowly to a particular group of financial firms.

Figure 2C: The objectives hierarchy – a definition of terms

① Primary objective

Hierarchy – highest priority objective, to be pursued above all others.

Focus – typically spanning one or more significant policy areas. Can be clarified by including a definition of relevant terms in legislation.

Purpose – provides an overarching direction to the Reserve Bank. Guides the behaviour of senior managers when making policy decisions and deciding on the scope of their mandate. Frequently used in public communications to justify policy actions.

Example – *protect and enhance the stability of New Zealand's financial system.*

② Secondary objective

Hierarchy – significant priority, to be actively pursued alongside primary objective.

Focus – usually narrower than the primary objective, relating to a specific policy priority.

Purpose – often used to clarify the regulator's role in an area not obviously within the scope of its primary objective. Encourages the regulator to allocate dedicated resources to a particular area. Features prominently in public communications.

Example – *subject to achieving financial stability, the Reserve Bank shall facilitate the development of New Zealand's capital markets to support sustainable economic growth.*

③ Considerations

Hierarchy – moderate priority, to be considered while pursuing higher-priority objectives. Precise legal wording determines how actively the regulator considers each requirement: 'may have regard to' ⇨ 'shall have regard to' ⇨ 'must take into account' ⇨ 'shall give effect to'.

Focus – narrow. Can be a list of specific 'regulatory principles' that must be considered when taking regulatory actions.

Purpose – used to guide the regulator's behaviour while pursuing its higher-priority objectives. Often used as a counterweight to higher-priority objectives to ensure the regulator considers a broad range of matters before taking regulatory action.

Example – *in pursuing its financial stability objective, the Reserve Bank shall have regard to the following regulatory principle: minimising the regulatory burden on financial firms.*

The Minister of Finance has already taken an in-principle decision to have just one primary objective (financial stability) to guide the Reserve Bank's financial policy decisions. However, some of the elements of financial stability (objectives A1-A7 discussed above) could still feature in legislation as part of the definition of financial stability, or as functional objectives that apply to specific policy areas (such as macro-prudential policy, prudential regulation or crisis management).

For objectives B1-F2 described above, there is a choice on whether to include them at all in the legislation – and if so, whether to include them as secondary objectives or considerations. In making them considerations, there is a choice on how actively the Reserve Bank should pursue them based on the precise wording used: ‘may have regard to’, ‘shall have regard to’, ‘must take into account’ or ‘shall give effect to’.

Figure 2D: Options for increasing the intensity with which a consideration must be pursued

The Reserve Bank does not currently have any secondary objectives, but it does have a number of considerations that are specified as ‘shall have regard to’ or ‘must take into account’ statements. These require the Reserve Bank to consider a number of matters when making policy decisions, but they do not impose particularly difficult requirements for evidence. These considerations typically have two forms:

- Regulatory principles – these feature prominently in the NBDT Act and IPSA and require the Reserve Bank to take into account a number of factors (such as competition, and minimising compliance costs) when exercising its powers over NBDTs and insurers.
- Other considerations – the Reserve Bank Act has a number of sections that require the Reserve Bank to ‘have regard to’ other factors when pursuing its policy objectives. For example, for monetary policy, it must have regard to the “efficiency and soundness of the financial system”.

How objectives could be specified in legislation

The Reserve Bank’s objectives can be specified using three main mechanisms:

- Primary legislation.
- Government directions/financial policy remits.
- Objectives the Reserve Bank has discretion to interpret.

Primary legislation – this is the main mechanism for legislating the Reserve Bank’s objective set. The objectives are embedded in law, therefore reducing the scope for political interference over time, and providing regulatory stability.

However, defining the objective set only as primary legislation reduces its flexibility to evolve over time. In addition, overly prescriptive legislation can affect the still-evolving policy framework’s ability to develop, and hamper the Reserve Bank's operational independence. Other mechanisms may be needed to clarify the objectives on a more flexible basis.

Government directions/financial policy remits – the Minister of Finance currently has three ways to influence the Reserve Bank's regulatory objectives and approach without legislative change:

- Commenting on the Reserve Bank's Statement of Intent to influence its strategy, which the Reserve Bank must consider
- Providing a 'letter of expectation' to the Reserve Bank to set out the government's priorities, which the Reserve Bank has discretion to consider but is not bound to do so
- Formally directing the Reserve Bank to 'have regard to' government policy, which the Reserve Bank must follow but so far it has never been used.

Alternatively, the Minister could be required to issue formal guidance to the Reserve Bank via a 'financial policy remit' (similar to the BoE's remit) or a 'statement of expectation' (similar to that of the Australian Prudential Regulation Authority [APRA]).

Following Phase 1 of the Reserve Bank Act Review, a remit was created for the new MPC. This has a legal basis in the Reserve Bank Act and is issued by the Minister of Finance following public advice from the Reserve Bank. The MPC's remit provides guidance on the operational objectives of monetary policy, including details of the numerical inflation target and how 'maximum sustainable employment' should be defined.

A financial policy remit could be crafted for a similar purpose, with different kinds of guidance. It could include:

- **A risk appetite statement** – this would state the Government's tolerance for financial crises, to guide the Reserve Bank in how strictly it should set prudential standards. For example, the Government could state a tolerance for a crisis 'once every 200 years' (a 0.5 percent probability per year), which would guide the Reserve Bank in fine-tuning its policy settings (e.g. its capital levels). However, the usefulness of this absolute risk measure would be debatable given that it is difficult to pin down a precise number that reflects society's risk preferences, and even harder to hold the Reserve Bank to account for adhering to that figure.

  A more practical alternative would be a risk appetite statement that takes a relative, rather than an absolute, approach. For example, the Australian Government issues a statement of expectation to APRA that directs it not to "seek to guarantee a zero failure rate of prudentially regulated institutions". This guides APRA to not set prudential standards so strictly that they eliminate the risk of bank failure entirely. Guidance like this could be used to provide an upper boundary to the Reserve Bank's prudential standards.

  The Government could also specify a lower boundary for prudential requirements, by requiring New Zealand's prudential settings to be 'safer' than an international benchmark. This lower boundary could be specified broadly, so the Reserve Bank would have discretion to define a package of regulatory measures and supervisory intensity that would deliver a level of financial stability that is higher than international norms. This would allow flexibility for higher standards in one area (e.g. capital) to offset lower standards elsewhere (e.g. supervision).

Alternatively, the statement could refer to explicit standards for specific policy areas and require the Reserve Bank to set prudential requirements at least as strict as international norms (such as Basel III). The more specific the requirement, the more the Reserve Bank's policy choices would be constrained. For example, if the Reserve Bank were required to meet standards at least as strict as all Basel III minimums, it would have to match standards across a wide range of policy areas (including capital and supervision). This would ensure that New Zealand's regulatory regime kept pace with international standards, while still allowing some tailoring to New Zealand's risk preferences.

No matter how specific the risk statement was, by clearly establishing that the Reserve Bank should not operate a zero-failure regime *and* that its standards should be stricter than international norms, it would impose two boundaries between which the Reserve Bank was to set prudential regulations.

- **Targets and metrics** – a key feature of the MPC's remit is its definition of the inflation target. It provides a clear numerical goal for monetary policy, which is used to hold the Reserve Bank to account for its policy decisions. Ideally there would be a similar target for financial policy, but its multi-dimensional nature means no such target exists. Some commentators have suggested that the Reserve Bank be given several targets for different variables (e.g. house prices or the credit-to-GDP ratio). However, this could risk too much attention being paid to certain aspects of financial stability, when a holistic approach is better.[11]
- **Government economic priorities** – the remit could specify the Government's economic priorities for the financial sector. For example, if the Government wanted to put more emphasis on developing New Zealand's capital markets and supporting financial sector innovation, the remit could specify those policy priorities and guide the Reserve Bank to use its prudential powers (where possible, and in keeping with its financial stability mandate) to support them. This is a key feature of the UK Financial Policy Committee's remit, which allows the UK Government to nudge the BoE's financial policy decisions, without greatly undermining the BoE's independence.
- **Weightings for different objectives** – the remit could also specify how the Reserve Bank should prioritise, if it were given multiple objectives at the same tier in the objective hierarchy. Such guidance is more likely to be required if the Reserve Bank is given a complex objective set with many competing lower-tier objectives, as it will be more difficult to hold the Reserve Bank to account to deliver on multiple fronts at once and there is a risk of cherry picking. The main cost of including such guidance is to reduce the flexibility of the Reserve Bank to vary how much weight it puts on competing objectives based on its own assessment of the policy priorities of the time.
- **Macro-prudential policy** – the remit could include a section to guide the Reserve Bank's approach to macro-prudential policy, and cover any additional transparency or accountability requirements that apply when using macro-prudential tools. Certain tools (such as LVR restrictions on residential lending) have more pervasive distributional consequences than others, so it may be

[11] Another issue with numerical targets is that the Reserve Bank only has limited control over some of the variables in question and there is uncertainty as to what the 'right' target level should be. For example, with house prices, it is unclear what the optimal rate of house price inflation should be and how much the Reserve Bank can control house prices, given that it can only affect the demand for housing (via the price and quantity of credit), not the supply.

appropriate for them to have different accountability arrangements (as discussed in Chapter 3 of Consultation Document 2B).

This approach has two key benefits:

- Including detail like this in the remit would eliminate the need for the current, non-statutory Macro-Prudential Memorandum of Understanding between the Minister of Finance and the Reserve Bank.
- Using a remit rather than primary legislation to provide this guidance would enable the approach to macro-prudential policy to become more flexible over time – a key concern given that macro-prudential policy is still an evolving policy area.

Discretion to the Reserve Bank – the Reserve Bank would be given the discretion to interpret its objectives and define its own performance measures, as long as it publicised its approach in advance. It is already required to do this to some extent via the annual Statement of Intent (SOI) process, which is overseen by its monitoring agent (currently the Reserve Bank Board), the Minister and ultimately by Parliament and the public.

The SOI process can be used to provide direction to the Reserve Bank's functions beyond what is included in legislation. This can be particularly useful where the legislation is not very prescriptive (to enable flexibility) or does not include explicit objectives – such as in relation to the Reserve Bank's balance sheet function (as discussed in Chapter 4 of Consultation Document 2B). Through the SOI process the Reserve Bank can articulate its principles for guiding these functions, either in the SOI itself or in framework documents cited in the SOI. Some central banks, including the BoE, publish extensive documents outlining their approaches to these functions (such as the Sterling Monetary Framework). The Reserve Bank has recently taken similar steps, although in a different policy area, with its recent publication of a Macro-prudential Policy Framework.

The SOI approach supports the Reserve Bank's operational independence by encouraging it to specify both how it intends to meet its objectives and any detailed performance measures it intends using to prove it is meeting its statutory obligations. However, some stakeholders have criticised the SOI process for:

- not being transparent enough about the Reserve Bank's regulatory strategy
- not giving the Government enough voice on broader prudential standards.

This leaves an open question as to whether the SOI approach, combined with a clearer objective set and broader governance changes (discussed in Chapter 3), is enough to hold the Reserve Bank to account for meeting its objectives – or whether other devices (such as a financial policy remit) are also required.

How the legislation will be structured

Another factor to consider when specifying the Reserve Bank's objective set is the structure of the Reserve Bank's legislation – the number of Acts, their content, and how they interact with one another. The legislation is currently structured around three (soon to be four) Acts:

Figure 2E: Current legislative structure

Reserve Bank of New Zealand Act 1989	Non-bank Deposit Taker Act 2013	Insurance (Prudential Supervision) Act 2010	Financial Markets Infrastructure Act (TBC)
▪ Institutional objectives, governance, and functions of the Reserve Bank. ▪ Bank regulation, supervision, and crisis management	▪ NBDT regulation and crisis management	▪ Insurer regulation, supervision, and crisis management	▪ FMI regulation, supervision, and crisis management

The current legislative structure has evolved in a piecemeal fashion over time as the Reserve Bank has been given new responsibilities for regulating more types of financial firms. This has led to inconsistencies in the legislation for different sectors; for example, the Reserve Bank Act has less guidance on objectives than the more modern NBDT Act and IPSA (which contain detailed regulatory principles that apply when regulating the NBDT and insurance sectors).

One option is to keep the current legislative structure and design the objective set around it. However, it may be worth considering an alternative structure that splits the Reserve Bank Act into two:

- An 'institutional Act' covering the Reserve Bank's objectives, governance, and functions (which would include the Reserve Bank's prudential functions as well as other functions, such as monetary policy and currency functions).
- A 'Deposit Takers Act' covering the prudential regulation of banks and NBDTs. This would merge the Reserve Bank Act's content on the banking sector with the NBDT Act's content, with the aim of unifying the deposit-taking regime (see Chapter 4 for more detail).

Figure 2F: Potential revised legislative structure

Reserve Bank of New Zealand Act (TBC)	Deposit Takers Act (TBC)	Insurance (Prudential Supervision) Act 2010	Financial Markets Infrastructure Act (TBC)
▪ Institutional objectives, governance, and functions of the Reserve Bank	▪ Regulation, supervision, and crisis management of banks and NBDTs	▪ Insurer regulation, supervision, and crisis management	▪ FMI regulation, supervision, and crisis management

Practically, splitting the legislation could enhance its clarity, purpose, and accessibility and allow each financial sector to have more focused objectives. This was also the approach taken when setting up the FMA with the Financial Markets Authority Act 2011.

Other legislative structures are also possible. For example, the Deposit Takers Act could be split into two separate Acts, one covering business-as-usual regulation and supervision, and the other crisis management and resolution. The latter could be appropriate if the resolution framework expands significantly (for example, with the introduction of specific resolution objectives).

Part III: An illustrative example of the Reserve Bank's full objective set

Given the number of potential objectives highlighted so far, and the potential mechanisms for achieving them, the Reserve Bank's objectives could be many and varied. To help focus discussion on the most appropriate objectives, an illustrative example has been developed below that may help you to clarify the options. Note the specific wording and legislative structure are indicative only; the final version will be developed using feedback from you and other stakeholders and in consultation with the Parliamentary Counsel Office.

Reserve Bank Act

Purpose	The purpose of this Act is to promote the prosperity and wellbeing of New Zealanders and contribute to a sustainable and productive economy by providing for the Reserve Bank of New Zealand, as the central bank, to be responsible for the following functions:
Monetary policy function	The Reserve Bank, acting through the Monetary Policy Committee (MPC), has the function of formulating monetary policy with the economic objectives of: ▪ achieving and maintaining stability in the general level of prices in the medium term ▪ supporting maximum sustainable employment. The MPC must, in acting under this section, have regard to: a) the stability of the financial system b) any matter provided for in a monetary policy remit.
Prudential regulation, supervision & enforcement function	The Reserve Bank has the function of formulating and implementing prudential regulation, supervision and enforcement that is directed to the objective of protecting and enhancing the stability of New Zealand's financial system; including by: ▪ protecting and enhancing the resilience of the financial system ▪ protecting and enhancing the resilience of Reserve Bank-regulated firms ▪ mitigating excessive variability in the financial cycle ▪ protecting and enhancing public confidence in the financial system. In acting under this section, the Reserve Bank must have regard to: a) the economic objectives of the MPC b) any matter provided for in a financial policy remit c) the list of regulatory principles set out in the Deposit Takers Act 20xx, Insurance (Prudential Supervision) Act 2010 and Financial Market Infrastructure (FMI) Act 20xx.
Resolution function	The Reserve Bank has the function of managing the failure of any Reserve Bank-regulated entities directed to the resolution objectives specified in the Deposit Takers Act, IPSA and the FMI Act.
Other functions	*Note: This Act does not provide explicit objectives for the Reserve Bank's currency and balance sheet management functions, but both would be specified more clearly than they are in the current Reserve Bank Act.*
Information-sharing provisions	In performing its functions under this Act, the Reserve Bank shall seek to undertake its responsibilities as transparently as possible and explain its policy and regulatory actions clearly.
Coordination provisions	In performing its financial regulatory functions under this Act, the Reserve Bank shall seek to work with other relevant regulatory bodies (including the Treasury and the Financial Markets Authority).

Remit for the Monetary Policy Committee

Note: The Minister sets the MPC's remit following advice from the Reserve Bank. The remit sets the operational objectives of monetary policy, including other matters the MPC must have regard to.

Excerpts of content (from the current MPC remit):

For the purpose of this remit the MPC's operational objectives shall be to:

- keep future annual inflation between 1 and 3 percent over the medium term, with a focus on keeping future inflation near the 2 percent mid-point. This target will be defined in terms of the All Groups Consumers Price Index, as published by Statistics New Zealand
- support maximum sustainable employment. The MPC should consider a broad range of labour market indicators to form a view of where employment is relative to its maximum sustainable level, taking into account that the level of maximum sustainable employment is largely determined by non-monetary factors that affect the structure and dynamics of the labour market, and is not directly measurable.
- In pursuing the operational objectives, the MPC shall:
    - i. have regard to the stability of the financial system
    - ii. seek to avoid unnecessary instability in output, interest rates and the exchange rate
    - iii. discount events that have only transitory effects on inflation, setting policy with a medium-term orientation.

Remit for financial policy

Note: The Minister sets the remit following advice from the Reserve Bank. The remit provides guidance to the Reserve Bank on how to enact its prudential regulatory responsibilities, and includes a risk appetite statement, the Government objectives the Reserve Bank must have regard to, and details of the macro-prudential toolkit and transparency requirements.

Example of possible content:

Risk appetite statement *– the prudential regulation regime should operate to maintain a level of financial stability that is at least as stable as implied by international standards (as defined by Basel III), while not seeking to guarantee a zero failure rate of regulated entities.*

Government economic priorities *– subject to achieving financial stability, the Reserve Bank shall aim to facilitate the development of New Zealand's capital markets for the purpose of supporting sustainable economic growth, including by developing the market for green finance.*

Macro-prudential policy *– an important element of the Reserve Bank's financial stability objective is to protect and enhance the resilience of New Zealand's financial system, not just the resilience of individual institutions. As part of that system-wide role, the Reserve Bank should consider using its prudential powers to reduce excessive volatility in the financial cycle caused by credit, asset price or liquidity shocks. This may include making cyclical adjustment to prudential standards, and imposing lending restrictions on the standards used by regulated entities. Given the potential distributional consequences of lending restrictions, I expect the Reserve Bank to consult the Minister of Finance, the Treasury, and other relevant parts of government before any material change in policy. In addition, in making any macro-prudential policy changes that could affect the economic cycle, the Reserve Bank should have regard to the MPC's economic objectives.*

Deposit Takers Act

Purpose	*The purpose of this Act is to protect and enhance the stability of New Zealand's financial system. That purpose is achieved by:* a) *establishing a system for licensing deposit takers* b) *imposing prudential requirements on deposit takers* c) *providing for the Reserve Bank to supervise compliance with those requirements* d) *conferring certain resolution powers on the Reserve Bank to act for deposit takers in financial distress or other difficulties.*
Prudential regulation, supervision & enforcement function	*When performing the functions of formulating and implementing prudential regulation, supervision and enforcement, the Reserve Bank must take into account the following regulatory principles:* 1. *The need to use the Reserve Bank's regulatory resources in the most efficient and economical ways.* 2. *The need to avoid unnecessary compliance costs and ensure that any burdens imposed on the financial sector are proportionate to the benefits.* 3. *The desirability of effective competition in the market for Reserve Bank-regulated services, and the need to set regulations, where possible, in ways that facilitate effective competition in the financial system.* 4. *The desirability of providing adequate information to enable members of the public to make informed financial decisions.* 5. *The importance of recognising that it is not a purpose of this Act to eliminate all risk of firm failure and that members of the public are responsible for their own financial decisions.* 6. *The need to foster high standards of finance and the desirability of sound governance and effective risk management practices.* 7. *The desirability of consistent and fair treatment of similar financial institutions and the need to explain regulatory actions clearly.*
Resolution function	*When managing the failure of any Reserve Bank-regulated deposit takers, the Reserve Bank must pursue the following resolution objectives:* 1. *Promote and seek to maintain the stability of the financial system of New Zealand, including by:* - *ensuring continuity of critical financial functions* - *preventing contagion* - *maintaining market discipline* - *protecting and enhancing public confidence.* 2. *Protect insured depositors to the extent covered by compensation schemes.* 3. *Protect client funds and client assets.* 4. *Protect public funds, including by minimising reliance on public financial support.* 5. *To the extent not inconsistent with the above objectives, minimise the costs of resolution and avoid the unnecessary destruction of value for owners and private creditors.*

Questions for consultation

2.A What other objectives should the Reserve Bank have?

- Which of the objectives discussed in Chapter 2 should feature in the Reserve Bank Act, and why?
- Are there any other objectives not covered in Chapter 2 that should be considered?

2.B Should the Reserve Bank be given a more explicit climate change objective? If so, what would be your preferred mechanism for achieving this?

2.C Where in the legislative hierarchy should any additional objectives sit – as 'secondary objectives', or as 'considerations' that the Reserve Bank must look at?

2.D How should the Reserve Bank's objectives be specified? Do you see a role for a 'financial policy remit'? If so, what should it include?

2.E What is your view on creating a new 'Deposit Takers Act' that combines material from the NBDT Act with the Reserve Bank Act's banking regulation material?

2.F Looking at the example of the Reserve Bank's objective set, which elements do you support and which would you change, and why?

Chapter 3: How should the Reserve Bank be governed?

Overview

Consultation Document 1 considered whether the Reserve Bank's governance arrangement should move from a single decision-maker model (the status quo) to a more typical board structure, and whether a statutory Financial Policy Committee (FPC) should be established with responsibility for prudential policy. In addition, the consultation document considered the merits of moving responsibility for external monitoring of the Reserve Bank from the current Reserve Bank board to the Minister's policy department (the Treasury).

The Minister has made three in-principle decisions:

- A new governance board will be established with statutory responsibility for all Reserve Bank decisions (except those reserved for the MPC). 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.[12]

This chapter is structured into two sections:

- Section 1 describes the rationale for the above in-principle decisions and provides detail on the allocation of responsibilities under the governance model.
- Section 2 considers whether the Crown entities legislative framework would be appropriate for the Reserve Bank, and describes key features of the board model and choices around the design of these features.

[12] A further option being considered through the Review is for administration of primary legislation to sit with the Treasury, as the Minister's policy department. The role currently sits with the Reserve Bank. Decisions on administration of primary legislation have been delayed for the time being so they can be considered in light of the broader framing of the Reserve Bank's institutional and regulatory independence.

Section 1: In-principle decisions

Should the Reserve Bank have a governance board?

The Minister has taken an in-principle decision to establish a new governance board with statutory responsibility for all Reserve Bank decisions (except those reserved for the MPC).

A board model is used for all Crown entities (including the FMA) and is common among private sector companies. The new board will have responsibility for organisational matters (including budget, risk and audit, strategy, and the performance of management), prudential policy and functions (including supervision and enforcement) and other policy functions (such as currency and balance sheet management). The Governor, as CEO, will have delegated day-to-day responsibility for running the Reserve Bank within parameters set by the board. The board will have non-executive members; section 2 of this chapter has options for its composition.

Rationale for decision

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 separation of governance and management functions. The establishment of a new governance board was supported by the Independent Expert Advisory Panel, the Reserve Bank, and the Treasury.

The board will be accountable for the performance of the institution as a whole, will set the organisation's strategy, and will oversee the actions of management (the Governor and senior staff), while management will have delegated day-to-day responsibility for running the institution within the parameters set by the board. This would be an improvement on the existing governance model, where governance and management roles are combined in one individual – the Governor.

A switch to a governance board will have costs and potential risks. For example, the speed of a single decision-maker model can be hard to match, and the risks that are common to group decision-making structures (such as 'groupthink'[13] and 'social loafing'[14]) could undermine the potential benefits of a board. However, the prevalence of boards in the public and private sectors, in New Zealand and overseas, suggests these potential costs and risks are manageable – particularly if the board comprises highly capable individuals, and if management is empowered to make decisions rapidly when required.

Feedback from stakeholders

In response to Consultation Document 1, a number of points emerged from stakeholder feedback.

- **Strong support for a governance board** – the vast majority of stakeholders thought a new governance board should be established to replace the single decision-maker model. Most thought such a board would be well placed to oversee corporate and operational decisions,

[13] A tendency for individuals to prefer uniformity rather than challenge the group.

[14] Where people put less effort into achieving a goal when they work in a group than when they work alone.

including those relating to the Reserve Bank's strategy, risk appetite, budget, and management. That said, some stakeholders noted that the change was not without risks, particularly if board members were appointed on political grounds and switched to advocacy roles, lacked sufficient expertise to make decisions, or failed to delegate to the CEO effectively.

- **Issues with the existing Reserve Bank board** – a number of stakeholders questioned the existing role of the Reserve Bank board. Without decision-making rights, the board's ability to challenge and influence the Governor is limited.
- **Composition** – many stakeholders thought that the calibre of board directors was critical to success, and supported having non-executive members on the basis that they would bring a diversity of views, independent challenge, and accountability. Several stakeholders noted the importance of an effective board chair to encourage productive debate, and of hiring high-quality board members to hold the Governor to account.

Should the Reserve Bank have a statutory Financial Policy Committee?

The Minister has made an in-principle decision to not establish an FPC. Instead, the new governance board will be responsible for all Reserve Bank decisions (except those reserved for the MPC).

Rationale for decision

A board model can offer a robust governance structure. It is widely used in the public and private sectors, and is also consistent with state sector governance best practice for independent institutions; all New Zealand Crown entities (including the FMA) have board governance structures.

The board model is also well understood domestically and internationally, and underpinned by robust legal and corporate governance frameworks. In contrast, a statutory FPC is little used for prudential policy (with the BoE being a notable exception) and no Crown entities have statutory committees.

While stakeholders strongly supported the establishment of a new board, views differed on whether the board, or a separate statutory FPC, would provide the best governance arrangements for prudential policy. The Independent Expert Advisory Panel members' views also differed, with a majority favouring the board controlling prudential policy (to avoid diluting its role and introducing additional complexity) and a minority supporting an FPC (to increase the prominence and focus of prudential policy decisions). The decision to not establish an FPC was supported by the Treasury and the Reserve Bank.

Building on the features of effective governance in Consultation Document 1 (pp. 75-76), Table 3A lists the key strengths and challenges of a board model.

Table 3A: Strengths and challenges of a board model

Strengths	Challenges
Consistency and credibility – a board structure provides for group decision-making within an efficient, robust, and well-regarded governance structure. It is common in the private and public sectors, both domestically and internationally.	**Directing board focus appropriately:** the Reserve Bank is a complex organisation with a range of functions. The challenge faced by a board will be to find the right space in which to maximise the value of their role in setting strategy and holding management to account, within the framework provided by the Reserve Bank's statutory objectives and functions.
Simplicity – concerns about role clarity in a more complex model (such as the FPC model) would not be a feature with a governance board. The board would be responsible for all functions outside of monetary policy, and delegate to management where appropriate. In a more complex model, roles would need to be carefully defined in legislation, with the potential for unforeseen outcomes when complex governance undermines efficient decision-making.	**Quality of decisions** – the wide-ranging expertise required at board level means that some board members with decision-making power would have less-than-desired experience in prudential policy. This could affect the quality of debate and decisions, as board members may not have the knowledge needed to challenge management.
Strong internal accountability – the separation of governance and management functions allows the board to assess management performance objectively. A governing body that is accountable for management actions has strong incentives to ensure that those actions are undertaken appropriately.	**Non-executive members' participation could be impaired** – the wide range of board responsibilities risks overburdening part-time non-executive members. It could be difficult to secure suitable appointees in New Zealand's small labour market and manage any conflicts of interest.
Efficiency and flexibility – delegations, divisions, and internal committees can provide the focus and expertise necessary to undertake quality prudential policy decisions and efficient functioning.	**Potential hierarchies** – a board may prioritise its financial policy responsibilities over those to the MPC.

While an FPC could potentially have addressed some of the challenges of the board model (for example, by bringing more specialist expertise and focus to prudential policy decisions) these challenges could also be addressed by a board model.

Boards are designed to be flexible, and can adapt to provide effective governance based on their specific objectives and operating environments. The Reserve Bank clearly needs board members with significant experience and skills in prudential matters, so this criterion for appointment, together with a robust appointment process, could be included in legislation.[15] The board will have non-executive members to promote independent challenge and diversity, and further specialist expertise can be incorporated through delegation and the use of committees.[16] The use of committees and effective delegations can allow for the efficient operation of institutions with a broad range of functions.

The FMA is a good example of a regulator with a wide range of regulatory powers operating under a flexible board structure. The FMA delegates extensively to its CEO (including regulatory decision-making power) while taking responsibility for decisions on sensitive and strategic matters. When exercising reserve powers, the FMA often uses 'divisions' (groups of at least three board members) to consider matters requiring more specialist or dedicated expertise (such as class exemptions) and for decisions on the use of significant regulatory tools (such as beginning enforcement action). Board members on divisions are selected for their background and expertise on the matters being considered, which can provide greater focus and efficiency, and also mitigate any conflicts.

Differences between monetary policy and prudential policy

The decision not to establish an FPC may appear inconsistent with the decision to establish an MPC in Phase 1 of the Reserve Bank Act Review.

However, important differences between monetary and prudential policy mean that the optimal decision-making structure may not necessarily be the same for both. Some of these differences are set out below:[17]

- **Focus** – monetary policy typically tends to centre on one key decision made on a regular basis: setting appropriate interest rates. Monetary policy is also generally underpinned by a clear (inflation-related) target or range. These characteristics mean that monetary policy can be reasonably well demarcated from other policy areas and decided on by a specialist committee. In contrast, prudential policy applies to a wide range of financial institutions and involves decisions on numerous policies, tools and approaches, including capital, liquidity, macro-prudential settings, supervision, and enforcement. Consequently, a specialist committee may not represent the most effective governance model to manage the wide-ranging nature of financial policy responsibilities.
- **Maturity** – as noted above, the objectives and tools of monetary policy are generally well understood. The way in which the tools achieve the objectives (the 'transmission mechanism') is also well researched. As a result, it is common for central banks to have formal monetary policy committees operating within a reasonably familiar framework. In contrast, the prudential policy framework is still evolving, with the GFC forcing jurisdictions to rethink and reform their approach to prudential policy. In particular, formal macro-prudential frameworks are relatively new, and the governance framework for macro-prudential decisions is still evolving. Only the BoE

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[15] For monetary policy, only people who have appropriate knowledge, skills and experience to assist the MPC may be appointed, and industry representatives may not be appointed (clause 15, schedule 2 of the Reserve Bank Act).

[16] The Crown Entities Act 2004 anticipates the use of specialist committees to advise a board. Schedule 5 of the Act allows a board to appoint committees to advise it on any matter relating to its function. Provided one member of the committee is a director, there is no requirement for a committee member to be a director.

[17] See Warsh (2014), pages 43 – 44, for a fuller description of some of these differences.

currently has a formal statutory FPC taking macro-prudential decisions (although a number of central banks have non-statutory FPCs).

- **Consultation processes** – monetary policy decisions are necessarily taken behind closed doors, and committees can be effective decision-making structures to embed the required external specialist expertise. In contrast, prudential policy typically entails external consultation processes enabling stakeholders to submit their own perspectives to decision-makers prior to decisions being taken. These processes provide scope for stakeholders to challenge policy proposals and contribute specialist expertise outside of the formal decision making structure.
- **Data** – deliberations on monetary policy generally involve analysing aggregate data, while micro-prudential judgements are largely directed at particular financial institutions. The data used can be institution specific (and sensitive) which can create sensitivities around communications and conflicts of interest.

Feedback from stakeholders

Stakeholders strongly supported the establishment of a governance board, although there were mixed views on the best arrangements for prudential policy. Most preferred a board-only model over an FPC, reflecting a familiarity with the board structure and concerns about the complexity that an FPC would add to a governance structure. However, a number of stakeholders expressed support for an FPC. In particular, those stakeholders with central banking experience could see the merits of an FPC.

Stakeholders favouring a board-only model tended to emphasise the additional complexity that an FPC would introduce to the governance structure. Concerns raised about the FPC included difficulties in specifying the roles and responsibilities of the board and statutory committees, the overlap of responsibilities between the board and committees, administrative requirements, and potential conflicts between decision-making bodies. These stakeholders thought a board model was a robust governance model, and that the perceived benefits of an FPC could be delivered through a well-designed board structure.

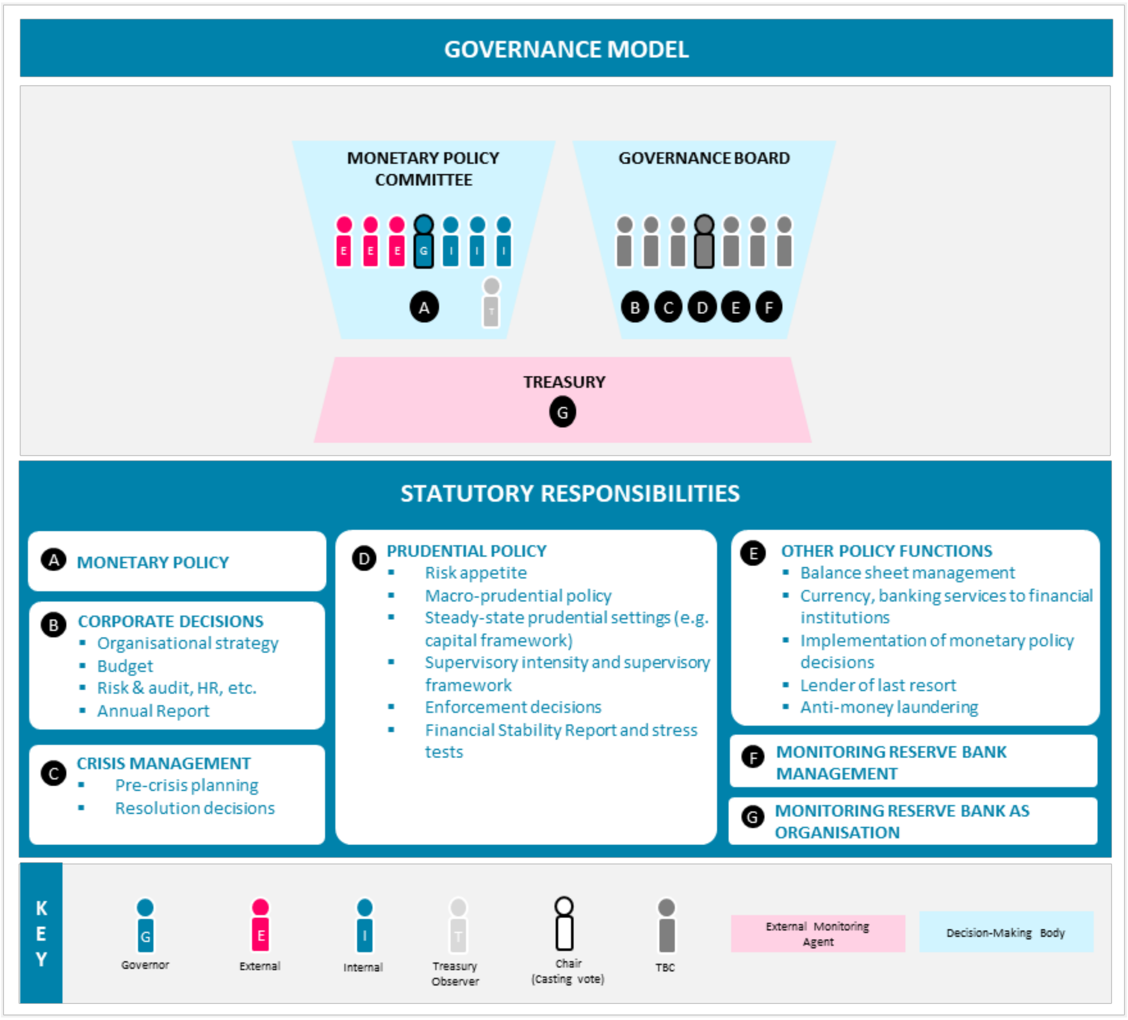
Stakeholders favouring an FPC noted that the main reasons to establish a statutory committee are to provide for specialisation and focus, and to give decision-making rights to non-executive members as an accountability check on prudential decision-making. An FPC would also establish a clear body with a public profile that the financial industry and wider public would know is accountable for financial policy decisions. Having an FPC could avoid over-burdening non-executive members and would allow individuals to be recruited to the board, or to the FPC, based on their expertise.

Many stakeholders emphasised the importance of having high-calibre members and a robust appointment process. Some stakeholders were concerned that there could be difficulty recruiting suitably qualified and non-conflicted members to the decision making body. There was strong support for including non-executive members on the basis that they bring diverse views, independent challenge, and accountability. Others noted the importance of delegations, particularly for decisions involving firms. They thought the body responsible for setting the prudential framework should have good oversight of supervision and enforcement decisions but delegate most decisions to management.

The allocation of responsibilities under the proposed governance model

Figure 3A shows at a high level how statutory functions would be allocated under the proposed governance model. Further detail is provided in the sections below. Note that, while the Governor's powers over key day-to-day functions would be covered through delegations, in practice the Governor would still be the Reserve Bank's key public face and Chair of the MPC.

Figure 3A: Allocation of responsibilities under the proposed governance model



Allocation of responsibilities

Corporate governance – the governance board will be responsible for:

- setting the Reserve Bank's overall direction, which includes developing strategic policies to achieve its goals, managing operational and policy risks, and using resources efficiently. This direction would be based on the Reserve Bank's legislative objectives as identified or clarified by the Government or Minister over time[18]

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[18] Chapter 2 provides further details on the Reserve Bank's financial policy objectives and how they may be clarified.

- ensuring that all the Reserve Bank's departments, and the MPC, are appropriately resourced and functioning to deliver on the Reserve Bank's strategy.

Given the cross-over of responsibilities and co-dependencies between the board and the MPC, there will be a need for coordination and oversight on corporate governance matters. The most obvious co-dependencies relate to budgeting (funding the Reserve Bank's monetary policy function and MPC policy recommendations that have resourcing implications) and strategy (to demonstrate how the MPC will achieve its policy responsibilities).

Prudential policy – the board will be responsible for all prudential decisions, including supervision and enforcement activities (although Reserve Bank staff will do most of this under delegated authority from the board).

Given that prudential policy is a broad, interconnected area, requiring complex judgements in the short and long term – and the Reserve Bank's responsibility for overseeing the banking, insurance and NBDT sectors – the board will need to:

- comprise members with a broad range of experience
- set up a coordination mechanism between monetary and prudential policy, to ensure that the impacts of decisions on other policy areas are sufficiently understood
- set up a process for resolving conflicts across policy areas (such as between monetary and prudential policy) and within prudential policy (such as between macro-prudential and micro-prudential objectives).[19]

Crisis management – Chapter 5 in Consultation Document 2B discusses the Reserve Bank's crisis management framework, including the roles and responsibilities, resolution objectives and powers for crisis management. It proposes that the Reserve Bank be confirmed as New Zealand's resolution authority, with responsibility for making resolution decisions and ensuring that the legislated crisis management framework can be implemented.

Under this framework, the board would be responsible for:

- resolution planning (before a bank failure or crisis)
- exercising resolution tools and powers, in conjunction with other supporting functions like depositor protection arrangements, in a bank failure or crisis, or in the lead-up to it.[20]

Pre-crisis planning is essential to a successful bank resolution regime. The board would be responsible for ensuring that the legislated crisis management framework can be put into action, and that regulated entities and their creditors have as much certainty as possible ahead of a crisis on the likely resolution options.

However, crisis management decision-making is not well suited to part-time, non-executive members, as decision makers will need to be able to move quickly, have immediate access to relevant information, and coordinate with relevant departments and ministers. In addition, if the board has both prudential and crisis management responsibilities, there will be a conflict of interest

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[19] In pursuing its objectives, the MPC is required to have regard to the efficiency and soundness of the financial system and any matter provided for in the monetary policy remit – see section 8 of the Reserve Bank Act.

[20] See Box 5E in Chapter 5 of Consultation Document 2B for a description of bank recovery actions and bank resolution actions.

between the supervisory function and taking timely action to resolve failing institutions (a risk of undue regulatory forbearance).

For these reasons, while the board will be responsible for all crisis management planning and decisions, it is expected the board will delegate the use of resolution tools to the Governor or a small number of board members. Risks associated with a board having both prudential and resolution responsibilities can be mitigated by structurally separating the Reserve Bank advice on these functions (although the board would still be responsible for decisions on both functions). These arrangements would be consistent with international best-practice guidance and bank resolution and crisis management arrangements in other jurisdictions such as the UK and Hong Kong.

Balance sheet, currency, and other functions – the board will be responsible for managing the Reserve Bank's balance sheet and currency functions.

The ability of the Reserve Bank to create currency enables it to undertake a variety of important functions including acting as lender of last resort, monetary policy implementation, and dealing in foreign exchange. Balance sheet functions are described in more detail in Chapter 4 of Consultation Document 2B.

In some cases, balance sheet activities relate to monetary policy responsibilities (e.g. implementing monetary policy), and will require appropriate coordination arrangements with the MPC. In other cases, they can cause conflicts of interest with other functions – for example if the board is responsible for prudential supervision, being a lender of last resort, and being the resolution authority. Arrangements to mitigate these conflicts will be needed, such as through separating advice on these functions in the Reserve Bank. Issues in managing the Reserve Bank's balance sheet are discussed further in Chapter 4 of Consultation Document 2B.

Delegations framework and committees

The board, as the governing body of the Reserve Bank, will have authority to exercise all powers of the Reserve Bank in relation to its responsibilities. However, as is standard practice in any effective governance model, it is anticipated that the board will delegate a wide range of functions to the Governor as CEO. Delegations reflect the split between governance and management functions within board structures.[21] Governance includes ensuring that systems and processes are in place that enable the organisation's strategy to be given effect, and that direct, shape, enable, and oversee an organisation's management. Management is concerned with carrying out the organisation's day-to-day operations within parameters set by the board. The decisions of the board will be informed by in-depth analysis and information provided by Reserve Bank staff.

An effective delegations framework is necessary for the efficient operation of an institution. Boards that routinely infringe upon management responsibilities risk upsetting a structure that is intended to help both of them. Effective delegation is particularly important in supervision and enforcement decisions. While legislation will specify supervisory powers, the Reserve Bank will have discretion on how they are used, based on its regulatory strategy and approach (Chapter 2 has more on how the Reserve Bank's risk appetite could be agreed and specified).

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[21] For a description of the role of a board see chapter 8 of Consultation Document 1.

The delegations framework should ensure that:

- the board's focus is set at the appropriate level, such as on strategic planning, performance monitoring, key policies, and decisions
- regulatory decisions are efficient and timely
- those with delegated functions have relevant expertise.

A CEO (in this case the Governor) is generally delegated responsibility for managing the organisation's day-to-day functions and implementing strategy and policy within the parameters set by the board. Strategy documents, key policies, statutory reporting and transparency responsibilities, are typically matters that are reserved for the board, although staff can be delegated responsibility for preparing relevant documentation for approval. The board also often takes responsibility for sensitive matters, such as those that set precedents, involve significant risks, or involve a material change to established policy or strategy.

That said, some sensitive matters may not be the most efficiently dealt with by the full board. This may be because the organisation needs to act quickly, such as a regulated entity in financial distress. In these circumstances, the need for appropriate oversight could be provided by delegated decisions to a sub-set of the board (as in the FMA's 'division' structure). In most cases where quick decisions are required, the board, or a sub-set of the board, will have been kept informed about the matter prior to a decision being sought. Alternatively, the CEO could be empowered to make decisions as long as appropriate notification and other accountability requirements (such as post-event assessments) are complied with.

A board will typically use committees where this will enhance the board's effectiveness in key areas. A committee is different to a division, in that it does not make decisions that bind the board. It is common for a board to establish an audit committee with responsibility for overseeing the preparation and audit of financial statements. The Reserve Bank already has an audit committee and uses a number of internal committees to advise on its monetary policy and financial stability responsibilities. The FMA notes:

> *"In large or more complex companies, board committees can significantly enhance effectiveness. A committee can facilitate closer scrutiny of issues and more efficient decision-making. Committees maximise directors' skills, knowledge and experience, and can help spread the workload among directors."*

and

> *"The board is ultimately responsible for its committees and their work. The board should be well informed about decisions for which it is ultimately responsible. Committee proceedings should be reported back to the board. Non-committee directors should have the opportunity to comment on the committee's business, or have it explained to them, where necessary."* (FMA, 2018, principle 3).

Who should monitor the Reserve Bank's performance?

The Minister has made an in-principle decision to establish the Treasury as the Reserve Bank's monitoring agent, replacing the role of the existing Reserve Bank board. This will align Reserve Bank monitoring arrangements with those of a Crown entity, and make the Treasury responsible for assessing and reporting on the Reserve Bank's performance (including the performance of the MPC).

This section provides further detail on the Reserve Bank monitor role and how the Treasury could undertake its monitoring responsibilities.

Rationale for decision

This change will help address one of the key structural shortcomings of the existing governance model – the limited powers of the current Reserve Bank board.

As noted in stakeholder feedback, the Reserve Bank board is not well placed to monitor and assess the Reserve Bank's operational performance. It has no formal decision rights (outside appointments), no independent resourcing, limited financial policy expertise, and there are practical challenges in balancing its duties to the Minister with its relationship with the Reserve Bank.

Moving to a Crown entity-style monitoring agent will address some of these issues and delineate monitoring roles more clearly. It will see the:

- new governance board providing greater oversight of the Reserve Bank's day-to-day running, including the resourcing and functioning of the MPC
- the Treasury (as external monitor) providing an independent cross-check of the Reserve Bank's overall performance, on behalf of the Minister. The Treasury is well placed for this role given its close relationship with the Minister and its independence from the Reserve Bank.

The establishment of the Treasury as the Reserve Bank's monitoring agent was unanimously supported by the Independent Expert Advisory Panel, the Reserve Bank, and the Treasury.

Feedback from stakeholders

Stakeholders agreed that establishing a new governance board would provide a better internal cross-check on management at the Reserve Bank, and so reduce the need for a bespoke monitoring agent. Several stakeholders thought the Reserve Bank monitor needed additional powers and resources. Stakeholders strongly supported the view that the Treasury should monitor the Reserve Bank.

Consultation 1 also considered enabling the Controller and Auditor-General to conduct performance audits and inquiries into the Reserve Bank's activities.[22] This could replace the existing arrangement under which the Minister can commission a performance audit of the Reserve Bank. Stakeholders were generally supportive of such a change, and this will be considered in the context of changes to the broader accountability framework.

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[22] Under the Public Audit Act 2001, the Controller and Auditor-General is not able to "inquire, either on request or on their own initiative, into any matter concerning [the Reserve Bank's] use of its resources". The Controller and Auditor-General is not able to examine under a Performance audit "the extent to which [the Reserve Bank] is carrying out its activities effectively and efficiently". The Controller and Auditor-General supported the removal of this provision in their submission to Consultation 1.

Other options considered

The idea of establishing a central external monitoring agent ('a regulator to the regulators') was considered, but not supported. This was because the Crown entities framework provides an established model with clear lines of accountability – and, while recent reports have noted potential issues with the model, they primarily reflect monitoring practice, given that the monitor's performance depends on a sufficient investment in capability, and ministerial engagement.[23]

Where there are broader problems with regulator performance monitoring (that are also applicable to other economic regulators such as the FMA and the Commerce Commission), these issues should be addressed at that level, rather than through the creation of Reserve Bank-specific arrangements.

The role of the Reserve Bank monitor

The Crown entities monitoring framework

The Minister has made an in-principle decision to establish the Treasury as the Reserve Bank's monitoring agent. While the Reserve Bank is not a Crown entity, the Treasury would work in a similar way to a Crown entity monitor, ensuring consistency with monitoring arrangements throughout the state sector.[24]

'Monitoring' refers to the processes in which a minister oversees an agency and ensures that it is meeting its legislative duties, using taxpayer funds appropriately, and acting in line with agreed strategic directions. However, while a minister is ultimately accountable to Parliament for a state sector agency's performance, the agency makes most of its strategic and operational decisions. This separation of functions creates an agent/principal risk, in which the agent (the regulator) may undertake their duties in a way that conflicts with the interests of the principal (the responsible minister). Monitoring helps the principal to ensure that the agent is discharging its duties as intended.

Section 27A of the Crown Entities Act 2004 describes the monitor's role as:

> *a) to assist the responsible Minister to carry out his or her role; and*
> *b) to perform or exercise any or all of the following functions, duties, or powers:*
> *i. administering appropriations*
> *ii. administering legislation*
> *iii. tendering advice to Ministers*
> *iv. any other functions, duties, or powers in this Act or another Act that may, or must, be performed or exercised by the monitor.*

The State Services Commission's (SSC's) guidance on monitoring arrangements emphasises the board's role as decision-maker. The Government's Enduring Letter of Expectations to all statutory Crown entities also stresses boards' importance in monitoring performance:

> *"Your board is the most important monitor of entity performance. We expect boards to provide to responsible Ministers high quality information and analysis on entity performance against plan, implications for future performance, and risks and*

[23] A number of recent reports (see the Productivity Commission's 2014 report on regulatory institutions and practices and the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry in Australia) have noted potential shortcomings in regulator monitoring.

[24] See Section 2, which considers the merits of establishing the Reserve Bank as a Crown entity.

opportunities facing the entity. We also expect you to have a constructive working relationship with your monitoring department." (New Zealand Government, 2012).

The external monitor of the Reserve Bank is not a substitute for the board and the MPC, and should not try to second-guess decisions made by the board or the MPC. Instead, the monitor should focus on the entity's strategic direction, its contribution to the Government's goals for the sector, and its performance against its statutory objectives.

While certain monitor responsibilities are reasonably generic (advising on appointments, administering appropriations), monitor activities vary. The SSC notes:

"Monitoring is an art, not a science, and what is good practice is still emerging. Departments are experimenting with various monitoring approaches, including more formal risk assessment tools, relationship assessment tools, monitoring plans, periodic reviews… and evaluations undertaken to review policy effectiveness." (SSC, 2014, p. 11).

The broad legislative parameters, and the SSC guidance, suggest that a monitor should take a judgement-based approach, reflecting the capability of the entity being monitored, its contribution to the Government's objectives and sector priorities, and the risks and opportunities within the sector.

Potential issues with the Crown entities monitoring framework

In its 2014 review of New Zealand's regulatory institutions and practices, the Productivity Commission found that monitoring effectiveness varied (Productivity Commission, 2014, pp. 357-360). It identified some key problems with the current monitoring arrangements, and made recommendations to address them (see Table 3B):

Table 3B: Monitoring arrangements – Key problems and recommendations to improve the effectiveness of monitoring

Key problems	Key recommendations
Insufficient support from departments – a lack of support from monitors in appointments, policy advice, and resourcing. A lack of priority around legislative change was identified as being of particular concern.	**Providing greater stability in monitoring staff** – departments should appoint suitably qualified staff for sufficient terms to support good working relationships with Crown entities.
Role confusion – there is not a clear sense of the relative roles of the monitor and of the regulator, which may lead to confused accountabilities, issues falling through the cracks, and blame shifting. A close relationship between a monitor and a regulator can make it difficult for the monitor to assess the regulator independently.	**Refocusing engagement back onto the board** – monitoring practices should more squarely focus on assessing how well the board is carrying out its legislative responsibility to govern and oversee the entity effectively and efficiently.

Key problems	Key recommendations
Inadequate capability – monitoring staff lack the capability, knowledge, and seniority to engage effectively.	**Making closer links between policy and monitoring staff** – departments should ensure strong links between monitoring and policy functions, so that monitors have a sufficient understanding of the regulatory regime and the environment in which the Crown entity is operating.
A lack of focus on performance and strategy – too much focus on financial performance and reporting, and not enough focus on performance and strategy.	**More risk-based monitoring and reporting** – departments should move towards risk-based monitoring, with higher-performing Crown entities subject to less frequent reporting obligations.

The Productivity Commission also saw merit in a specialised review process, using the Performance Improvement Framework, for regulators to help fill the gap in current monitoring practices.[25]

The Treasury as the Reserve Bank monitor

A monitor's core responsibility is to provide the responsible minister with an independent view of an entity's performance. As external monitor of the Reserve Bank, the Treasury would monitor the performance of the board and the MPC as the statutory decision-makers of the Reserve Bank.

If the Treasury is to effectively monitor the performance of the Reserve Bank against its main policy functions, it will need a good understanding of the Reserve Bank's policy areas and the Reserve Bank's regulatory operating environment. This will build on the current arrangement, in which the existing board monitors the performance of the Governor and the MPC, and the Treasury monitors the Reserve Bank in its role as the Minister's lead policy adviser on economic and fiscal policy. The Treasury's existing role is undertaken by policy teams, and includes advising the Minister on matters relating to policy, funding, and accountability.

This policy adviser role would continue under the proposed arrangements and, given the synergies between policy functions and monitoring, there would be benefits in monitoring functions being undertaken by policy teams. The monitoring role would represent a subset of the matters of interest from a public policy point of view – rather than an alternative or conflicting performance perspective to that provided by the policy teams. At times, there may be a tension between the Treasury's policy and monitoring responsibilities and it will be important to manage this. However, as noted above, the monitoring function has a different focus from the policy function. The monitor should focus on the Reserve Bank's capability to make robust policy decisions (including expertise, resourcing, and governance arrangements) and the process adopted by the board (including stakeholder and agency consultation, and cost benefit analysis). The monitor should not seek to second guess policy decisions made by the board or the MPC.

It will be important to distinguish between the Treasury's role as monitor (on behalf of the Minister) and the Treasury observer on the MPC. In the former role, the Treasury will be monitoring the

[25] The Performance Improvement Framework (PIF) is a framework to support continuous improvement across the state sector. The PIF is managed by the Performance Improvement Programmes Group at SSC.

performance of the board and the MPC. In the latter role, the Treasury observer will primarily support MPC decision-making and help to coordinate monetary and fiscal policy, with both functions subject to conditions of confidentiality and avoiding conflicts of interest.

The Treasury will consequently need to ensure that the monitor and observer roles are separate, so as to mitigate any conflicts of interest. For example, if members of the MPC view the Treasury observer as part of the performance-monitoring function, discussions and debates at the MPC may be constrained, with impacts on decision-making quality.

There would also be benefits in making the Treasury's monitoring responsibilities and approach more specific – especially given the Productivity Commission's comments on a lack of clarity in the monitor role, and a lack of resourcing and priority for monitoring functions. The change could address these issues, and better set expectations around the Monitor's specific responsibilities particularly with regard to monitoring the MPC and its members, in order to avoid any suggestion that the Treasury was second-guessing monetary policy decisions. It would also be consistent with the SSC's guidance for monitoring departments, which suggests that they should consider having explicit agreements with their ministers on their monitoring responsibilities and approach. Where a department has significant monitoring responsibilities, the agreement should cover the:

- specific tasks required
- monitoring priorities based on the department's risks
- relationship management arrangements
- level and type of monitoring capability that will be sustained
- information and analysis that will be provided to the Minister
- frequency with which the above information will be supplied.

Transparency requirements

The transparency of the Reserve Bank's operations is a key pillar of the accountability framework. Consultation Document 1 outlines the current transparency requirements, noting that the Reserve Bank's reporting requirements could be strengthened and aligned with the Crown entity requirements, where appropriate. Stakeholders did not provide any strong views against this approach.

The statutory reporting requirements detail the minimum amount of information that an entity needs to disclose, and are often deliberately broad to ensure durability and flexibility. However, best-practice transparency and reporting should extend beyond these requirements to better inform stakeholders and set their expectations. The Reserve Bank already goes beyond the legislative reporting requirements and employs a range of communication and consultation devices (although these are not formalised).

The Review is now considering:

- whether the Reserve Bank should be classified as a Crown entity (see Section 2 below). This would see the transparency requirements of the Crown Entities Act 2004 apply to the Reserve Bank. Subsequent work will consider whether the alignment of reporting requirements with the Crown entity framework is sufficient or whether additional bespoke arrangements are required

- whether aspects of the Reserve Bank's current reporting practices should be formalised
- whether the Reserve Bank's objectives should include a behavioural principle to 'share information and promote understanding' (this is discussed in Chapter 2)
- whether additional transparency requirements are needed to cover certain decisions or functions of the Reserve Bank. For example, Chapter 7 of Consultation Document 2B discusses specific reporting requirements relating to the Reserve Bank's funding and resourcing.

Subsequent consultation will progress these aspects based on feedback received, and also set out the transparency and accountability framework that will apply to the Reserve Bank across its responsibilities.

The Reserve Bank's operational independence

One of the guiding principles of this Review set out in the terms of reference is that the Reserve Bank's 'operational independence' should be retained. Consultation 1 outlined why operational independence is important.

There was generally strong support from submitters for the Reserve Bank's operational independence in relation to prudential policy. However, some submitters noted a desire for some ministerial involvement to clarify the Reserve Bank's financial policy mandate (potentially through a remit) and for financial policy matters involving distributional affects (such as macro-prudential policy). Submitters generally expressed 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 Reserve Bank's use of direction powers.

How is operational independence being addressed in this round of consultation?

Operational independence is multidimensional. The intensity of the Minister's involvement in Reserve Bank matters is dependent on the nature of the activity, and the appropriate degree of operational independence will vary across functions. Due to this complexity, this round of consultation does not discuss operational independence in a discrete section. Rather, this consultation document, and Consultation Document 2B, discuss the Minister's role across a range of functions and activities in more detail, where appropriate.

Subsequent consultation will look to progress key topics of the review based on feedback received. The implications for the Reserve Bank's operational independence in respect of its responsibilities, and the role of the Minister, will be considered as part of this process.

Operational independence goes hand-in-hand with a robust transparency and accountability framework. The transparency and accountability framework will complement the discussion of operational independence to enable stakeholders to see how the arrangements will work together.

Questions for consultation

3.A What factors are most important for achieving the establishment of an effective governance board with responsibility for all the Reserve Bank's decisions outside of monetary policy?

3.B What is the appropriate degree of delegation from the board to the Governor? Are there any decisions that should be reserved for the board?

3.C What approach should the Treasury adopt in monitoring the Reserve Bank? What should the Treasury's monitoring responsibilities be? Should the Treasury's monitoring responsibilities be different for the MPC?

Section 2: Follow-up questions for consultation

What should the board model's key features be?

The Reserve Bank's success will ultimately depend on the quality of its decisions. The board's effectiveness in making quality decisions will depend on the:

- skill and experience of board members
- legislative framework the board is operating under
- operational procedures adopted by the board when discharging its statutory responsibilities.

Some key features of the board model will be contained in legislation, while other aspects will be left to the board to determine.

This section covers some key features of the board model, and considers choices around the design of these features. It broadly assumes that the MPC will continue in its current form, although it suggests options for change in the MPC governance arrangements if they are to be consistent with the direction of reform for financial policy.

The section first considers the legislative framework that the board would be operating under. Given that the board model and monitoring arrangements share common features with those of Crown entities, the merits of reclassifying the Reserve Bank as a Crown entity are considered.

Institutional form – should the Reserve Bank be a Crown entity?

The Crown entities framework

The Review's terms of reference state that the Reserve Bank's operational independence remains paramount, and will be protected. One of the key questions for the Review is how this operational independence should be best expressed.

In New Zealand, entities that operate with a degree of independence from the Government are typically established as 'Crown entities' under the Crown Entities Act. The governing body of a Crown entity is a board, which is responsible to the relevant minister for fulfilling its legislative obligations. The board appoints a CEO who is charged with the day-to-day running of the entity under the oversight of the board. The minister's department is generally tasked with being an external monitor of the Crown entity, providing a degree of oversight to assist the minister in carrying out their role.

The Crown Entities Act provides for three Crown entity types: Crown agent, autonomous Crown entity, and independent Crown entity. The entities' governance arrangements depend on the degree of independence they require from the Government (see Box 3A).[26] The key differences relate to the appointment and dismissal processes, and the minister's ability to direct the entities. A comparison of the key features of Crown entities against the proposed board model is shown at Table 3C below.

Box 3A: Entity type

Crown agent (CA) – the agent is required to 'give effect to' Government policy. It has a large degree of ministerial oversight.

Autonomous Crown entity (ACE) – the entity is required to 'have regard to' Government policy as one of a number of factors. It can still have a large degree of ministerial oversight.

Independent Crown entity (ICE) – the entity must be independent from ministers to preserve public confidence in its role. The minister cannot under the Crown Entities Act direct the entity in how to undertake its functions, but can have indirect influence through budget monitoring and the SOI process. An ICE can be directed by its minister, if provided for under the entity's own legislation.

The Reserve Bank was established before the Crown Entities Act was introduced. Its single-decision-maker model, combined with unique board-monitoring arrangements, has historically been seen as inconsistent with governance arrangements in the Crown entities framework. It has its own category in the state sector.

Over time, parts of the Crown entities framework have been incorporated into the Reserve Bank's governance model including:

- Ministerial direction powers under section 68B of the Reserve Bank Act, which largely draw on the autonomous Crown entity model
- Crown entity-style reporting requirements, such as SOIs.

The Minister's in-principle decisions to introduce a board and appoint the Treasury as external monitor mean that the Reserve Bank will look relatively similar to a Crown entity (except for some specific features such as the MPC). There may be benefit in harmonising the Reserve Bank's governance and accountability arrangements with the framework for other independent Crown entities, where appropriate.

[26] Crown Entities Act, section 3.

Table 3C: Key features of Crown entities and the proposed board model

	Crown entity model	Board model[27]
Governing body	▪ The board.	▪ The board (all functions outside of formulating monetary policy) and the MPC.
Appointments	▪ CA – the Minister. ▪ ACE – the Minister. ▪ ICE – the Governor-General, on recommendation of the Minister.	▪ The board – the Minister (note appointment options considered in design feature 3 below). ▪ The MPC – the Minister on nomination by the board (note appointment options considered in design feature 3 below).
Removals	▪ CA and ACE – the Minister. ▪ ICE – the Governor-General for just cause, on the advice of the Minister after consultation with the Attorney-General.	▪ The board – the Minister would remove or advise on removals, potentially on the basis of certain criteria (e.g. breach of duty). ▪ The MPC – the Governor General on advice from the Minister including for breach of duty
Ministerial power to direct	▪ CA – must give effect to Government policy if directed. ▪ ACE – must have regard to Government policy if directed. ▪ ICE – no ministerial power unless in legislation. ▪ All – subject to 'whole-of-Government directions' (these do not apply to statutorily independent functions).	▪ The MPC – must formulate monetary policy for one or more economic objectives if directed. ▪ The current Reserve Bank Act contains a number of direction powers, including section 68B, which requires the Reserve Bank to have regard to Government policy if directed.[28] Ministerial consent is required for some actions, including appointments of statutory managers,[29] and revocations of bank licences.
Relationship with the responsible minister	▪ The board is accountable to the Minister for all decisions.	▪ The board is accountable to the Minister for all decisions outside of monetary policy. The MPC is accountable to the Minister for monetary policy decisions.
Accountability for day-to-day operations	▪ The CEO, who is appointed by the board.	▪ The Governor (CEO under legislation). Note appointment options considered in design feature 3 below.
Assessment of performance	▪ The board assesses the CEO's performance. ▪ The monitoring department helps the responsible minister to assess the board's performance.	▪ The board assesses the CEO's performance. ▪ The monitoring department helps the Minister to assess the board's and the MPC's performance.

[27] Note the options in Section 2 on the composition of board members, and on appointments and removals.

[28] These are powers contained in the current Reserve Bank Act as amended. Phase 2 of the Review is considering whether there is a case for making the Reserve Bank's operational independence more explicit, for example by removing the requirement for the Minister's consent for certain policy instruments and direction powers. See Chapter 7 of Consultation Document 1.

[29] Individuals appointed by the Minister (on the advice of the Reserve Bank) step in and run a commercial bank in the interests of the New Zealand public when the bank is failing.

Why change the current approach?

A high degree of public confidence in the Reserve Bank's decisions is needed, which requires an appropriate level of operational independence from the Minister. The required level of independence could be well suited to an ICE, where the decision maker is not subject to easy dismissal, or directions on Government policy (except where explicitly provided for in legislation). From a legal standpoint, the Reserve Bank's designation as an ICE would primarily affect the role of the Minister and their direction powers. It would have important value in signalling the Reserve Bank's broader relationship with the Government.

In contrast to ICEs such as the FMA, a case can be made that the Reserve Bank's unique status in the state sector has hampered clarity in defining that relationship. The rationale for the Minister's role in the Reserve Bank's prudential policy functions is unclear and inconsistently applied.

The IMF commented on this situation in its 2016/17 FSAP, expressing concern about ambiguity in the roles of the Treasury and the Minister. The IMF noted that "Procedural clarity, and transparency and traceability of coordination processes, are important to further strengthen the operational independence of the RBNZ" (IMF, 2017, p. 38). Reclassifying the Reserve Bank as an ICE would provide an opportunity to reassess and redefine the rationale for the Minister's involvement (for example, where there are fiscal implications) and apply this consistently and explicitly to Reserve Bank functions where the Minister's involvement is appropriate.

While it would be possible to create that clarity through changes specific to the Reserve Bank, good practice suggests that the starting point should be to use a standard organisational form, then tailoring where appropriate rather than creating a bespoke model. Using an ICE model would:

- provide clarity on the Reserve Bank's independence
- make its institutional components consistent across the state sector for operationally independent institutions (and not duplicated across legislation) and future proof the model in the event of subsequent changes to the Crown Entities Act 2004
- align the Reserve Bank with the FMA. The current 'twin peaks' regulatory model (where prudential regulation and financial market conduct are separated) has resulted in different governance models and relationships with ministers.

While these are good reasons to consider changing the Reserve Bank to an ICE model, it is important that the Reserve Bank has all of the qualities (such as independence and governance arrangements) it needs to operate effectively and fulfil its functions. Any shift to an ICE model would have to accommodate distinctive Reserve Bank features, including:

- **Responsibility for decisions** – an ICE board is responsible for ensuring that the entity fulfils its functions and appoints its own CEO. Under the proposed board model, responsibility is split between the MPC (for formulating monetary policy) and the board (for all other functions). Currently the CEO (the Governor) is appointed by the Minister.
- **Ministerial involvement** – the Minister can clarify the Reserve Bank's objectives in monetary policy through the monetary policy remit, and the Review is considering similar arrangements for the Reserve Bank's financial policy responsibilities. Consultation Document 2B also proposes that the Minister has a power of direction in certain circumstances related to bank resolution and crisis management.

Board composition

The following section considers options relating to the composition of the board, and how board members are appointed and removed. Provisions relating to board composition are expected to be prescribed by legislation.

Design feature 1: How many non-executives should the board have?

Executive members are employees. They typically work full-time and offer in-depth knowledge to decision making, partly via their managerial responsibilities. However, executive members of the Reserve Bank (excluding the Deputy Governor) ultimately report to the Governor as CEO.

Non-executive members are not employees; they have no management responsibilities, and are likely to work part-time. They can reduce the risk of groupthink, particularly among groups where one member (such as a CEO) has disproportionate influence (particularly over other executive members). Non-executive members are independent of the entity's management, and therefore more likely to provide objective judgements and robust challenge, and advocate greater transparency in decisions.

Non-executive members can increase the diversity of perspectives at the board level, which can be valuable where decisions have to be made in uncertain conditions – as is the case for policy decisions at the Reserve Bank. If different people could reasonably reach different conclusions, even when decisions are based on the same set of information, a diverse group is likely to improve the decision-making process. There is also a case for non-executive members where an organisation is exercising significant statutory powers. This allows for a clearer functional separation between management's supervisory and investigative teams, and the institution's decision makers.

The Institute of Directors in New Zealand describes the benefits of diversity as follows:

> *"A board with a variety of perspectives is likely to ask a wider range of questions when presented with options. Introducing diversity is about fresh thinking and appropriate challenge to board decision making and the culture of the board. Overly homogenous boards run the risk of groupthink and struggling with change. Such challenges are not insurmountable, but the more awareness a board has of itself the more likely it is to deal with the issue well."* (Institute of Directors in New Zealand, 2018, section 2.4.5.).

A board's composition can be:

- fully non-executive – the FMA and nearly all Crown entity boards are fully non-executive
- majority non-executive – many private companies have a majority of non-executive members. The New Zealand Stock Exchange recommends that New Zealand listed companies have a majority of non-executive members.[30] The current board of the Reserve Bank has a majority of non-executive members
- balanced – the BoE's FPC has an equal number of executive and non-executive members

[30] See the NZX Corporate Governance Code, which recommends that an issuers board comprise a majority of non-executive directors.

- majority executive – the MPC has a majority of executives
- fully executive – both APRA and the Australian Securities and Investments Commission (ASIC) adopt this model. A fully executive model is out of step with Phase 1 of the Review and conventional practice in the New Zealand public sector.

To be consistent with governance in the New Zealand state sector as well as best-practice corporate governance, the board will have some non-executive members, but there is an open question as to how many. The Review's Phase 1 decisions indicated a desire for group decision-making and genuine external challenge for important policy decisions. A board model will provide these attributes for all the Reserve Bank's functions through having non-executive members.

Listed company boards and public sector boards in New Zealand are typically fully non-executive or majority non-executive.

- A fully non-executive board has the advantage of boosting accountability by providing a clear split between governance and management decisions. For Crown entities, having a CEO on the board could result in ambiguity around who they owe their duties to. A CEO will typically owe their duties to the board appointing them but, as a board member, the CEO would also owe duties to the responsible minister, resulting in potential conflicts. The clear lines of accountability provided by a fully non-executive model is a key reason for the model being so prevalent among Crown entities.
- Having executive members on the board can undermine internal accountability by blurring the line between governance and management responsibilities. Executive members will likely struggle to detach themselves enough from their management responsibilities to take a fully independent perspective and hold management (including themselves) to account.
- Including executive members on the board would represent a change from standard practice in the New Zealand state sector. As has been noted above, Crown entities' boards appoint their CEO, who will then typically make decisions about senior leadership appointments. If executive members were included on the board, accountability principles would suggest these members should be appointed by the Minister. This would provide the Minister with decision rights over some members of the Reserve Bank's senior leadership team. The Governor (as CEO) can help shape and direct the Reserve Bank by recruiting and appointing employees to key positions in the executive leadership team, but Ministers' appointment rights for executive board members can erode this power.

There is nonetheless a case that, in complex areas such as financial policy, providing for some formal executive involvement at the board level may enhance the richness of discussion. While a board can seek advice from management (and the CEO will be present at board meetings, alongside senior managers where relevant) there may be a case that including the CEO, and one or two more key executives, as decision-makers could provide the board with greater confidence to take complex or difficult decisions. Boards with a mixture of executive and non-executive members are commonplace in the private sector and among public sector regulators and central banks internationally.[31] A

[31] Hybrid boards include the court at the BoE, the UK Financial Conduct Authority, the Bank of Japan, the Reserve Bank of Australia and Sweden's Financial Supervisory Authority.

majority of executive members is not recommended, as this could undermine the board's internal accountability arrangements.

The decision-making model, and the approach to public communications, are also relevant in deciding the number of non-executive members. Boards typically adopt a consensus-based decision-making model and a collegial approach to public communications, which can make it difficult to assess individual members' contributions and performance, and to hold them to account. It is beneficial to have a clear majority of non-executives, because accountability can be reinforced in board discussions, in which non-executive members are expected to promote debate and challenge.

Design feature 2: What kind of non-executive members should be on the board?

The importance of expertise – stakeholders emphasised the importance of recruiting non-executives who are highly capable, have expertise in policy, and are free from political influence.

The Institute of Directors in New Zealand cautions against pursuing diversity at the expense of expertise:

> *"Diversity on the board should always be approached through the lens of demonstrated competence. Unless competency is the key consideration in respect of a potential director, a policy of diversity at all costs runs the risk of tokenism and creating disunion."* (Institute of Directors in New Zealand, 2018, section 2.4.5.).

The Crown Entities Act 2004 recognises the importance of promoting diversity at the board level but this is subject to the requirement that only people with the appropriate knowledge, skills, and experience should be appointed to the boards of Crown entities. The Reserve Bank Act also recognises the importance of expertise, by requiring the Minister to have regard to a person's knowledge, skills, and experience when considering the appointment (or reappointment) of a non-executive member of the current Reserve Bank board.[32]

It is not expected that all board members will be subject matter specialists. A range of skills and experience will be required on the board to cover the range of its responsibilities. Key decisions made by the board will often be informed by in-depth analysis provided by Reserve Bank staff, and board members will need to have a sufficient level of knowledge to understand and interrogate this analysis. Where further specialist or independent expertise is required to inform board decisions, there are options available to the board – including hiring external advisers, and setting up advisory committees. Members will also often have skills (and access to networks) that will broaden the perspective they bring to the Reserve Bank.

Phase 1 of the Review recognised the importance of having non-executive members with relevant knowledge and experience and built-in criteria targeted at the expertise required. Similar provisions would be needed for the skills and expertise required on the board. For prudential policy, relevant knowledge and experience would likely include prudential policy, regulatory and supervisory expertise, and experience in the banking, insurance, and finance sectors. Specifying such requirements in legislation, supported by a robust appointments process, would help to ensure that members appointed are able to robustly engage in the decision-making process.

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[32] See the Crown Entities Act 2004 section 29 and the Reserve Bank Act section 56.

FMA and Treasury representation – the FMA's primary objective is to promote and facilitate the development of fair, efficient, and transparent financial markets, which is critical to achieving public trust and confidence in the financial system. There is a close connection between the FMA's and the Reserve Bank's responsibilities, and financial policy decision-making could be enhanced through the FMA's involvement. Given the importance of regulatory coordination between the Reserve Bank and the FMA, an FMA representative could be included on the board, in either an observer or a voting capacity. They could be a non-executive director on both the FMA and Reserve Bank boards. An FMA representative could enhance coordination and reduce the challenge in recruiting suitably qualified individuals.

The MPC has a Treasury observer who helps in coordinating monetary and fiscal policy. The case for having a Treasury representative on the Reserve Bank board may be less compelling, given that:

- the Treasury has a narrower interest in day-to-day financial policy matters, and is more focused on tail-end risks that could have fiscal and broader economic implications
- a Treasury representative (even in an observer capacity) could create conflicts of interest and be seen as undermining the Reserve Bank's operational independence. This risk is potentially accentuated in light of the Treasury's representation on the MPC as an observer.

Alternative arrangements include:

- the board extending invitations to the Treasury where its involvement is required or would be beneficial
- enhancing coordination arrangements between financial sector agencies more generally (see Chapter 6 of Consultation Document 2B).

Design feature 3: How should members be appointed to/removed from the board?

While sustained high-performance among regulatory agencies depends on effective internal and external governance, it is no cure-all. The best governance systems count for little if the agencies do not have capable leaders with the right mix of skills.[33] A board's appointment processes must therefore be robust, and guided by a high-quality analysis of the mix of skills it needs.[34]

There is debate about the degree to which ministers should be involved. Some argue that independence is needed to ensure public trust and confidence in independent regulators, and others that ministerial involvement is needed for democratic legitimacy (Productivity Commission, 2014, pp. 262-263).

In New Zealand, the debate has tended to favour ministerial involvement. This is because the authority of independent institutions ultimately derives from Parliament, so it is appropriate that Parliament (through the relevant minister) is involved in the appointment (and removal) process.

That said, the risks of undue ministerial influence in the appointment/removal process were thought serious enough to justify keeping the current 'double veto' arrangement for the MPC, in which the Minister retains the right to appoint, but may only appoint a person recommended by the board.

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[33] See Partridge and Thomasson (2018), p. 79, and Productivity Commission (2014) p. 265.

[34] The SSC notes the importance of ensuring there is public trust in the integrity and effectiveness of those appointed to the boards of state sector agencies. The SSC has published board appointment and induction guidelines which are available here.

However, these risks are arguably lessened in a group decision-making model, as the individual appointments have less influence. Group decision-making also provides an extra safeguard in staggered appointment terms and varied term lengths, which make it more difficult for a Minister to influence decisions through the power of appointment.

Current appointment and removal arrangements

Table 3D shows the current appointment and removal provisions for the existing board, the MPC, and the Governor and Deputy Governor.

Table 3D: Status quo appointment and removal provisions for the Board and the MPC

	Appointment and removal process
Governor	The Minister on the Board's recommendation. Removed by the Governor-General on advice from the Minister. *Ex-officio* member of the board and the MPC. Governor is CEO under statute.
Deputy Governor	The Minister on the Board's recommendation (consults the Governor). Removed by the Governor-General on advice from the Minister. *Ex-officio* member of the MPC.
Board	The Minister. Removed by the Governor-General on advice from the Minister.
Non-executive MPC	The Minister on the Board's recommendation. May be removed by the Governor-General on advice from the Minister.
Executive MPC	The Minister on the Board's recommendation (consults the Governor). May be removed by the Governor-General on advice from the Minister.

The arrangements retain the 'double veto' for all appointments (apart from board members). This ensures an 'arm's-length' arrangement from the Minister and promotes merit-based selection.

Options for appointments and removals under the governance board model

The establishment of a new governance board requires a reassessment of the appointment and removal provisions.

Unlike the existing Reserve Bank board, the new board will have statutory responsibility for financial policy in addition to corporate governance and the Reserve Bank's performance as an organisation. Given the benefits of delegating financial system functions and objectives to an operationally independent institution (Hunt, 2017), it is important to ensure that the appointment and removal process appropriately balances the need to preserve both democratic accountability and the Reserve Bank's operational independence. It is also more practical to have a standard process for all board and committee members as far as possible.

The following are options for appointments to the board and/or the MPC:

- **The ICE model for board appointments** – the Governor-General appoints/removes ICE board members on the minister's recommendation or advice. Members can only be removed for just cause, after consultation with the Attorney-General.

While the Reserve Bank is not an ICE, it has many of its characteristics, so the Crown entities framework provides a useful starting point. However this arrangement may not be seen as sufficiently 'arm's-length' from the Minister. In addition, if the ICE model for board appointments/removals were adopted, there would be separate processes in place for board and MPC members, creating additional complexity and inconsistency across the appointment and removal process.

- **An independent nominating committee for all appointments (including MPC members)** – in Phase 1 of the Review, former State Services Commissioner Ian Rennie recommended establishing a nominating committee for non-executive appointments, comprising at least four qualified people appointed by the Minister (Rennie, 2018, recommendation 6). The committee would nominate candidates (based on agreed appointment criteria) to the Minister, who would make appointments after consulting other political parties. The committee members would have proven skills and experience in identifying potential board members. This model is similar to that used by the Guardians of the New Zealand Superannuation Fund. A separate panel was recommended by Ian Rennie for executive members, although the process for all appointments could be tailored to include consultation with the Reserve Bank.

  This model could provide one appointment process for all members, mitigate against undue political influence, and provide strong political legitimacy to appointments through the cross-party consultation process. More importantly, it would provide a credible and enduring appointment process targeted at the specific skills and experience required by the board.

- **The board appoints/removes executive MPC members** – changes in the board's responsibilities may mean there are advantages in simplifying the arrangements for executive MPC appointments.

  The newly established board will have an interest in ensuring that the MPC has well-qualified individuals appointed as part of its governance responsibilities. Executive MPC members are Reserve Bank staff selected on the basis of their expertise and experience in monetary policy. Although unlikely, the Minister could refuse to appoint Reserve Bank staff approved by the Governor under the current arrangements. It could be argued that it is not appropriate for the Minister to have this power given that the Reserve Bank is in a better position to assess who is best placed to serve on the MPC.

  An alternative arrangement is for the board (or a non-executive committee of the board) to appoint (and remove) executive MPC members after consultation with the Minister. This would give responsibility to a body with a better knowledge of the Reserve Bank and the skills and expertise required at the MPC level, and mitigate the influence of hierarchies in the Reserve Bank. However, if the Minister does appoint/remove MPC members this could potentially cause concerns about the democratic legitimacy of these appointments, including the appointment of the Governor who is an executive member and chair of the MPC (see the section on options for appointing the removing the Governor below).

- **The Deputy Governor** – the position of Deputy Governor was created in legislation to address the risks of having a single decision-making structure, under which one individual had the responsibility and accountability for all the Reserve Bank's functions. In the event that the Governor was unavailable, it would enable another person to step into their shoes.

This 'key person' risk does not exist in the group decision-making structure (for example, no Crown entity has appointed a Deputy Chief Executive). With the establishment of a new board, the legislative requirement for a Deputy Governor role could potentially be removed.[35]

- **Appearances at select committee** – under this approach, all appointees (including all board and committee members) could appear in front of a Parliamentary select committee after they have been appointed. This process would provide greater transparency around appointments, and provide an opportunity to engage appointees on matters relating to their responsibilities. The process would happen after the appointment, preserving the Minister's appointment powers.

  This process would represent a change from standard practice in the New Zealand state sector, and it would be unusual to have the process apply only to Reserve Bank appointees. However, the involvement of Parliament in the appointments process does have international precedent. For example, parliamentary scrutiny of appointments is used at the BoE and the Board of Governors of the Federal Reserve System in the United States. The UK's House of Commons Treasury Committee notes that the process provides greater transparency (incentivising appointers to appoint members with the required qualities) and enhanced public awareness of the bank's operation and its individual members' roles.[36]

Options for appointing and removing the Governor

In a conventional governance board model, the appointment and removal of the CEO is arguably the board's most important function. Through it, the board influences the culture and performance of the institution, and in this sense the CEO is the key conduit between the institution and the board. The CEO is charged with running the organisation and implementing policy within a board-determined framework, and the board relies on the CEO to ensure high standards of performance by management. It is therefore essential that the board has the trust and confidence of its CEO; if it loses this trust, the board ultimately has the power to remove the CEO.

The current appointment arrangement for the Governor differs from the conventional approach (used by New Zealand Crown entities), in which the responsible minister appoints the board and the board appoints its CEO. However, it is currently seen as appropriate given that the Governor (not the board) has statutory responsibility for the Reserve Bank's functions, and is accountable to Parliament.

The new board will have significant statutory policy and corporate responsibilities, and monetary policy is the responsibility of the MPC. In these circumstances, where statutory responsibility for the Reserve Bank's functions is no longer vested in the Governor, there is arguably a strong case for the board to have the right to determine its CEO's appointment and removal. The process could involve a requirement for the board to consult with the Minister. Giving the board appointment and removal rights would provide the board with a powerful tool to hold the Governor and management to account, and could also insulate the Governor from undue political influence (they would owe their duties to the board, not the Minister).

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[35] Careful consideration would need to be given to the implications of removing the legislative requirement for a Deputy Governor. For example, there would be legislative implications for monetary policy given the Deputy Governor is an ex-officio member of the MPC.

[36] House of Commons Treasury Committee – The Monetary Policy Committee of the BoE: appointment hearings 2005-2006 – available here.

Board procedure and operation

The way the board operates, including how it makes and communicates decisions, will not be fully set out in legislation. The legislative framework will typically provide for key parameters within which a board operates (such as responsibilities, powers, accountabilities, reporting, composition, and conflicts of interest), while the board is given flexibility to regulate its operating procedure.

While not generally a legislative requirement, as a matter of good practice, a board will often adopt a charter to clarify how it intends to operate, and to enhance the transparency of its responsibilities and operations. The Institute of Directors in New Zealand notes:

> *"The board charter is a cornerstone document of the board and sets out the organisation's direction, purpose and goals. It also describes the values of the organisation, and the roles and responsibilities of the board. Developing a board charter is an opportunity to think creatively and critically about the board. A charter provides clarification for the board itself and can make board responsibilities and operations transparent to the public. This is particularly important if transparency is expected of the board."* (Institute of Directors in New Zealand, 2018, section 2.3).

A board may also voluntarily choose to enhance corporate governance arrangements by establishing other procedures and protocols to guide approaches to its responsibilities. It is common for a board to adopt a code of conduct to set standards for the appropriate ethical and professional conduct of members, and to provide guidance on managing perceived or actual conflicts of interest. Boards will typically approve terms of reference for any committee of the board.

However, as with the MPC, there could be some statutory settings, and potentially secondary instruments, that provide further guidance on the board's operational procedures. Schedule 5 of the Crown Entities Act provides a template for the board procedure of statutory entities. The Reserve Bank Act requires that a charter and code of conduct be in place for the MPC. The charter must include requirements for records of MPC meetings and their publication, and for communications by MPC members of information relating to the MPC or its functions, powers, or duties (Sections 63A to 63M.

How a board makes and communicates decisions are key features of the board's operating procedure and are considered further below.

Decision-making

In group decision-making, choices are made between individualistic decision-making ('voting') and collective decision-making ('consensus') models.

- In a voting model, options are put to a vote and the majority determines the decision.
- In a consensus model, members typically aim to reach a joint position and agree to support the consensus view. There is generally a provision for voting where consensus is not reached.

Table 3E: Pros and cons of voting and consensus models

	Voting	Consensus
Pros	▪ Every member has to reveal their preference – this can avoid free riding (particularly if votes are published). ▪ Can help to mitigate groupthink. ▪ Familiar, conventional, efficient. ▪ Useful when time constraints make reaching consensus difficult.	▪ Ensures buy-in of all members, thus increasing the likelihood of success. ▪ Members strive to make the best decision for the group rather than compete for personal preferences. ▪ Members' contributions can be identified to help avoid free riding. ▪ All perspectives are taken into account.
Cons	▪ Publication of votes could lead to external pressure on members. ▪ Members may not reveal true positions due to concerns about appearing incompetent, and not challenge conventional wisdom. ▪ May not encourage full-group discussions/interactions. ▪ Creates winners and losers.	▪ Can be time consuming. ▪ The larger the group, the more difficult it is to achieve consensus. ▪ Promotes convergence of views, which can undermine diversity benefits. ▪ Assumes all members are willing and able to challenge dominant members.

Maier (2010, p. 14) notes the longstanding debate among central bankers about whether a committee should use voting or consensus decision-making models, and concludes that there is no reason to believe that either of the two options always delivers better results. Regardless of whether decisions are taken by vote or consensus, an institution's culture and governance structure will be major factors in determining decision-making effectiveness. Maintaining a culture that promotes contemplation and meaningful debate before decisions are taken will likely be at least as important as whether decisions are made by voting or consensus.

A consensus approach is likely to be preferable for a board governance model

Boards typically use a consensus model to make decisions. This reflects directors' collective responsibility and accountability for their organisations' decisions. All directors are bound by a board's decision, even if they have expressed reservations at the time or dissented. Decisions by consensus are usually made after full discussion and debate. The chair's role is to ensure that all views are heard, and that any variances in opinions are thoroughly talked through before decisions are made.

Consensus decision-making does not require boards to always reach consensus. A healthy board should debate a range of views before a decision is made. If it is not possible to reach a consensus, other options may need to be considered, such as putting the decision to a vote, or delaying the decision pending further information. Directors objecting to a proposed decision may have their dissent formally recorded, although they will still be bound by the board's majority decision. A consensus model is consistent with the approach used by financial regulators in New Zealand, Australia, and the UK.

Communications

The Reserve Bank currently releases considerable information about its outlook for the economy, and the rationale for its policy decisions, including through regular *Monetary Policy Statements*, *Financial Stability Reports*, and speeches. Policy bodies can also choose to communicate information about the views of board or committee members, including publishing transcripts of meetings or making member votes available. Broadly speaking, the spectrum of options ranges from 'individualistic' to 'collegial' (see Table 3F).

Table 3F: Approaches to communications

	Individualistic	⟷	Collegial
Minutes and written statements	Range of views, attributed to individuals.	Range of views but no attribution.	Consensus views only.
Publication of votes	Individual votes.	Balance of votes.	No votes published.
Speeches	Individual speeches, no constraints.	Individual speeches, approved by board.	Support consensus.

A key benefit of the individualistic approach is its influence on behaviour. Making individual members' contributions transparent creates an incentive for members to take care in their deliberations, while also reducing their ability to free-ride on others' contributions. However, an individualistic approach can also affect group dynamics. For example, there is evidence suggesting that the US Federal Reserve's decision to publish transcripts of meetings with a five-year lag had the effect of inhibiting debate and the free flow of ideas.[37]

A collegial approach to communications is likely to be preferable for prudential policy

A heavily individualistic approach to communication is unlikely to be appropriate for prudential policy. Warsh (2014) considered whether the individualistic transparency requirements that applied to the BoE's Monetary Policy Committee should be applied to its prudential counterparts. He concluded that they should not, due to the nature of the decisions and the consensus decision-making model. He observed that:

- the task of making sound decisions for individual institutions could be undermined if internal deliberations were made public. Effective communication in the micro-prudential context involves a regulator's communications to regulated firms, rather than to the public
- the task of making sound prudential decisions could be undermined if discussions were made public. In concentrated financial systems, discussions are likely to be full of institution-specific information. Macro-prudential policy is in its formative years of development and members benefit from a relatively unconstrained space for open discussion and deliberation

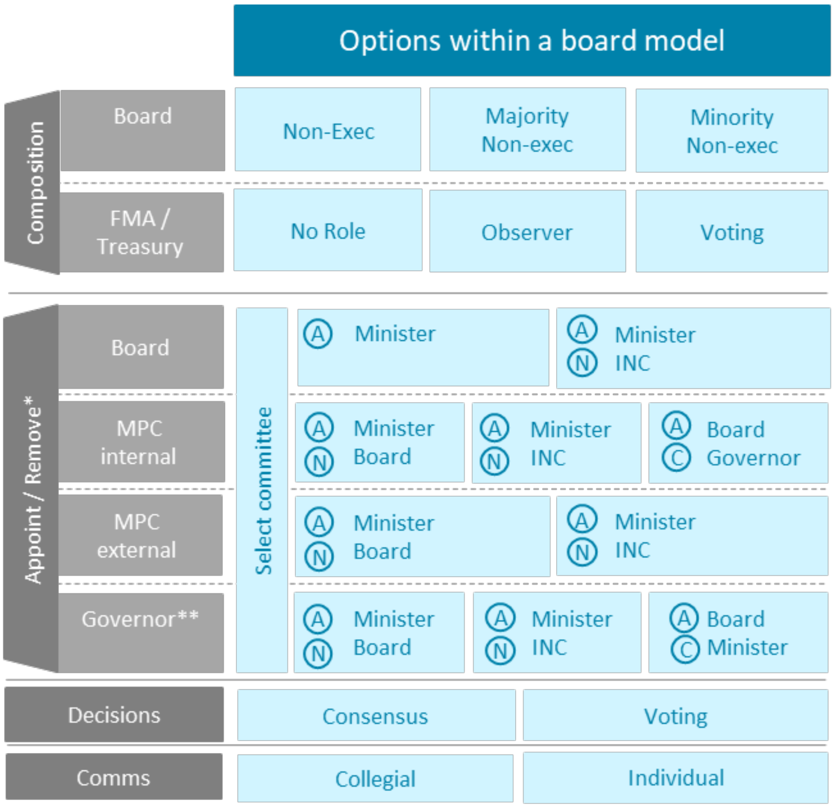
[37] See Warsh (2014), pp. 32-34 summarising the academic research on the Federal Open Market Committee of the Federal Reserve's practice of publishing transcripts of meetings.

- accountability could be better served through other mechanisms, including select committee appearances, policy statements, public reporting on key policy areas, and member speeches (pp. 43-47).

Rennie found no evidence of financial policy committees that released information on votes or individual contributions, and suggested that the need to provide certainty and clear guidance argued in favour of acting collegially in public (2018, p. 34). A collegial approach to communications is consistent with financial regulatory practice in New Zealand, Australia, and the UK.[38]

Summary of options

Figure 3B: Summary of design feature options



* Removals would follow a similar process to appointments but with the involvement of the Governor-General as is currently the case.
** If the board appoints the Governor (as CEO) the Governor would cease to be an *ex-officio* member of the MPC and would be appointed/removed using the similar process for internal members. Any role of the Minister would be limited to consultation.

INC = Independent Nominations Committee

Ⓐ Appoints Ⓝ Nominated Ⓒ Consulted

[38] The following regulators do not publish minutes or transcripts – In the UK, the PRA and the FPC at the BoE (the FPC does publish a record) and the Financial Conduct Authority; in Australia, APRA and ASIC; and in New Zealand, the FMA.

Questions for consultation

3.D Do you think there is merit in reclassifying the Reserve Bank as an independent Crown entity?

3.E For the new governance board:

i. what should the split of executive and non-executive members be?

ii. what skills and expertise should non-executive members have? Is there merit in having representation from the FMA and/or the Treasury?

iii. how should members be appointed and removed? Should the board be able to appoint the Governor as CEO?

3.F Are there any aspects of the board's operation would benefit from legislative clarity or guidance?

Chapter 4: How should the regulatory perimeter be set?

Overview

This chapter follows up on one of the core topics covered in Consultation Document 1: how should the regulatory perimeter – the boundary between regulated and unregulated firms – be set?

Consultation Document 1 asked whether it would improve the efficiency and coherence of the regulatory framework for both the banking and NBDT sectors to sit within the same regulatory regime. This would be consistent with the approach in a number of other jurisdictions.

Section 1 provides the answer to that question based on an in-principle decision from the Minister. Section 2 sets out a series of follow-up questions on the potential design of that framework.

Section 1: In-principle decision

How should the regulatory perimeter be set?

The Minister has made an in-principle decision to bring the bank and NBDT regulatory regimes together into a single 'licensed deposit taker' framework. This decision was unanimously supported by the Independent Expert Advisory Panel, the Reserve Bank, and the Treasury.

This single framework will:

- centre on an activities-based definition of deposit taking (to be developed), capturing firms that are in the business of borrowing and lending
- be regulated and supervised by the Reserve Bank under a single piece of legislation
- retain the restrictions on the use of certain words such as 'bank' and 'banking'
- provide for a risk-based licensing and regulatory framework by aligning entities' compliance requirements with the scale of their activities and the risks they pose to the financial system.

A move to an integrated deposit-taker framework would not mean the same rules would apply to all entities. There is a need to support tailored approaches for institutions of different scales or with specific business models.

Rationale for decision

A well-specified perimeter needs to:

- capture the right types of entity. In the prudential regulatory system, it must enable the Reserve Bank to respond appropriately to threats to financial stability
- be designed in a way that empowers best-practice regulation. The way in which entities are brought into the perimeter and regulation is applied to those entities can have meaningful impacts on long-term regulatory outcomes.

The current regulatory perimeter broadly captures the right entity types. However, there are design issues with the portion of the perimeter that captures deposit takers. New Zealand currently has two parallel regimes regulating this group:

- **A 'names-based' banking regime** – firms that undertake financial services and want to use certain restricted words (e.g. 'bank' or 'banking') in their names or advertisements must register with the Reserve Bank. Once registered, banks are both regulated and supervised by the Reserve Bank. However, this registration is essentially voluntary. Firms may undertake bank-like activities (activities tied to borrowing and lending) without registering as 'banks' as long as they do not call themselves 'banks'.
- **An NBDT regime** – broadly speaking, if firms want to undertake borrowing and lending, and are seeking to fund those activities (at least in part) by offering debt securities to retail investors (such as deposits), they must be licensed as NBDTs. Once licensed, NBDTs are regulated by the Reserve Bank, but are supervised by private sector entities known as financial markets supervisors (FMS).

These two regimes support each other in that if a firm chooses not to register as a bank but takes deposits, it is captured under the NBDT regime. Nonetheless, given that the two regimes largely seek to address the same risks, it is likely that regulating both banks and NBDTs under a single framework would improve the regime's efficiency and coherence.

A single licensed deposit taker framework has three key advantages over the status quo:

- **Increased regulatory efficiency** – maintaining two regulatory regimes adds complexity to the regulatory system, and introduces the risk of the regimes diverging. A number of divergences have emerged between the bank and NBDT regimes over time. These divergences are more about regulatory complexity than underlying differences between the two sectors. Examples include the application of macro-prudential policy to banks but not NBDTs, and differences in crisis management tools. Having two regimes also has a resourcing impact on the Reserve Bank.
- **Regulatory neutrality** – currently, firms undertaking similar activities are not treated the same way. For example, NBDTs do not have access to the same disclosure and governance exemptions as banks, and they cannot use certain terminology. This can create the perception that NBDTs are 'second-class' firms, reducing their ability to compete. While NBDTs are subject to less prescriptive capital and operational requirements, the differences in treatment between banks and NBDTs cannot be seen as explicitly risk-based. The different supervisory models also have different cost implications: bank supervision does not result in direct costs to banks, in contrast to NBDTs who pay for FMS supervision.
- **Growth compatibility** – the NBDT regime is the likely location for challenger or new entrant deposit takers, given it has lower minimum capital requirements than the banking regime. The supervisory model for NBDTs is based on the oversight of trust deeds by FMS. This model provides clear value for secured products such as debentures. In the future, new entrants will nonetheless come in various shapes and sizes, have innovative business models, and use new ways of meeting regulatory requirements. These firms may struggle to build digital models around FMS oversight.

There is also a link between the regulatory perimeter and the issue of depositor protection. As is discussed in Chapter 5, the Minister has made an in-principle decision to introduce a scheme that will protect eligible deposits up to an insured limit. The limit is proposed to be in the range of $30,000-$50,000 per depositor per insured entity.

There is a strong case that the design of the deposit taking perimeter should align with the design of any depositor protection scheme. Competitive neutrality has typically been one of the core principles of depositor protection schemes. In Australia, the UK, and other markets, these schemes are usually extended to all licensed deposit takers on the basis that they are subject to broadly similar regulatory requirements. Introducing depositor protection would be more complicated under the current regulatory framework; given the different rules and supervisory arrangements that apply to banks and NBDTs, the two regimes cannot be seen as directly comparable.

Feedback from stakeholders

Stakeholders were almost universally supportive of shifting to a single deposit-taking framework, subject to the considerations discussed below.

Stakeholders emphasised the high degree of change and innovation currently taking place in the financial system, including financial technology innovations (FinTech). A background paper accompanying this consultation examines some of the specific challenges associated with the regulation of FinTech (MinterEllisonRuddWatts, 2019).

Stakeholders noted that there are important issues relating to setting the final perimeter boundaries that require further meaningful consultation. Stakeholders considered that there was a good in-principle case for all firms offering 'banking-like' products to retail customers, such as deposits, to be regulated under the same regime. The case was less clear for firms that offered different types of products, or that operated different business models, such as certain finance companies or wholesale funded non-deposit taking lending institutions (NDLIs).

Stakeholders emphasised the need for any framework to allow for differences in both regulation and supervisory intensity between firms. While accepting this principle, several stakeholders nonetheless noted that the NBDT sector included a number of smaller entities that would need to make improvements in areas such as governance as part of a shift to a single deposit-taking framework – particularly if the framework provided for deposit protection.

A number of stakeholders also said that the Reserve Bank's objectives and funding would need to ensure that it invests sufficient resources and focus (both supervisory and policy) on smaller deposit takers, including giving appropriate consideration to sector specific risks, competition and regulatory efficiency.

Other options considered

The other option that was considered involved retaining the current banking and NBDT regimes for the longer term. Provided appropriate changes are made in areas such as the Reserve Bank's objectives and funding, this option was considered undesirable.

The current framework lacks coherency and could become more complex in the future. As discussed above, there are potentially meaningful efficiency benefits for both the Reserve Bank and the deposit-taking sector in bringing the banking and NBDT regimes together.

Section 2: Follow-up questions for consultation

Part I: What features should a deposit-taking regime have?

Two key questions relating to the deposit-taking perimeter need addressing in the remaining phases of consultation:

- How should the boundary of the deposit-taking perimeter be set?
- Should the regime include some differentiation of rules for different types of deposit-taking firms?

If a final decision is made to shift to a single deposit-taking perimeter, policy work on these questions will be progressed, informed by stakeholder feedback. The design and operation of transitional arrangements will be important given the impact on regulated entities.

How should the boundary of the deposit-taking perimeter be set?

Reflecting good regulatory practice, the deposit-taking perimeter should be 'activities based'. Activities based regulation applies rules to entities based on the activity or function they undertake (for example taking deposits or carrying on the business of insurance), rather than their name or legal form.

As the Reserve Bank Act operates on an opt-in basis for banks, the perimeter for deposit taking is currently set primarily by the definition of 'NBDT' in the NBDT Act. An entity is defined as an NBDT if it:

- makes a 'regulated offer' of debt securities under the Financial Markets Conduct Act 2013 (FMC Act).[39] In broad terms, this is an offer made to at least some retail investors, and
- carries on the business of borrowing and lending money, or providing financial services, or both.

Under the FMC Act, a debt security means "a right to be repaid money or paid interest on money that is, or is to be, deposited with, lent to, or otherwise owing by, any person".

The simplest option for integrating the banking and NBDT regimes would be to use the existing NBDT definition to set the boundaries of the deposit-taking regime.

This is unlikely to be the best approach. Internationally, deposit taking perimeters are most commonly set by reference to lenders that *take deposits from the public*, rather than offer *debt securities* (Bossu and Chew, 2012, pp. 7-8).[40] The EU, for example defines a 'credit institution'

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[39] The NBDT Act also captures offers to two types of investors that are considered to be wholesale investors under the FMC Act. The first are 'eligible investors', being persons that have certified they have sufficient experience and knowledge to assess the risks and merits of an offer. The second are persons that are considered to be wholesale investors on the basis that they meet certain investment activity criteria.

[40] With 'the public' being relatively synonymous with the concept of a retail investor.

(equivalent to a licensed deposit taker) as "an undertaking the business of which is to *take deposits* or other repayable funds *from the public* and to grant credits for its own account".[41]

There are challenges that exist in differentiating a 'deposit' from other forms of debt securities.[42] A number of approaches are nonetheless available that help provide certainty around the boundaries of the term: for example by framing the definition around the concept of a retail deposit, and then excluding certain types of products or types of offers from the definition for completeness.[43]

Framing definitions around 'retail' deposits has the benefit of focusing the 'inner perimeter' (being those entities subject to a licensing framework, and to whom rules relating to capital, liquidity and governance apply) around firms that provide 'banking-like' services to the public. These firms face a number of potential market failures that justify the application of prudential regulation and supervision, namely negative externalities, moral hazard and information asymmetries. Deposit accounts and other associated services (such as cheque accounts or ATM facilities) provide a critical economic service for bank customers. When these types of entities fail depositors can face a disruption in their access to funds that they rely on for basic transactions. This can also cause widespread disruption in the economy (Fiennes, 2016, p. 3).

A focus on firms that take retail deposits would mean that firms would sit outside the inner perimeter if they were in the business of lending, but funded themselves solely through one or both of the following sources:

- retail issues of longer-dated 'capital markets' products such as bonds, debentures or medium term notes
- the wholesale markets (for example through securitisation).

These types of funding models are not well suited to the conventional types of prudential regulation that apply to deposit takers (for example rules around liquidity and capital). As a result, the benefits that come from bringing these firms within the inner perimeter are unlikely to outweigh the costs.

Firms that rely on longer-dated 'capital markets' funding do not generate the same systemic risk or moral hazard concerns as firms that take deposits. Longer-dated funding does not have the same vulnerability to runs as liquidity products such as deposits. Investors also more clearly understand they are taking on risk with products like bonds than with deposits.

The same is true of wholesale funded firms, such as NDLIs. Wholesale funded firms tend not to hold capital in the same manner as retail deposit takers, and are subject to relatively strong market discipline. Wholesale funded firms primarily generate risks to financial stability through their interconnection to firms within the regulatory perimeter, or through their contribution to more systemic concerns, such as excessive credit growth. As a general rule, these risks be managed without the need for capital and liquidity requirements (for example, risks related to

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41 See article 4(1) of the EU's Capital Requirements Regulation 2013.

42 See European Banking Authority (2014).

43 For example, in the UK, Article 5 of the Financial Services and Markets Act (Regulated Activities) Order 2001 defines the term 'deposit' relatively broadly and then excludes various types of instruments, such as debentures or bonds, and qualifying issues of commercial paper.

interconnectedness can be managed through rules applies to licensed deposit takers, such as restrictions on the provision of 'warehouse' funding).

Under the framework noted above, retail issuers of longer-dated debt securities would not sit within the inner perimeter for prudential regulation. Instead, these issuers would be subject to conduct regulation under the FMC Act regime, and oversight from a FMS. This appears appropriate, given the primary focus for the regulation of these issuers would be fair, efficient and transparent markets, rather than financial stability. Recent reforms to the conduct regulatory regime (including the licensing of FMS have also reinforced the role of FMS as 'frontline supervisors' for certain types of issuance, including debt securities.

To sharpen the distinction between licensed deposit takers and other issuers of debt securities, some jurisdictions have also introduced warning statements and restrictions on use of words such as 'deposit'.[44]

Should the regime allow for different rules between types of firms?

Two criteria from the Treasury's 'attributes and indicators of best practice' regulation support a differential approach for smaller and less complex entities:

- **Growth compatibility** – economic objectives are given appropriate weightings relative to other specified objectives, including factors contributing to higher living standards.
- **Proportionality** – the burden of rules and their enforcement is proportional to the issues being addressed and the expected benefits of the regulation.

In the case of existing NBDTs and new deposit takers, there is a risk that the creation of a single licensed deposit-taker framework could mean the application of requirements designed for larger and more complex firms apply to these smaller firms. This could generate market distortions, as it may unduly penalise the competitive position of this group of smaller entities, without any strong prudential justification.

There are two broad approaches to address this risk:

- **A categorisation approach** – deposit takers are classified into tiers (or classes) according to their size or complexity, and a specific set of rules is applied to all deposit takers within each tier.
- **A specific standard approach** – all entities are subject to a standard rulebook, but exceptions apply to each relevant rules (for example liquidity or reporting requirements) for deposit takers meeting specific criteria.

While the first approach is relatively simple and transparent, the second permits finer adjustments of rules to the characteristics of deposit takers. It therefore appears preferable, as long as the design of prudential regulatory instruments provides sufficient flexibility, and the Reserve Bank is able to invest sufficient focus on the needs of smaller entities.

Under the current Conditions of Registration (CoR) model for making prudential rules, for example, the Reserve Bank already applies differential requirements in a number of areas. This could be

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[44] In Australia, see APRA's Banking Exemption No. 2 of 2018.

preserved under a shift to other rule-making models (such as Standards, discussed in Chapter 1 of Consultation Document 2B).

Part II: How should perimeter flexibility be maintained across the prudential regulatory system over time?

Stakeholders strongly supported the introduction of tools such as exemptions and designations, on the basis that they would enable the regulatory system to address new risks, provide flexibility for different business models, and adapt to new innovations such as FinTech. The tools proposed in Consultation Document 1 were relatively high level: exemptions, designations, and tools relating to the macro-prudential perimeter.

This consultation document seeks views on three specific proposals for supporting an adaptable and flexible perimeter:

- Enhanced perimeter monitoring
- A designation regime
- A distinct 'macro-prudential perimeter'.

This consultation document is not seeking views on exemption powers. The case to include these powers in a licensed deposit taking framework is very strong. The ability to grant exemptions would provide the Reserve Bank with the ability to address rigidities in the regulatory framework, and ensure that requirements can be tailored to either avoid unnecessary compliance or support innovation.

Enhanced perimeter monitoring

In New Zealand, as in many other jurisdictions, regulatory perimeter reviews are often undertaken in response to concerns about a particular activity or firm type. There is no formal process to ensure that reviews of financial stability risks include assessments of related regulatory gaps or the adequacy of the regulatory framework.

Any modification or change to the perimeter needs to be based on both good quality data, and robust Reserve Bank or CoFR analysis of emerging risks: are there areas where the design of the perimeter is either failing to address new risks, or hampering desirable activities?

The FSB (an international body that monitors and makes recommendations about the global financial system) recommends the establishment of a process that involves:

- a regular and specific focus on the adequacy of the regulatory perimeter, supported by assessments of financial stability risks
- the participation of all relevant agencies (not just those involved in financial stability analysis), thereby contributing to a coordinated policy response (FSB, 2016, p. 3).

To support this type of proactive oversight, an emerging practice internationally is to apply data or registration requirements to firms that sit outside the licensed deposit taking framework.[45] These requirements are designed to enable regulators to monitor and respond to any emerging risks or other trends relevant to stability and efficiency. Australia, for example, has recently introduced a 'Registered Financial Corporation' (RFC) framework.[46] If introduced in New Zealand this would create a set of entities that, while not licensed, would have to provide data to the Reserve Bank. In effect, these entities would form an 'outer perimeter'.[47]

More structured oversight would help ensure that risks were identified early. It would not, however, alter the mechanism for changing the perimeter itself.

A designation regime

To accommodate new developments in the financial sector (for example new areas of risk, or innovation) there is a case to provide for the Reserve Bank to extend the definition of a deposit-taking institution if required. The Reserve Bank could 'designate' an entity or a class of entities as deposit takers. Alternatively, the Reserve Bank could make a recommendation for a designation, subject to approval by the Minister. This would allow the regulatory regime to respond quickly and effectively to new developments.

From a policy perspective, there are two key challenges associated with using a designation power: there is a need to assess not only *when* there might be a case for using the power to address a perceived regulatory gap, but also *how* bringing the entity or class of entities into the licensing framework would achieve the desired policy outcome.

Designations are likely to be most effective when the rules that would be applied to the designated entity or class of entities are broadly similar to those of existing licensed entities. In considering NDLIs, for example, traditional models of deposit-taking regulation (for example the application of capital requirements) are likely to provide a challenging fit. This would support limiting a designation model to cases of regulatory arbitrage: where firms were operating models that were *in substance* taking deposits from the public, but had structured themselves *in form* to be outside the perimeter. This aligns with the focus of the designation power in the FMC Act.

The case for more substantive levels of intervention (such as those noted in Figure 4A) through designation powers is harder to make. In order to operate effectively, perimeter tools need a high threshold for activation, with clear processes to ensure accountability for decisions. Tools based on more subjective assessments (such as impacts on financial stability) can have a negative impact on certainty (for example by reducing investor confidence in particular funding models). This is an issue

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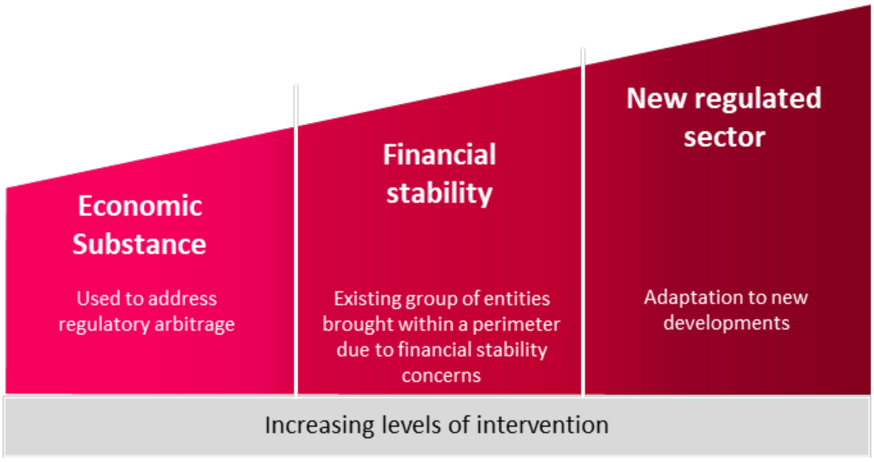
[45] The FSB notes that a key step towards managing emerging risks "is the establishment of system-wide monitoring arrangements that assess sources of systemic risks within and beyond the bounds of prudential regulation" (FSB, 2015, p. 3).

[46] Registered Financial Corporations (RFCs) lend money but are not ADIs prudentially regulated by APRA. Some RFCs must, however, register with and periodically report balance sheet data to APRA, with the frequency of reporting depending on scale. For example, RFCs above AU$400 million must submit every month and those with less than AU$50 million not at all. See the Financial Sector (Collection of Data) Act 2001.

[47] The Reserve Bank's monitoring capability could be enhanced with more formalised reporting and data collection requirements. The Reserve Bank Act provides the Reserve Bank with relatively broad data gathering powers. There are nonetheless practical barriers to the effective use of these powers in some areas, both in terms of definitions, and the identification of relevant entities.

of particular sensitivity in New Zealand: New Zealand has relatively thin capital markets, and our lack of diversity in funding options can itself be seen as a potential vulnerability.

Figure 4A: Optionality for a designation power



There are models that allow for the development of different rules that would apply to newly designated entities. The UK, for example, uses a model in which 'regulated activities' are listed in delegated legislation administered by the UK Treasury.[48] In order to address the challenge of applying rules to entities that are newly designated into the regulatory perimeter, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA)'s have broad discretion to make any rules that they consider advance their objectives, rather than these powers being limited in scope to defined matters such as capital. This rule-making discretion sits uneasily in New Zealand: in the New Zealand context, it is likely that effectively addressing the needs of a new sector would require changes to primary legislation, including potential amendments to existing rule-making powers.

If we accept that bringing an entirely new sector within the perimeter will require at least some degree of change to primary legislation, there is a strong argument for building a higher degree of future proofing into the primary legislation itself, rather than seeking to rely on designation powers. The FMC Act, for example, has a flexible licensing framework for 'market services' that can be tailored to accommodate a number of different activities.[49] This minimises the legislative change that is required for new market services to be added to the FMC Act regime. Financial advice has recently been added as a new market service, and a similar approach is being used to create a new regulatory regime for financial benchmarks.

A distinct 'macro-prudential perimeter'

Macro-prudential tools are currently applied through CoRs. As a result, they currently apply only to registered banks. These tools are not inherently connected to the inner perimeter for prudential regulation. Given their systemic focus and the nature of the tools themselves, there is no reason in principle why macro-prudential tools should not be applied on a more entity neutral basis. In many

48 See the Financial Services and Markets Act (Regulated Activities) Order 2001.

49 The licensing framework in the FMC Act is framed around the ability of an applicant to effectively perform the market service, and also allows for eligibility criteria to be prescribed in regulations.

other countries, macro-prudential tools are applied more broadly. Given this context, it would therefore seem desirable to establish both:

- a core 'inner perimeter' of entities subject to both prudential and macro-prudential regulation under the deposit-taking framework
- an 'outer perimeter' of entities that are subject to risk assessment (and potential data or registration requirements), with the ability to apply specific macro-prudential rules if needed.

This is of particular relevance to lending standards. One option would be to make certain lending standards applicable to all relevant lenders, even if they do not take deposits from the public. This could be desirable because lending restrictions have the potential to be undermined if NDLIs are willing to offer loans that have been restricted in other areas by macro-prudential rules (a phenomenon known as 'regulatory leakage'). A compromise may be to apply the restrictions to deposit takers only by default (as in recent changes in Australia) but retain the option to extend the application of these restrictions should it be justified.

Questions for consultation

4.A What is the appropriate definition of 'deposit taker'? Do you agree that the definition should be framed around entities that take retail 'deposits' and lend? If not, what approach do you consider would be preferable?

4.B Should the Reserve Bank's ability to monitor non-licensed entities be enhanced, for example through increased data reporting requirements? What do you consider would be the costs and benefits of such an approach?

4.C Should the Reserve Bank be given discretion to extend the perimeter within clearly specified parameters to avoid regulatory arbitrage (such as designating in entities with business models economically similar to deposit takers)? Do you agree that changes that are more significant may be more suited to legislative change, supported by pre-positioning?

4.D Should tools that are not linked to licensing have a different perimeter? For example, it is common internationally for non-bank lending institutions to be subject to macro-prudential lending tools, even though they do not take deposits.

Chapter 5: Should there be depositor protection in New Zealand?

Overview

New Zealand stands apart from the rest of the world in having no formal or permanent arrangements to protect depositors at failed deposit-taking institutions (called 'banks' in this chapter). [50]

If a bank fails, it may not be able to pay back the customers who have placed money with it (depositors). Currently, depositors in failed banks may get special support decided by the Government on a case-by-case basis, or be treated like other investors in the bank and lose some or all of their money.

This chapter follows up on the question asked in Chapter 4 of Consultation Document 1: should there be depositor protection in New Zealand?

The first section summarises the feedback from the consultation and outlines the Minister's response.

The second section looks into follow-up issues raised by the feedback. It includes an outline of:

- how a depositor protection scheme might fit into New Zealand's broader prudential framework
- what public policy objectives a New Zealand depositor protection scheme might have
- some high-level design options for a New Zealand depositor protection scheme.

Section 1: In-principle decision

Should there be depositor protection in New Zealand?

The Minister has made an in-principle decision to start developing a formal scheme to protect depositors in New Zealand in the event that the banks holding their deposits fail. The Minister has also made an in-principle decision that the scheme will protect eligible depositors' savings up to an insured limit, proposed to be in the range of $30,000-$50,000 per depositor. This decision was supported by the Reserve Bank and Treasury. The Independent Expert Advisory Panel, in contrast, asked for more information to assess the net benefits of depositor protection in the context of broader changes to New Zealand's prudential framework. This is provided in Section 2.

Implementing the Minister's in-principle decisions will require further work and public consultation. Among other things, a work programme to develop a protection scheme that is the best for New Zealand will need to consider options around:

- the public policy objectives that the protection scheme should advance

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50 This chapter uses the term 'bank' to refer to any deposit-taking institution. This is for simplicity, and reflects the Minister's in-principle decision to regulate the banking and non-bank depositor sectors under the same regulatory perimeter (see Chapter 4).

- how the protection scheme should function within the parameters of the Minister's in-principle decisions (the scheme's mandate, governance, coverage and scope, and pay-out procedures)
- how the protection scheme should be financed (the size of the scheme, who should fund the scheme, how that funding should be collected – for example, through up-front industry levies – and the need for supplementary public funding)
- whether there should be a 'depositor preference' for protected depositors' claims.

This consultation seeks initial feedback on some of these options. Final decisions on these options will be taken later in the Review process, when they can be considered in the context of decisions to be made on New Zealand's broader prudential framework.

Rationale for decision

A depositor protection scheme will protect New Zealanders from the risk of losing their savings in banks.

The Minister's in-principle decision to develop a scheme to protect depositors recognises the vital role of deposits in our financial system. Deposits are a major source of funding for New Zealand banks, deposit accounts are a critical economic service for bank customers, and depositors' confidence underpins the smooth functioning of the financial system. At the same time, banks do not hold enough liquid assets to redeem all deposits on the spot. This makes even solvent and viable banks susceptible to runs if depositors lose confidence in the safety of their deposits. The GFC showed that a loss of confidence in one bank can rapidly spread throughout the financial system through 'contagion' that causes instability and destroys financial and social capital.[51]

By protecting New Zealand depositors from the consequences of risks beyond their control and improving their personal resilience to financial shocks, depositor protection can contribute to public confidence in financial services and help to prevent contagion. Working with the rest of New Zealand's prudential framework, a depositor protection scheme should contribute to the stability of New Zealand's financial system and support greater wellbeing for New Zealanders.

Of course, New Zealand's prudential framework is changing, and not just because of the Reserve Bank Act Review. Decisions yet to be made on regulatory capital settings,[52] the supervisory approach, and bank resolution arrangements, could all affect expected outcomes for bank depositors and so affect the economic impact of a scheme designed to protect them. Many Review stakeholders told the Review Team that it was hard to assess the case for having a special scheme to protect depositors at this time, given the ongoing developments in other parts of the prudential framework.

Accordingly, the depositor protection scheme's connection with the wider prudential framework will be an important factor in work to come to design and calibrate a scheme that is the best for New Zealand. To help frame this next stage of work, Section 2 of this chapter explores:

- the way depositor protection would interact with other regulatory tools

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[51] Social and financial capital are two of the four capitals in New Zealand's Living Standards Framework. The other capitals are natural capital and human capital. The four capitals are the assets that generate wellbeing now and into the future, promoting higher living standards for New Zealanders. Looking after intergenerational wellbeing means maintaining, nourishing, and growing the capitals.

[52] Separate to the Review, the Reserve Bank is reviewing the capital adequacy framework for registered banks.

- the high-level economic implications of having a dedicated depositor protection scheme
- the objectives of depositor protection
- what all of this implies for options around scheme design and calibration.

Section 2 focuses on deposit insurance as the main mechanism to protect depositors.

Feedback from stakeholders

The Review process has shown that depositor protection is an important issue for New Zealanders, and that a significant majority of New Zealanders think that depositors in failing banks should be better protected. Of the 67 written submissions received from the consultation, around three-quarters (49) addressed it – and of those, more than 80 percent favoured strengthening protection for New Zealand depositors in some way.

- Of the 67 submissions, 32 were in favour of a formal depositor protection scheme.
- Nine preferred alternative ways to protect depositors, including stopping banks failing in the first place, or enhancing the special support for depositors decided by the Government on a bank-by-bank basis.
- Eight thought that bank depositors should not be treated differently from other bank investors.

Submitters in favour of a depositor protection scheme represented a broad cross-section of New Zealanders, including the general public, industry practitioners and experts, special interest groups, past governors of the Reserve Bank, and three of New Zealand's five largest banks.

Submitters who did not support a depositor protection scheme included NBDTs, non-financial corporates, and two of New Zealand's five largest banks. They either were opposed to special protections for depositors in-principle, or thought that – given the safety and soundness of New Zealand's banking sector – the benefits of developing formal procedures to protect depositors in a bank failure event did not justify the costs.

The preferred mechanism to protect depositors was an insurance system that guaranteed protected depositors would be repaid up to a pre-announced limit. While many stakeholders also supported an option to move depositors (and the insurance scheme that protects them) closer to the front of the queue to be repaid in a bank failure through a 'depositor preference', few submitters thought that a depositor preference would on its own be an effective tool to protect depositors. Some investors that the Review Team talked with were also concerned that a depositor preference might increase the cost and volatility of New Zealand banks' funding.

In addition to the first round of consultation, the Review ran a separate survey of 1,000 New Zealanders on the issue of depositor protection. This showed a limited understanding amongst survey participants of the status quo, with only a quarter aware that they stood to lose money in a bank failure. When the status quo and the various protection options were explained to survey participants, three-quarters supported introducing some form of depositor protection in New Zealand. Of those, two-thirds supported deposit insurance up to a guaranteed limit and one-third favoured a depositor preference. One in 10 survey participants wanted to keep the status quo.

Submitters agreed that the first round of consultation had identified the main costs and benefits of depositor protection, but there were different views on its objectives. The consultation process identified three possible objectives:

- to protect individual depositors with small balances from losing their savings
- to contribute to financial stability and public confidence in the financial system before and after a bank failure
- a combination of the two (a scheme with 'dual objectives').

Just over half of the submitters thought that a scheme to protect individual depositors would also contribute to public confidence and financial stability. On the flip-side, almost as many thought that protecting depositors would not contribute to financial stability, as it could encourage banks and depositors to take more risks. Those submitters generally thought a scheme focused on protecting depositors with small balances from losing their savings would be the best for New Zealand.

Section 2: Follow-up issues and questions for consultation

Part I: How does depositor protection fit into the prudential framework?

Part I positions depositor protection within New Zealand's broader prudential framework. This is information that was requested by the Minister, the Independent Expert Advisory Panel, and several submitters to the consultation.

The financial safety net and the potential role of depositor protection

The FSB identifies depositor protection as a key standard for sound financial systems,[53] one of five key elements that together make up a 'financial safety net' to protect society from the damage caused by bank failures and financial crises. The financial safety net works by influencing and constraining the behaviour of banks and their customers, to:

- keep banks safe and sound
- keep the financial connections between banks running smoothly and resiliently
- keep bank stress contained and orderly when something goes wrong.

As well as contributing to higher living standards for everyone, an effective financial safety net gives regulators credible options for managing bank risks and failures, and gives governments comfort that they do not need to intervene unnecessarily in regulators' work to deal with bank risks and failures.[54]

The financial safety net is shown in Figure 5A. It shows that every element of the safety net overlaps. Although depositor protection is most visible when bank risks crystallise and cause banks to fail – as an 'ambulance at the bottom of the cliff' – it also overlaps with elements of the safety net that are

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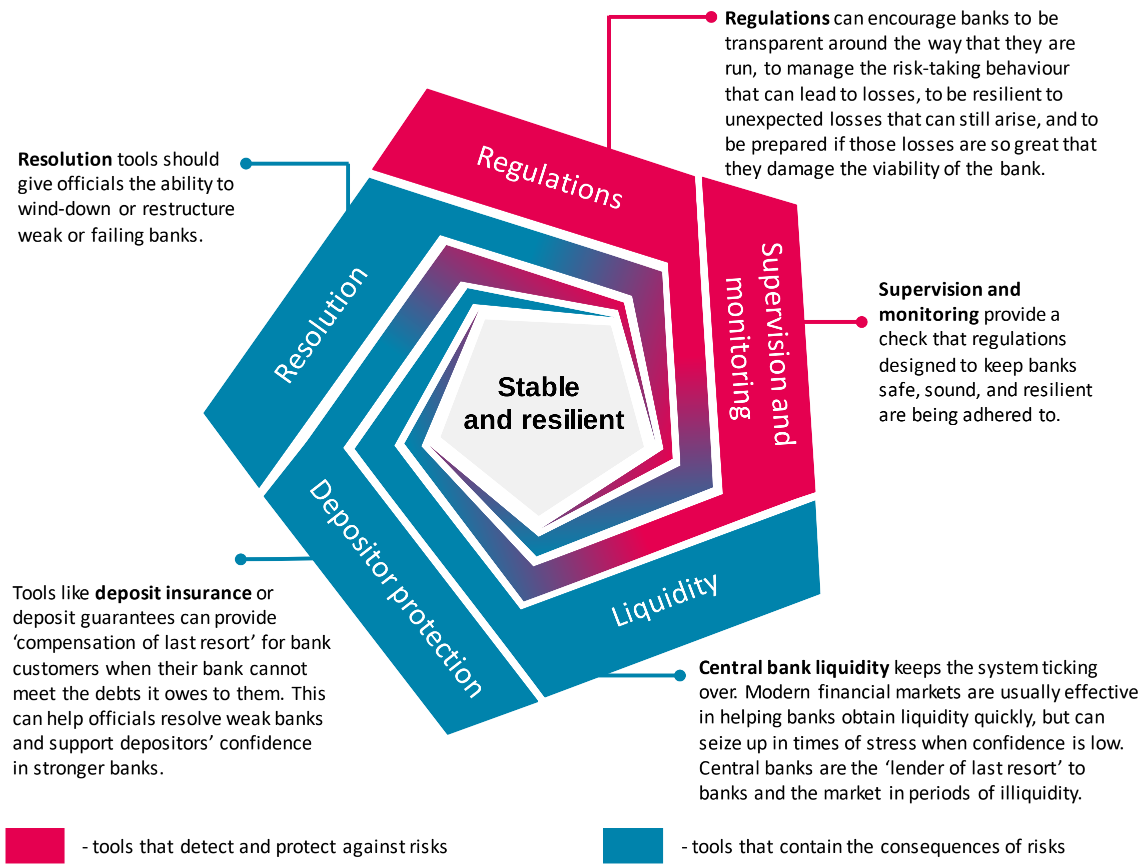
[53] The FSB Compendium of Standards lists the various economic and financial standards that are internationally accepted as important for a sound, stable, and well-functioning financial system. It includes Core Principles for Effective Deposit Insurance Systems.

[54] Chapter 5 of Consultation Document 2B discusses the New Zealand's bank resolution and crisis management regime in detail, including the role of government in bank resolutions.

designed to detect and protect against bank risks before they crystallise – the 'fence at the top of the cliff'. The way depositor protection overlaps with the other safety net elements is explored below.

Figure 5A: The financial safety net



1) Depositor protection can support bank resolution

Depositor protection is part of a wider 'crisis management framework' to deal with failing banks. As explained in Consultation Document 1, this framework comprises a depositor protection element (how depositors' financial interests in failing banks are treated) and a resolution element (how the Government and resolution officials deal with failing banks). Both elements closely interact. At a high level, depositor protection supports orderly resolution, because:

- **Depositor protection makes resolution that doesn't rely on public money more credible** – processes to wind up failing banks can be long and disruptive, even for the smallest banks. Depositors could be locked out of their accounts, making it difficult for them to pay rent, buy food, or make mortgage payments, at least while alternative payment channels are set up. Depositors could also face the prospect of losing all or part of their savings in the bank, and may have to wait years, possibly, to get their share of any eventual pay-out.

  Many submitters to the consultation doubted that governments would expose New Zealand depositors to this process. They questioned the credibility of New Zealand's existing resolution tools to impose losses on depositors in failing banks, and thought that governments would feel compelled to step in with public money to prevent depositors from shouldering losses. The IMF's 2016/17 FSAP agreed, stating in a technical note on contingency planning and crisis management that, without depositor protection, New Zealand did not have a "truly credible alternative to a bail-out" (IMF, 2017, paragraph 82). Having clear, robust, and permanent arrangements to protect depositors at failing banks from the threat of disruption and loss will help to address this credibility deficit. In particular, it will make viable the orderly resolution of small failing banks without the need for ad hoc government intervention.[55]

- **Depositor protection makes resolution more predictable** – without a formal depositor protection scheme, depositors and investors in New Zealand banks face uncertain risks. This uncertainty was reflected in the survey of 1,000 New Zealanders, with only some survey participants realising they stood to lose money if their banks failed. Others thought that their deposit would be protected from loss, or that their bank would be protected from failure.

  If depositors (and other bank stakeholders) cannot predict what will happen to them (and their banks) in a failure event, they may struggle to identify and price their risk exposures. This may lead them to mismanage those risks, or misallocate their resources. A depositor protection scheme will make resolution processes and outcomes more predictable for everyone, allowing risks to be made more transparent and better managed.

- **Deposit insurance makes resolution more flexible** – depositor protection can give officials flexibility and independence to deal with a troubled bank using the most appropriate approach for that bank. Without a stand-alone depositor protection scheme, supervision or resolution officials (in New Zealand, the Reserve Bank) may be constrained or directed by the Government to use a particular recovery or resolution approach to get an acceptable result for depositors.[56]

Box 5B explains how deposit insurance might work to help manage a bank failure event.

2) Depositor protection and effective resolution support emergency liquidity tools

- Most central banks, including the Reserve Bank, maintain an emergency liquidity facility that allows them to lend directly to banks at times when banks might be unwilling to lend to each other. By standing ready as a 'lender of last resort', central banks can relieve tensions in funding markets, and reduce the risks (and costs) of a sudden withdrawal in market funding.

  However, the promise of central bank liquidity support – even if it is offered at punitive rates – can discourage banks from managing their liquidity prudently and make the financial system more, not less, vulnerable to stress (BoE, 2016). It might also make supervisors more likely to forbear on an unviable bank, putting off difficult decisions that deal with the bank's distress in the hope that a private solution will be found. This so-called 'gamble for resurrection' can make an unviable bank's eventual failure worse for its creditors, including its depositors. The GFC also

[55] Deposit protection could directly facilitate the orderly resolution of a small failing bank by rapidly paying out the bank's protected depositors. This would be a 'closed bank resolution'. Depositor protection could also contribute to the stabilisation of a large failing bank. This would be an 'open bank resolution, whereby the protection scheme could be 'bailed in' to absorb losses and help recapitalise the failing bank without actually paying out its protected depositors.

[56] A bank bail-out or an ad hoc deposit guarantee might be considered necessary for dealing with a failing bank. Another tool might be the Reserve Bank's 'Open Bank Resolution' (OBR) policy, which is flexible enough to allow for a '*de minimis'* protection for small depositors at large banks that are pre-positioned for the OBR policy. OBR can do this by departing from the creditor hierarchy, on a case-by-case basis, where it is necessary for financial stability or public confidence. Although the *de minimis* protection is not defined, past work by the Reserve Bank and the Treasury has indicated that the *de minimis* could be in the range of $500 to $10,000.

showed that, if central bank emergency liquidity is actually tapped, this can be a flag to the wider public of banking system distress that triggers retail runs.[57]

It is now widely accepted that central bank liquidity is not a stand-alone tool to deal with banks or markets in distress; it must be supported by effective depositor protection and resolution regimes (BoE, 2016).

3) Depositor protection can strengthen or weaken bank monitoring and supervision tools

- **Depositor protection can blunt depositor discipline** – protecting depositors from the consequences of risks can reduce their, and their banks', incentives to monitor risks and behave prudently. This is 'moral hazard', and is explored further in Box 5C. Moral hazard can add to risks in the banking system and make it more vulnerable to shocks. To avoid this, it is widely accepted that depositor protection has to be supported by an effective prudential supervision regime.
- **Strong supervision that detects the risks that could cause banks to fail can reduce the call on depositor protection** – proactive supervision can identify emerging stress at a bank and trigger early recovery actions that address the causes of the bank's stress before it tips into failure. At the same time, intensive supervision can create moral hazard itself: bank managers and investors might take their eyes off risks because they are confident that supervisors will keep them safe. Chapter 3 of Consultation Document 2B discusses the Reserve Bank's approach to supervision.
- **Depositor protection sharpens market discipline** – although a depositor protection scheme can weaken the incentives of the people who benefit from protection to monitor bank risk-taking, it can also sharpen the monitoring incentives of the people who are explicitly excluded from protection. This is especially because depositor protection makes resolution that doesn't rely on public money more credible: large investors who do not qualify for protection (or are only partially protected) can expect to bear losses in a bank failure rather than being bailed-out by public money, giving them clear incentives to monitor bank risks. Sharper monitoring from large investors will, in turn, encourage bank managers and owners to behave prudently. A preference for protected depositors would further focus the incentives of non-protected creditors to monitor bank risks. Box 5A explains how a depositor preference might do this.

4) Depositor protection and regulations can contribute to a stable and resilient banking system

- **Depositor protection reduces the reliance on prudential regulations to prevent banks failing** – depositor protection and resolution tools exist to keep bank failures orderly and contained. If they are effective, they will play a role in preventing distress at a single bank from spreading throughout the system as a damaging banking crisis. Without depositor protection and effective resolution tools to manage bank failures, regulators may be put under pressure to calibrate very stringent prudential regulations to stop banks from failing in the first place.
- **Prudential regulations that help to prevent banks failing can reduce the call on depositor protection** – the Reserve Bank imposes some key prudential requirements on banks operating in New Zealand. To make them less vulnerable to financial failure, the Reserve Bank requires banks to maintain a minimum level, and quality, of capital relative to their risk-weighted assets ('capital requirements'), and sets rules relating to banks' funding and liquidity management arrangements

[57] Northern Rock and Banco Popular are examples of bank runs linked to the announcement of emergency liquidity support. They are explored further in Part III of this chapter.

('liquidity requirements').[58] At the same time, requirements relating to banks' non-financial resources and capabilities – culture, conduct, governance and public disclosures – can encourage banks to behave prudently.

These rules reduce the risk of banks failing in the first place, so can reduce the call on 'bottom of the cliff' tools such as depositor protection to keep bank failures orderly and contained.

Box 5A: The case for a depositor preference

Table 5A: Benefits and costs of a depositor preference

Benefits	Costs
▪ Increases market discipline. ▪ Reduces the risk of retail bank runs. ▪ Reduces losses imposed on depositors in a failure. ▪ Imposes losses on creditors with a better ability to manage risk than depositors. ▪ Reduces the required size of a deposit insurance scheme.	▪ May increase the cost of wholesale funding (reflecting a shift in risk). ▪ Creates an uneven playing field across firms with a different proportion of deposit and non-deposit funding. ▪ Increases the incentive of a wholesale run (mitigated by the Reserve Bank's liquidity policy).

Currently, depositors are 'general' bank creditors. This means depositors' claims aren't secured by any specific assets, nor treated differently from any other unsecured claim. If a bank fails, depositors' and wholesale (i.e. professional and institutional) investors' claims are pooled together and losses are shared proportionally among them.

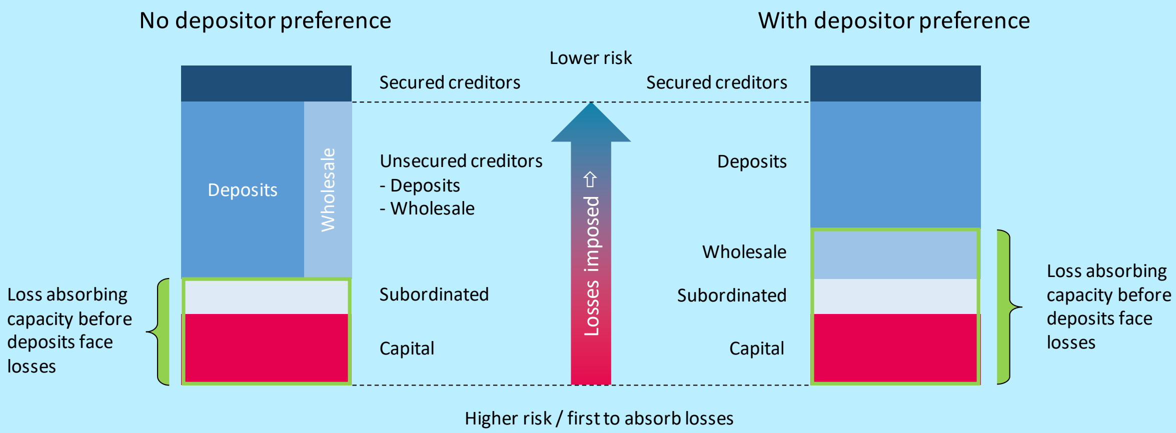
A preference would move depositors nearer to the front of the queue to be repaid in a bank failure, giving depositors a better chance of recovering their money (Figure 5B). A preference might seem redundant with deposit insurance. After all, depositors will be paid out promptly by the insurance scheme up to the insurance limit, whether or not they are 'preferred'. But a depositor preference *will* matter for the deposit insurer, who will become one of the largest creditors to the failed bank when it stands in the shoes of (assumes the claims of) the depositors it pays out. A preference for insured depositors will increase the insurance scheme's recoveries, and so reduce the financial burden it faces in the event of a payout. This means a preference might add credibility to an insurance scheme in the eyes of member banks and the public, and help the insurance scheme to support public confidence and financial stability in a stress event.

[58] For example, capital provides a cushion to absorb losses on loans and investments without triggering a failure event; stable 'core' funding reduces banks' portion of 'runnable' funding; and having a buffer of liquid assets can help banks to meet unexpected funding outflows, at least in the short term. The Reserve Bank's key prudential requirements are explained in more detail on the Reserve Bank website.

A depositor preference has significant distributional effects, however. The flipside of giving protected depositors a better chance of recovering their money from a failed bank is giving other creditors, like wholesale investors, a worse chance. This means the cost of banks' wholesale funding may increase. Wholesale creditors may also demand security in return for their funds, or lend for shorter terms, driving maturity and liquidity mismatches and making banks more vulnerable to disruptions in funding markets (although this could be managed to some extent by strengthening other parts of the safety net, like liquidity requirements and Reserve Bank liquidity facilities). The effects of this would be felt unevenly across New Zealand's banks, depending on the proportion of funding that they get from deposits (which tends to be higher at the smaller banks).

On net, any change in banks' average funding cost from a depositor preference would likely be marginal; and, to the extent that banks' funding costs increase, this would be 'market discipline' at work, indicative of sharper monitoring by non-preferred bank investors and a more efficient pricing and appropriate distribution of risks versus the status quo.[59]

Figure 5B: Stylised bank balance sheet with and without a depositor preference



Note: The balance sheets presented are a stylised representation of the banking system as a whole, and the relative sizes of the loss-absorbing capacity with and without a deposit preference would vary from bank to bank. It also demonstrates how capital acts to absorb losses, as it is the first line of defence.

Part II: The economic implications of depositor protection

Part II considers the potential economic consequences of protecting depositors. This is information that was requested by the Independent Expert Advisory Panel and several submitters to the consultation. A fuller cost-benefit analysis will follow in the next stage of work as more specific design features of New Zealand's depositor protection scheme are developed.

[59] The return an investor earns on their investment is the 'risk price'. Accurate risk pricing is a key part of the risk management process. Risk mispricing is believed to have caused a build-up of systemic risks that led to the GFC.

The economic benefit of depositor protection

The main benefit of a depositor protection scheme is that it gives the Government and resolution officials credible options to stop bank failures becoming disorderly bank crises.

At first glance, this may seem to overstate the benefits of protection. Certainly, the overlap between the safety net elements described in Part I of this section can make it seem that not every element of the net is needed, or that the additional benefits provided by each element are small: wouldn't stringent capital requirements that reduce the *risk* of bank failure be enough to protect depositors from the *cost* of bank failure without the need for a depositor protection scheme? To answer this question, it is worth remembering why the safety net exists in the first place: to protect society from the damage caused by bank failures.

The OECD says that if a country's safety net is incomplete, it will likely find it difficult to access effective solutions for dealing with serious problems in its banking system (Schich, 2008a and 2008b; Singh and LaBrosse, 2012). This is because risks and uncertainty are inherent in the banking sector: banks are subject to multiple sources of risk, and experience shows they fail for a variety of reasons. No single safety net mechanism can keep the banking system resilient to shocks, and relying too heavily on any one mechanism can be ineffective and costly to the real economy (White, 2010). Returning to the example of capital, even with stringent requirements banks can still fail.[60] Moreover, building 'balance sheet fortresses' on high capital requirements might help to make individual banks more sound (other things being equal), but might also lead to a lack of innovation and challenge in the banking sector, especially without effective depositor protection and resolution tools in the safety net to allow banks to safely exit the market (Bernet and Walter, 2009).

In an effective and efficient prudential framework, the five elements of the safety net must each be strong in its own right, and work well together. In line with this, most jurisdictions have strengthened every safety net element since the GFC, with stronger regulatory requirements (particularly around capital, liquidity, and governance) and more intensive supervision at the 'top of the cliff', complemented by special bank resolution regimes and stronger depositor protections to deal with banks that may still fall to the bottom.

The OECD (2013) and IMF (2017) have both warned that, without depositor protection, New Zealand is particularly vulnerable to contagious bank runs that can escalate into banking crises that destroy social and financial capital. The financial costs alone could be profound and long-lasting: experience overseas suggests that in a bank crisis GDP might fall 20 percent below trend, and the Government debt-to-GDP ratio might increase by 30 percentage points for a decade (Aikman *et al*, 2018).

Working together with the rest of the safety net, depositor protection will help to shield New Zealand from these costs.

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[60] Separate to the RBNZ Act Review, the Reserve Bank is reviewing the capital adequacy framework for registered banks, and has proposed increasing banks' capital requirements. The Reserve Bank estimates that, under its proposals, a large bank might still fail every 200 years. However, there are four large banks in New Zealand and lots of smaller deposit takers, each of which might fail every 40 years (based on modelling by the BoE). There is inherent uncertainty in these estimates, and the banking system in even 10 years' time is unlikely to look like the system today, particularly as financial technology develops and alternative service providers gain a hold.

The economic costs of depositor protection

A depositor protection scheme will come with upfront costs of establishing a deposit insurer and ongoing operational costs.

Modern deposit insurance schemes are normally funded by levies on member banks, supported by a temporary funding backstop from the Government. Banking sector levies build the insurance scheme to a 'target size' that is proportional to the expected exposure of the scheme. Extraordinary levies are also used following a pay-out to rebuild the scheme back to target and repay the Government for any temporary funding. With low probabilities of bank failure (thanks to other safety net elements such as strong regulations) and access to government liquidity, the target fund size for a New Zealand insurance scheme is likely to be far smaller than the value of the deposits that the scheme insures. This also reflects that it is not expected that all banks will fail at once, and there are certain 'systemic' banks which would be resolved in a way that made the banks' assets immediately available to depositors (unlike a lengthy liquidation process), reducing the burden on the insurance fund. (Bank resolution options are discussed in box 5B below and Chapter 5 of Consultation Document 2B).

Looking at countries with banking systems and per capita GDP similar to New Zealand, a target size for a domestic insurance scheme of 2 percent of insured deposits would be large. At a per-depositor insurance limit of $30,000-$50,000, this implies an insurance fund of around $2-3 billion (Table 5B).[61] The Review Team estimates this could be built up over a decade through a levy of 5 percent of the banking sector's annual profits, or a premium of 20 basis points on banks' insured deposits. As discussed in Box 5A, a depositor preference might also increase funding costs for New Zealand's banks as risks are shifted away from depositors onto wholesale investors; the Review Team estimates that bank bond yields could be 10-30 basis points higher than current levels.[62]

Any increase in banks' funding or operating costs under a depositor protection regime might be passed on to bank customers through higher mortgage rates or lower term deposit rates, or might result in a lower supply of credit to the real economy. This could adversely affect investment and economic activity in New Zealand. Alternatively, the costs of pre-funding a deposit insurance scheme might be partly absorbed by banks' own margins and retained earnings. The extent to which costs are distributed between banks (as lower profits) and their customers (as higher borrowing rates) depends on competition and contestability in the banking sector.

Table 5B: Indicative deposit fund target sizes and costs

Insurance limit (per depositor)	Value of insured deposits	Target size (2% of insured deposits)	Share of one year's profits	Time to reach target (5% annual levy)
$10k	$58 billion	$1.2 billion	15%	3 years
$50k	$135 billion	$2.7 billion	34%	7 years
$100k	$174 billion	$3.5 billion	44%	9 years

In summary, a New Zealand depositor protection scheme is likely to come at a material cost to member banks (and their customers), particularly during the build-up stage post-establishment or if

[61] The insurance limits considered in Table 5B are based on currently-available data. In the next stage of work, more data will need to be gathered to more accurately assess the coverage and costs of a scheme with an insured limit in the range of $30,000-$50,000.

[62] Based on New Zealand subordinated debt and European senior non-preferred debt premiums.

the scheme is drawn on. It may also have implications for supervisory intensity and costs. However, the international consensus is that this is an appropriate redistribution of the costs of bank failure that will ultimately reduce the burden on taxpayers.

Box 5B: The role of deposit insurance in managing a bank failure

1. The point of failure

A small failing bank might be placed into insolvency. If so:

- An insurance scheme might rapidly pay out insured depositors from its available resources, up to the insured limit. This would result in a pay-out of between $0.4 -1.1 billion for a small bank, and less for an NBDT (Table 5C).
- Alternatively, the insurance scheme might support a private-sector solution for the failing bank, by funding the transfer of its insured deposits to a healthy bank. Rather than paying insured depositors directly, the insurance scheme would pay to the healthy bank the value of the deposits transferred to it: in other words, cash assets to match transferred deposits. Depositors would face no disruption in their access to banking services. These kind of resolution transactions are discussed in Chapter 5 of Consultation Document 2B.
- Without insurance, depositors' accounts and all the money in them would be frozen.

A large failing bank might be put into 'Open Bank Resolution' (OBR).[63] If so:

- When deposits are partially unfrozen the day after the bank's entry into OBR, the insurance scheme compensates (or 'tops up') depositors for the portion of their deposits that remain frozen, up to the insured limit.
- This means the insurance pay-out is far less than the value of the bank's insured deposits. For one of the four largest banks, we estimate an insurance pay-out of $3.8-11.5 billion. To fund this, the scheme may have to borrow $2.7-8.1 billion from the Government (Table 5C).
- Without deposit insurance, there is little legal or procedural clarity about how any particular creditor will be treated. Depositors may get access to an unfrozen portion of their money (say 70 percent), and smaller accounts may also get an unspecified upfront *de minimis* payment, which other creditors would pay for. All other money would be frozen.

Table 5C: Estimated insurance scheme pay-outs under different resolution options

Insurance limit	Small bank (insolvency)		Large bank (OBR)	
(per depositor)	Upfront pay-out	Borrowing	Upfront pay-out	Borrowing
$10k	$0.4 billion	Nil	$3.8 billion	$2.7 billion
$50k	$0.8 billion	Nil	$8.9 billion	$6.2 billion
$100k	$1.1 billion	Nil	$11.5 billion	$8.1 billion

[63] OBR is a Reserve Bank policy for keeping failing banks open while a longer-term resolution is found. Currently 10 banks are pre-positioned for OBR. OBR has never been used, and the 2016/17 FSAP (IMF, 2017) said that more work was needed to make OBR credible. Many submitters from the consultation also doubted if OBR could be credibly implemented under current settings.

2. Restructuring and wind-down

The failed bank now enters a lengthy wind-down or restructuring period. Based on past experience, this might take a year for a small bank, or five years or more for a large bank. An insurance scheme would take the place of insured depositors in this process, joining the queue of creditors to recover from the failed bank what it paid out (although people who had deposits above the insured limit would have to join the queue for that extra portion).

Given the liability structures and expected asset losses at New Zealand banks, as 'general creditors' depositors and the insurance scheme that protects them might recover 70-95 percent . As 'preferred creditors', depositors' recoveries might rise to 90-100 percent. Alternatively, the deposit insurance scheme could be used to finance compensation to the creditors of a liquidated institution (known as the 'rump') after resolution.

Any shortfall between the insurance scheme's pay-outs and recoveries, plus interest on the scheme's borrowings from the Government (assumed at 5 percent), would be recouped through extraordinary levies on the banking sector. In the Review Team's simple model, we estimate that extraordinary levies would be applied only after the completion of the resolution, and be charged at 10 percent of (unchanged) annual sector profits. Following a small bank failure, the scheme would be expected to return to its steady state rapidly, within a year of the failure. In the case of a Big 4 bank, the scheme might return to target within one to three years of the bank exiting OBR – or six to eight years after entering it (Table 5D).

Table 5D: Estimated time to recover deposit fund to target size

Insurance limit (per depositor)	Small bank (Insolvency)			Big 4 bank (OBR)		
	Net fund value (post recoveries and interest)	Shortfall to target	Years of extra levy charges	Net fund value (post recoveries and interest)	Shortfall to target	Years of extra levy charges
$10k	$1.1 billion	$0.1bn	<1 year	$0.5 billion	$0.7bn	1 year
$50k	$2.5 billion	$0.2bn	<1 year	$1.1 billion	$1.6bn	2 years
$100k	$3.2 billion	$0.3bn	<1 year	$1.5 billion	$2.0bn	3 years

Without deposit insurance, apart from funds received under OBR, individual depositors would have to try to recover their money as general creditors to a potentially lengthy and complex insolvency or statutory management process.[64] While they might recover 70-95 percent of their original deposits at the end of that process, they would have no certainty over final outcomes nor access to their deposits during it.

The economic implications of the status quo

While the analysis above compares depositor protection against 'no protection', this may not be an accurate reflection of the status quo. This is because experience in New Zealand and abroad suggests that, without an explicit depositor protection scheme, the gap in the safety net is filled by the

[64] Statutory management is one of several legal mechanisms available in New Zealand to deal with a failing bank.

promise or expectation of taxpayer support in a bank failure. This is known as 'implicit insurance', and is a pervasive feature of jurisdictions where explicit deposit insurance does not exist.

Having 'no protection' has repeatedly proven an impossible position to sustain in periods of economic and financial stress, when governments have been reluctant to let depositors in failed banks lose their money in banks, or their access to critical banking services. The Argentinian Government in the early 1990s tried to implement a clear and unambiguous commitment to not protect bank depositors, but was forced to abandon its approach in 1995 in the face of the shock to Argentina caused by a financial crisis in Mexico (the Tequila Crisis). More recently, in the GFC, governments around the world faced extreme pressure to put in place ad hoc arrangements to protect depositors from financial harm and to support confidence in the banking system. In New Zealand – singled out by the IMF in 2006 as the clearest example of a country that had tried to make an unambiguous commitment to offering neither explicit nor implicit deposit insurance (Hoelscher *et al*, 2006) – the Government was forced in 2008 to establish the emergency Crown Retail Deposit Guarantee Scheme (CDGS) to "stem the threat of depositors running from New Zealand banks and triggering widespread market disruption and economic instability" (Controller and Auditor-General, 2011, p. 5). The CDGS initially provided a coverage limit of $1 million per account holder per institution, later reduced to $250,000, and then in 2011 removed entirely.

Implicit insurance can be costly. It can be a 'contingent liability' on the Crown balance sheet that leaves taxpayers exposed to opaque and uncertain costs that are difficult to manage in normal times, and are likely to crystallise in stressed times - when taxpayers may be poorly placed to bear them. Other things being equal, the Government must keep central debt at a lower level in case it has to pay out on an implicit deposit guarantee. Expectations of implicit insurance will also distort private icentives to behave prudently, especially because experience shows that governments and officials will do more than promised – indeed, whatever it takes – to avoid a financial crisis (King, 2007).

A credible deposit protection scheme will clearly define the outer limit of the safety net, and cap expectations around who and how much is safe. Compared with implicit insurance, an explicit protection scheme can allow the costs of protecting depositors to be made more transparent and better managed, potentially lowering costs in the long term.

Part III: What public policy objectives should depositor protection promote?

This Part III considers the objectives of depositor protection in New Zealand. The objectives chosen for New Zealand's depositor protection regime will lay the foundation for the next stage of work and form the basis for the scheme's design. Within the parameters of the Minister's preferred protection range of $30,000-$50,000, there are important choices to be made here: a targeted objective to protect depositors with small balances from loss, for example, might require a narrower coverage and lower limit than would be necessary to advance a financial stability objective.

Option 1: Dual objectives

At an international level, the FSB recommends depositor protection to "maintain financial stability by protecting depositors and preventing bank runs" (FSB, 2012, p.6), and the International Association of Deposit Insurers (IADI) says depositor protection should "protect depositors and contribute to financial stability" (IADI, 2014, p. 18).

This best-practice guidance has been widely adopted internationally: modern depositor protection schemes generally have dual objectives linked to protecting individual depositors from loss, as well as contributing to the stability of the financial system by enhancing depositors' confidence in the banking system and/or mitigating depositors' incentives to join bank runs. Some even argue that an effective scheme "must primarily be directed at the improvement in system stability; depositor protection is a means to an end in this" (Bernet and Walter, 2009, p. 23). Depositor wellbeing, public confidence, and financial stability are widely recognised as being inherently intertwined.

Option 2: A sole objective

In contrast, some submitters from the first consultation did not think that a depositor protection scheme in New Zealand could support depositor confidence or mitigate the risk of bank runs without extraordinarily high protection levels, at which point the costs and moral hazards created by the scheme would be more likely to undermine, not support, financial stability. These submitters thought it was best for a depositor protection scheme to pursue consumer protection (or, equivalently, to prevent depositor hardship) as its sole focus.

This position – that depositor protection may not be effective in mitigating bank runs and should not seek to do so – is understandable, given the destructive run on the UK's Northern Rock in 2007, [65] the runs on various US banks during the GFC (for example, IndyMac, Wachovia, Washington Mutual), and the large-scale run on Spain's Banco Popular in 2017. All countries had deposit insurance systems in place when depositors ran.

Assessing the options – what deposit protection can and cannot do

Depositor protection clearly cannot *prevent* bank runs, stop banks failing, or guarantee public confidence in the banking system. But that does not mean depositor protection has no role to play in financial stability. Depositors are more likely to run if they are uncertain about possible (if unlikely) outcomes such as bank failures. Because a depositor protection scheme makes outcomes for depositors at failed banks more predictable, as discussed in Part I of this chapter, it should go some way to *reducing* depositors' incentives to join runs on distressed banks. In so doing, depositor protection will protect against the cost and damage of a wider loss of confidence that triggers a contagious run on otherwise healthy banks.[66]

There is a large body of evidence – both empirical and anecdotal – that deposit insurance can mitigate the risk of contagious bank runs and contribute to financial stability:

- Insurance has been shown to increase depositors' willingness to stay with distressed banks, helping to prevent inefficient and disorderly failures (Martin *et al*, 2018; Anginer *et al*, 2014).
- New Zealand's Crown Retail Deposit Guarantee Scheme "overall achieved its goal. No banks in New Zealand failed, and there was no run on banks. The economy was stabilised", and "investor confidence was maintained or improved during the term of the Scheme" (Controller and Auditor-General, 2011, pp. 5 and 12).

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[65] Not only was confidence lost in Northern Rock itself, but concern rapidly spread to other domestic and international banks and threatened to destabilise the whole system. The run was only arrested and confidence in the wider system restored when the UK Government promised a blanket guarantee of all deposits in Northern Rock.

[66] Creditors (including depositors) not fully covered by a deposit protection scheme will still have incentives to run from distressed banks. When they do, other safety net tools, such as liquidity support and resolution, should be available to help wind down the bank.

- No jurisdictions repealed their depositor protection regimes in response to lessons learned from the crisis,[67] even those that experienced bank runs; on the contrary, a growing international consensus has emerged around the value of stronger depositor protection (IADI, 2014).
- Evidence from the UK, Spain and Hong Kong shows that insured depositors have stayed put during bank stress events even where uninsured depositors and creditors withdrew from distressed banks, helping to prevent a wider loss of confidence in the banking sector.[68]

This suggests that New Zealand's depositor protection scheme, working with the rest of the safety net, may be able to advance dual objectives of protecting depositors from loss as well as contributing to a stable financial system. To do so will require good design, though, explored in Part IV below.

Box 5C: The moral hazard problem – how big is it really?

Moral hazard will be a cost of implementing formal depositor protection to the extent that: a) depositors currently monitor bank behaviour; and b) any reduction in monitoring by protected depositors is not offset by sharper monitoring by investors excluded from protection. In the debate about depositor protection, people who place a lot of weight on moral hazard costs implicitly assume that banking sector risks are better monitored and managed without it. In practice, whether private monitoring is effective in the absence of depositor protection is unclear, and the impact of depositor protection on bank risk-taking is hard to distinguish from the other elements of the safety net. There is as much evidence that depositor protection has favourable effects on banking systems as there is that it destabilises them.

Research in the 1980s showed that deposit insurance could maintain depositors' confidence in the safeness of their deposits and reduce the incidence of bank runs (Diamond and Dybvig, 1983). But cross-country studies in the following few decades found a positive relationship between the probability of bank crises and insurance, which could both discourage depositors from searching for the best bank for their savings, and encourage bankers to get more value from insurance by taking on more risks (Demirgüç-Kunt and Detragiache, 1999; Demirgüç-Kunt and Huizinga, 2004; Allen *et al*, 2011; Calomiris and Jaremski, 2016a). All of this strongly suggested that deposit insurance could dampen depositor discipline, cause excessive risk-taking, and financial instability.

However, the implied flip-side – that without insurance depositors will discipline banks and the system will be safer – is not supported in the data (Gropp and Vesala, 2004; Hoelscher *et al*, 2006; Anginer *et al*, 2014; Anginer and Demirgüç-Kunt, 2018). Studies linking insurance to banking crises are highly sensitive to the countries and crises selected (Hoelscher *et al*, 2006). When looking at advanced economies like New Zealand with strong institutional environments, the effect of insurance on crisis probability is weak.[69] Insurance schemes in the

[67] In New Zealand, the temporary Deposit Guarantee Scheme lapsed in 2011. The scheme was never intended to be permanent.

[68] The runs on Northern Rock and Banco Popular were both driven by the still-intact incentives of uninsured or partially insured depositors to run. Low limits and partial coverage – specifically intended to mitigate moral hazard – were a key design feature of the UK's insurance scheme in 2007 that left most depositors exposed to some risk of loss. Banco Popular suffered an outflow of uninsured local authority accounts, before being tipped rapidly into resolution and resolved within a day, without distress spreading more widely.

[69] This demonstrates how all of the safety net elements need to be strong and work together. In countries without strong regulation and supervision, focusing on the 'deposit protection' element of the safety net has undermined financial stability, not contributed to it.

US, Japan, Australia, the EU, Denmark and elsewhere have reduced bank risk-taking and enhanced monitoring by owners and bond holders (Karels and McClatchey, 1999; Imai, 2006; Martin *et al*, 2018). Where banks have high capital – like in New Zealand – the results of this are reinforced (Iyer *et al*, 2016).

In New Zealand, fewer than 10 per cent of retail depositors regularly consider the safety of their bank according to our survey of 1,000 New Zealanders. Bank switching rates amongst retail depositors are low, indicating customers are not actively seeking out banks that match their risk appetite. And there are limited channels for depositors to exert (and banks to feel) discipline. Reflecting this, many submitters from the consultation doubted the current value of depositor discipline, and saw little risk of moral hazard from a depositor protection scheme.

That said, past government interventions to support depositors *did* give rise to moral hazard and risky behaviour. Extending the Crown Retail Deposit Guarantee Scheme to unregulated and unsupervised finance companies in the GFC, for example, triggered a flow of deposits from banks to finance companies as guaranteed funding for their risky investment activities (Controller and Auditor-General, 2011). But the chance of this happening under a formal depositor protection scheme can be mitigated by good scheme design, such as charging member institutions risk-based premiums (Anginer *et al*, 2014). It is also addressed by the Minister's in-principle decision to develop a single regime for all authorised deposit takers: this means that any institution holding insured deposits would be expected to come under officials' scrutiny.

Finally, while moral hazard is often linked particularly with deposit insurance, it is a feature of all of the elements of the financial safety net. By interfering with the normal process of market discipline, any part of the net can make future crises more, not less, likely. This means that each element needs to be designed carefully and considered in-the-round, with the stability gained balanced against the moral hazards created across the whole net.

Part IV: Calibrating a depositor protection scheme

To be an effective component of New Zealand's financial safety net, the depositor protection scheme will need to be carefully designed. Choices around the scheme's mandate, governance, scope, pay-out processes, and funding mechanisms will all affect how well it can protect depositors and contribute to financial stability. Part IV considers in detail one aspect of the scheme's design – what might be the appropriate coverage level within the preferred protection range of $30,000-$50,000.[70]

The international approach

As noted above, depositor protection schemes around the world tend to have dual objectives of protecting depositors, and of contributing to public confidence and financial stability. International experience suggests that coverage may need to be significant for an insurance scheme to contribute meaningfully to financial stability, though. The deposit protection 'rule of thumb' is to set the coverage limit at a level that fully protects the vast majority of individual retail depositors (to

[70] The Minister has made an in-principle decision for the insurance limit to be in the range of $30,000-$50,000 per depositor. Amongst other design choices, more work will be required to determine the specific limit that is the best for New Zealand. This will include collecting a more granular breakdown of deposit account data.

mitigate bank run risks), while leaving a substantial portion of banks' deposit funds exposed to loss (to preserve market-based channels to discipline bank risk-taking).

Figure 5C illustrates the portion of New Zealand deposits would be covered at different levels of insurance, and the average approach to insurance coverage internationally. Figure 5C shows that an insurance limit of $50,000 would fully protect about 90 percent of individual deposit accounts in New Zealand, while leaving 60 percent of deposit funds exposed to loss. This coverage is broadly consistent with modern international averages – especially keeping in mind that the share of depositors that would be fully covered is likely to be higher in practice, as depositors split their accounts to take advantage of the protections. In comparison, a limit of $10,000 would fully protect 80 percent of deposit accounts while leaving about 80 percent of deposit funds exposed to loss. This would be significantly lower than modern international averages, and would ignore important lessons learned from the GFC: that "a too low coverage level leads to the complete ineffectiveness of deposit insurance" (Bernet and Walter, 2009, p.26), and that "covering the vast majority of depositors strengthens the role of deposit insurance systems in the safety net" (IADI, 2013, p.15).[71]

Figure 5C: Percentage of deposits covered at different coverage levels

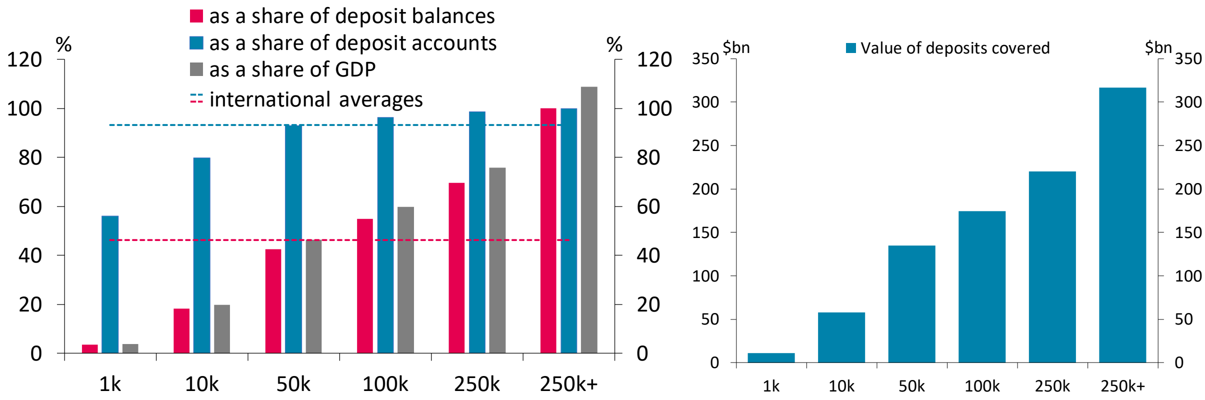
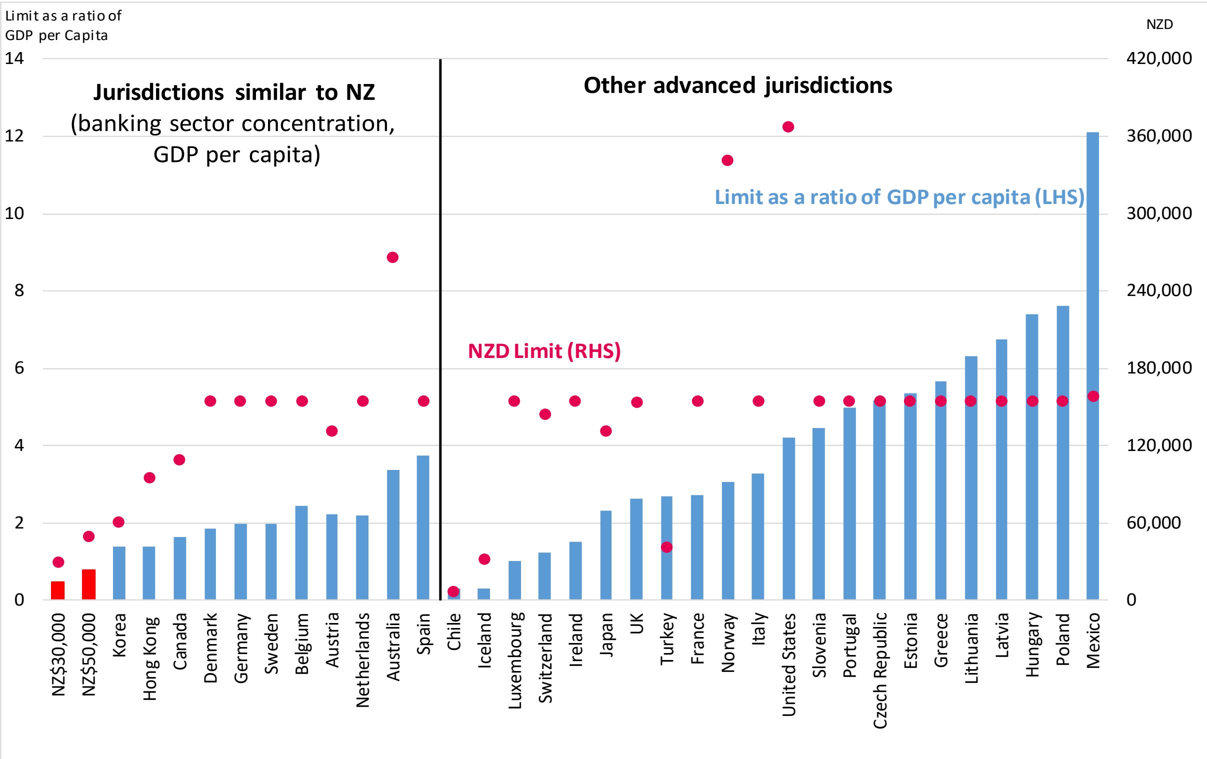


Figure 5D compares insurance limits across OECD jurisdictions. It shows coverage limits as a nominal dollar amount, and as a ratio to GDP per capita (a measure commonly used by the IMF to compare the adequacy of deposit insurance schemes across jurisdictions). It suggests that a protection limit for New Zealand of $30,000-$50,000 would not be out of line with international practice – albeit at the lower end of advanced economies with similarly concentrated banking sectors.

[71] Pre-GFC deposit protection coverage limits were set lower than modern coverage limits. In Germany, the UK, Switzerland, and Canada, pre-GFC coverage limits were less than half of their current levels. Pre-GFC schemes tended to be seen as devices for avoiding panic-based bank runs and protecting the most vulnerable depositors, and did not consider the impact that a single bank's distress might have on system-wide contagion and public confidence in highly interconnected modern banking systems. Since the GFC, depositor protection regimes have been made stronger as part of a broad package of regulatory reforms to increase the resilience of the financial system and economy to future shocks. A pre-crisis rule of thumb that the insurance schemes should fully cover 80 percent of depositors to be effective has been debunked. Modern schemes seek to cover more than 90 percent of depositors.

Figure 5D: Comparing deposit insurance limits in advanced jurisdictions



Balancing the depositor protection trade-offs

Transposing the Minister's in-principle decisions into practice will be a complex process that will have to be consistent with the scheme's chosen public policy objectives. It will also have to weigh up costs and benefits that are difficult to isolate and measure, and that change depending on market conditions, other safety net settings, and the design of the insurance scheme itself.

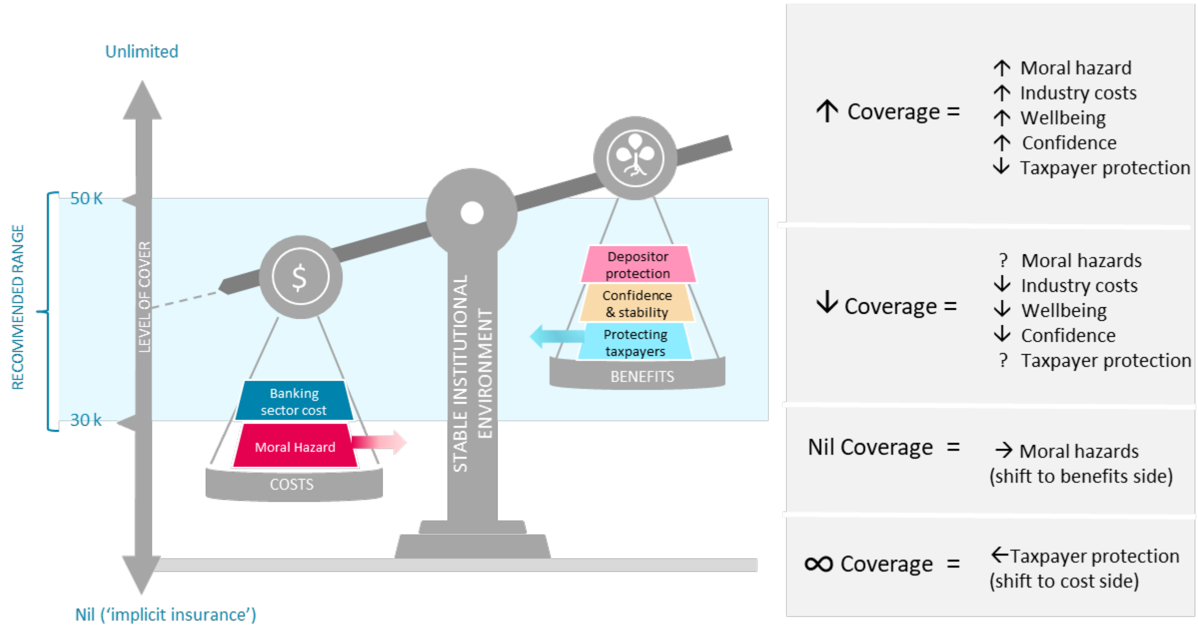
The possible objectives, benefits, and costs of a depositor protection scheme are shown in Figure 5E (below).

In choosing the right coverage level for New Zealand, decision-makers will have to weigh up:

- **banking sector costs** – deposit insurance scheme are typically funded from levies on member banks, backed up by temporary funding from the Government if a pay-out cannot be met from the scheme's available resources. The potential cost of the scheme to levy payers would increase broadly in line with the increase in coverage limit
- **protecting depositors from loss** – an insurance scheme protects depositors from loss and contributes to the living standards and wellbeing of New Zealanders by preventing a temporary decline in household savings and wealth in a bank failure. This benefit increases with coverage
- **contributing to public confidence and financial stability** – by protecting individual depositors from risks beyond their control, an insurance scheme can promote public trust in financial services and reduce depositors' incentives to join destabilising bank runs
- **moral hazard –** deposit insurance works by reducing depositors' incentives to monitor and respond to risks, so moral hazard is generally considered a cost of an insurance scheme. Box 5C considers the moral hazard problem in more detail

- **protecting taxpayers** – protecting taxpayers is generally a benefit of an insurance scheme because deposit insurance can give officials credible options to wind-up failing banks in an orderly way without the need for government intervention. However, if pay-outs need to be topped-up by temporary loans from the Government, the size of this benefit would fall.

Figure 5E: Trade-offs when calibrating a deposit protection scheme



Confidence and moral hazard effects work through the same channel - by altering depositors' incentives to respond to bank risks. This means that they rise and fall together as the insurance limit changes. Complicating the picture, though, are costs and benefits that vary with time. For example, moral hazard costs might be an important consideration for decision-makers during normal times, leading them towards lower insurance limits, while confidence benefits are likely to be the dominant factor in a crisis, forcing them towards higher limits. A well-designed insurance scheme needs to be able to withstand fluctuations like these, and the protection promised in normal times should not be changed during a crisis.

Varying the insurance coverage level will also affect the costs and benefits of insurance, as explained below:

- **Higher coverage** – higher coverage may add to confidence and wellbeing, but may also:
  - increase moral hazard (the more complete the coverage and the fewer creditors there are exposed to risk, the more likely will incentives to monitor bank risk-taking break down)
  - increase industry levies (see Table 5B)
  - draw on the taxpayer-funded backstop in the event of a pay-out (see Tables 5C, 5D).
- **Unlimited (or excessively high) coverage** – as coverage approaches 'unlimited' levels, the moral hazard problem becomes acute and the public cost of paying out insured depositors of a failed bank – the call on the taxpayer-funded back-stop – will probably exceed the cost of bailing out the bank. This means 'taxpayer protection' would become a cost of a deposit insurance scheme.

- **Lower coverage** – lower coverage may reduce moral hazard and industry costs, but will do less to support confidence or depositors' wellbeing. If the protection level is so low that it is not credible (i.e. people expect government support in a crisis over and above the stated protections), this feeds back as upward pressure on moral hazard and taxpayer costs. The risks of undershooting on insurance coverage levels were demonstrated in the GFC.[72]
- **No coverage –** if there is no coverage, government intervention becomes the only option if a bank fails to protect depositors' wellbeing and support public confidence. This is an implicit guarantee that cannot be priced in advance, but crystallises in a crisis at great risk to taxpayers – when history has shown that governments will do whatever it takes to restore stability in the banking system. An implicit guarantee also encourages risk-seeking behaviour in normal times. A pre-planned insurance scheme can be designed to keep intact market-based incentives to monitor and manage risks where an implicit guarantee cannot, so under these conditions moral hazard shifts to being a 'benefit' of an insurance scheme.

All of this indicates that very low or high coverage levels are not desirable, and the extremes of no or unlimited coverage may not be sustainable. This reflects modern international practice, as shown in Figure 5D. Most advanced countries have insurance (their scale has shifted up from 'nil') while countries that had high or blanket coverage during the GFC have since reduced it (their scale has shifted from 'unlimited').

At the same time, the range of limits in place across the OECD shows there is no 'ideal' coverage limit. Calibrating New Zealand's scheme within the parameters of the Minister's in-principle decisions will be a balancing act, and only one of a number of design features that need to be considered in building a scheme that is the best for New Zealand. This will follow in the next phase of work.

[72] Pre-GFC deposit insurance schemes tended to favour burden-sharing and low limits to try to mitigate moral hazard. These schemes failed to protect confidence or remove incentives to join bank runs when the crisis came, forcing governments to issue widespread or, in some cases, blanket guarantees, which realised the moral hazards that low coverage limits were designed to mitigate.

Questions for consultation

5.A Are the interactions between depositor protection and the other parts of the financial safety net set out in Part I of Section 2 described appropriately?

5.B What objectives should the depositor protection regime in New Zealand have? Should its objectives be:

- to protect depositors from loss?
- to contribute to public confidence and financial stability?
- both of these?
- something else?

5.C The Minister has made an in-principle decision that the depositor protection regime should have a limit in the range of $30,000-$50,000. Given your answer to 5.B, what coverage level would be best within this range?

5.D How would your preferred limit affect depositor wellbeing, public confidence, and depositors' responsibilities for their financial choices?

5.E Do you think the New Zealand depositor protection regime should be supported by a preference for insured depositors? How would this affect the costs and benefits of a depositor protection regime in New Zealand?

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