TE TAI ŌHANGA
THE TREASURY

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Safeguarding the future of our financial system

Executive Summary: The Reserve Bank's role in financial policy: tools, powers, and approach

Consultation Document 2B

Phase 2 of the Reserve Bank Act Review

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Executive summary

This consultation document seeks your views on the Reserve Bank of New Zealand's (the 'Reserve Bank') role in overseeing New Zealand's financial sector. It covers a wide range of potential legislative (and non-legislative) reforms that could help safeguard New Zealand's financial system. They include potential changes to the Reserve Bank's tools, powers, and approach to prudential regulation, macro-prudential policy, supervision and enforcement, crisis management, policy coordination, and resourcing.

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

Your views are welcome on all these important topics.
The deadline for submissions is 5pm on **16 August 2019**.

Context

In November 2017 the Government announced a substantial review of the Reserve Bank of New Zealand Act 1989 (the 'Reserve Bank Act'), with the aim of modernising the Reserve Bank's monetary and financial policy frameworks and its governance arrangements. The Review is one of the Government's initiatives to "grow and share New Zealand's prosperity more fairly" by supporting the development of a productive, sustainable, and inclusive economy.

Phase 1 of the Review (which is now complete) focused on improving the Reserve Bank's monetary policy framework. Key changes included introducing a new Monetary Policy Committee (MPC) responsible for monetary policy decisions, and giving the MPC a dual mandate to focus on delivering price stability and supporting maximum sustainable employment. These changes became law on 20 December 2018 and were implemented in the first half of 2019.

Phase 2 of the Review (which is the subject of this consultation document) focuses on the Reserve Bank's role in financial policy and how the Reserve Bank should be governed. The terms of reference for Phase 2 are broad and comprehensive, so the consultation has been split into three rounds. The first round took place between November 2018 and January 2019 and focused on five topics that were important in determining the direction of financial regulatory reform (see Consultation Document 1). The Minister of Finance made some in-principle decisions on these topics in April 2019 and they are summarised in Consultation Document 2A, which is being released in the second round of consultation alongside this document.

This document focuses on the remaining Phase 2 topics, which are summarised below.

1. What prudential regulatory tools and powers should the Reserve Bank have?

'Prudential regulation' is the set of rules and requirements that apply to New Zealand's banks.

Prudential regulation in New Zealand occurs through both primary legislation, which is agreed by Parliament and set out in the Reserve Bank Act, and delegated rule-making powers. Delegated powers include:

- Conditions of registration (CoRs), which define the majority of the prudential rules that registered banks must adhere to in order to operate in New Zealand

- Orders in Council (OiCs), which set out certain information that both registered banks and certain individuals must disclose to the market.

These foundations establish the high-level legislative framework while granting the Reserve Bank significant flexibility and discretion to set detailed rules and keep them up to date.

The scope of delegated rule-making powers could nonetheless be clarified. The Reserve Bank has used CoRs in ways that were not directly contemplated at the time the Reserve Bank Act was passed (such as macro-prudential policy).

There are also three potential issues with the rule-making model for the banking sector:

- **Legitimacy –** CoRs are used to set rules that have application to all banks, or classes of banks. The accountability mechanisms associated with CoRs did not anticipate them becoming such a significant policymaking tool. For example, changes to prudential rules are not subject to parliamentary oversight.
- **Transparency** – elements of the regulatory system can be difficult to navigate. Detailed policies are found in the Banking Supervision Handbook, which does not feature in the Reserve Bank Act. There is no centralised register of CoRs, and the Banking Supervision Handbook can at times be difficult to navigate.
- **Proportionality** – breaches of both the prudential rules and disclosure rules (which can be technical in nature) create criminal liability. Under the disclosure rules there are also currently no materiality thresholds. Enforcement tools can be seen as disproportionate with the nature of the conduct they seek to address.

Chapter 1 sets out a number of potential options for dealing with these issues.

- Enhancing the clarity and safeguards included in the high-level legislative framework, for example in relation to objectives and the scope of delegated rule-making.
- Reframing the core prudential rule-making instrument, noting three broad models are possible:
    - **Enhanced status quo** – continue with the current legislative framework for CoRs, while making improvements to the broader framework for rule-making (for example in relation to scope and process requirements) as well as operational changes.
    - **Standards** – in addition to the changes envisioned in an enhanced status quo, this model would increase the legitimacy of rule-making by replacing CoRs with an instrument (Standards) that was subject to parliamentary oversight, and potential disallowance.
    - **Regulations** – shifting from CoRs to a system of Regulations would improve legitimacy by giving the government the power to approve significant regulatory rule changes. Such a model would nonetheless reduce the Reserve Bank's regulatory independence and could introduce political risk to the rule-making process.
- Increasing process rights for administrative decisions.
- Adjusting the liability model from criminal to civil, alongside changes to breach reporting.

2. What role should the Reserve Bank have in macro-prudential policy?

Macro-prudential policy is an approach to prudential regulation that emphasises the risks to the financial system as a whole, rather than focusing solely on the stability of individual institutions.

Since the global financial crisis (GFC), most countries have added a macro-prudential overlay to their approach to prudential regulation, and many have used new tools – such as loan-to-value ratio (LVR) restrictions and capital buffers – to help prevent the build-up of systemic financial risks. Macro-prudential regulators have the difficult and often unpopular job of restricting the flow of lending to the economy, when a boom starts to threaten financial stability. Some macro-prudential tools can generate significant 'distributional' consequences that raise questions about whether central banks like the Reserve Bank should have sole authority to use them. Overseas, ministers and agencies outside the central banks also often have roles in macro-prudential decision-making.

Chapter 2 seeks your views on which macro-prudential tools the Reserve Bank should have, and whether special governance arrangements should apply when using these tools. Options for reform include:

- **macro-prudential tools** – the Reserve Bank could be restricted to using only capital and liquidity-related tools,[1] keep the right to also use LVRs, or it could be granted new powers to use other tools (such as debt-to-income [DTI] restrictions)
- **governance** – the Reserve Bank could keep its sole authority to use macro-prudential tools or it could be required to consult or seek approval from the Minister or other agencies (such as the Treasury or the Financial Markets Authority [FMA]) before making decisions.

3. How should the Reserve Bank supervise and enforce prudential regulation?

Supervision and enforcement are key components of the prudential regulatory framework. Effective supervision increases the likelihood that regulatory requirements will be met and emerging risks will be identified. Effective enforcement helps to deter or punish improper behaviour by sanctioning those who violate regulatory requirements.

The Reserve Bank's approach to supervision can be broadly characterised as 'light touch', relying on public disclosure and director attestations to ensure that regulatory standards are being met. In contrast, regulators overseas have tended to shift towards a more intrusive, sceptical, and active model of supervision since the GFC that relies more on independent verification.

Chapter 3 seeks your views on whether the Reserve Bank's existing supervisory powers and approach are appropriate or whether one of the following options is preferable:

- **Enhanced status quo** – the Reserve Bank maintains its existing supervisory approach, which involves desk-based monitoring, thematic reviews, and involvement in the Australian Prudential Regulation Authority's (APRA's) on-site visits to the four large Australian banks. However, the

[1] Examples of such tools include the counter-cyclical capital buffer (an additional capital requirement that is applied to banks when excess private sector credit growth is judged to be leading to a build-up of system-wide risk), sectoral capital requirements (an additional capital requirement that may be applied to a specific sector or segment in which excessive private sector credit growth is judged to be leading to a build-up of system-wide risk), and cyclically varying the core funding ratio (a minimum requirement for banks that specifies the proportion of a bank's lending that must be funded from stable sources to reduce vulnerability to disruptions in funding markets).

Reserve Bank increases the intensity of its approach by applying more supervisory resources to undertake off-site monitoring, particularly of larger banks.

- **Spot-check inspections** – the Reserve Bank is given a new legislative power to go 'on-site' to independently verify individual banks' compliance with prudential requirements, or to assess any emerging issues. It would do this on a targeted and discretionary basis, focusing on concerns raised through desk-based monitoring of individual banks.
- **Regular on-site inspections** – the Reserve Bank is given significantly more supervisory resources and the legislative power to go on-site, conducting regular inspections of all banks. This is broadly the model used by APRA, the United Kingdom's Prudential Regulation Authority (PRA) and Canada's Office of the Superintendent of Financial Institutions (OSFI). There is additional optionality around the Reserve Bank's interaction with APRA, and any on-site inspection regime for the Australian-owned banks.
- **Continuous monitoring** – the Reserve Bank locates supervisors permanently in banks so that they can undertake regular and very detailed inspections. Currently used in the United States for the largest financial institutions, this is the most intrusive and resource-intensive approach.

In terms of enforcement, the Reserve Bank already has a number of supervisory and court-based enforcement tools for prompting firms to take corrective action. However, these tools may not be enough to allow the Reserve Bank to respond to non-compliance appropriately – it currently relies on supervisory measures such as moral suasion to encourage change, and has yet to take court-based action against bank directors, which carries heavy criminal penalties.

Additional enforcement tools that could strengthen the Reserve Bank's enforcement role include:

- **statutory public notices** – public warnings supported by legislation
- **enforceable undertakings** – commitments from banks that are enforceable in court
- **infringement notices** – criminal offences that carry fines but do not result in criminal convictions
- **civil penalties** – non-criminal penalties that are applied under the civil standard of proof.

Chapter 3 weighs up the pros and cons of these tools and asks for your views on whether the Reserve Bank should be given legislative power to use them.

Chapter 3 also considers strengthening the Reserve Bank's operational independence for its supervision function by removing the Minister's role in issuing directions and bank deregistration.

4. How should the Reserve Bank's balance sheet function be formulated?

Since the GFC, many central banks have used their balance sheets to provide emergency lending to banks facing liquidity shortfalls (that is, being 'lenders of last resort') and to conduct quantitative easing to stimulate economic growth (implementing monetary policy).[2] These balance sheet tools are designed to support monetary and financial stability.

[2] Quantitative easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to increase the money supply and encourage lending and investment.

Chapter 4 discusses whether the Reserve Bank Act provides a sufficiently clear and appropriate legislative basis for the Reserve Bank to use its balance sheet for these purposes, or whether its role needs to be clarified. For example:

- **Lender of last resort** – the Reserve Bank can already lend to banks and other financial institutions to provide emergency liquidity assistance. However, the Reserve Bank Act could be clarified to state the conditions under which such lending can take place. For example:
  - amendments could clarify that the Reserve Bank has full discretion to lend to solvent financial firms, as long as the lending decision has a clear purpose, is temporary and is made independently of those responsible for supervising the firm (to avoid a conflict of interest)
  - the Reserve Bank could be allowed to lend to insolvent financial firms as part of a package of measures to restore them to viability. (These lending decisions would require Ministerial approval given the potential risk to public funds.)

- **Monetary policy implementation** – the MPC formulates monetary policy, which the Reserve Bank then implements. Normally it does this by managing the amount of liquidity in the financial system to keep actual interest rates consistent with the Official Cash Rate (OCR). However, in a severe downturn the MPC may need to use unconventional monetary policy tools (such as purchasing government bonds) to stimulate demand in the economy.

  These unconventional tools can create risks to the Reserve Bank's balance sheet and to public funds (which the Minister of Finance oversees). This raises questions of whether the MPC should have autonomy to decide on using such measures, or whether it should be required to first consult both the Reserve Bank Board (i.e. the proposed governance board outlined in Document 2A) and the Minister of Finance. One way to establish a clearer division of roles would be to include additional detail in the MPC's remit.

Your views are invited on whether the above clarifications would be worthwhile.

5. What features should New Zealand's bank crisis management regime have?

During the GFC many countries had to use public funds to bail out failing banks, to prevent them causing financial hardship for their customers and threatening the stability of the financial system and the wider economy. This was because those countries lacked credible alternative tools to resolve systemically important banks smoothly.

Since the GFC, countries have undertaken deep and wide-ranging regulatory reforms to ensure that failing banks can be wound up in an orderly way without relying on taxpayer support.

The Reserve Bank Act already has systems that are recognised internationally as important for effective resolution. However, as has been noted by the International Monetary Fund (IMF) and other stakeholders, New Zealand's crisis management regime falls short of best practice in some areas. Chapter 5 outlines reforms that could be used to enhance New Zealand's crisis management regime. These include:

- clearly designating the Reserve Bank as New Zealand's resolution authority, responsible for resolving failing banks

- specifying a clear set of resolution objectives to guide the Reserve Bank's decisions on how best to resolve a failing bank and ensure it can be held to account for its decisions
- clarifying instances when the Reserve Bank needs to consult or seek approval from the Minister to use a resolution power, such as when public funds might be at risk
- ensuring that the Reserve Bank has broad enough powers to resolve a failing bank without severe systemic disruption or exposing taxpayers to loss, such as a power to 'bail in' unsecured debt to recapitalise a bank
- establishing clear protections for creditor property rights, which could include creditors receiving compensation if a resolution decision makes them worse off than they would have been in liquidation
- ensuring that funding options are available to facilitate resolution, so that resolution authorities do not have to rely on public ownership, bailouts, or government guarantees to resolve failed banks.

All of these reforms could potentially be implemented in New Zealand to bring the existing crisis management framework into line with international best practice and provide more options in resolution decisions. Chapter 5 summarises the pros and cons of these reforms and seeks feedback on which are worth pursuing.

6. How should the Reserve Bank coordinate with other government agencies?

The Reserve Bank is one of many agencies responsible for overseeing New Zealand's financial sector and broader economy. The Treasury, the Ministry of Business, Innovation and Employment (MBIE), the FMA, the Commerce Commission and various other government agencies have distinct roles that intersect with those of the Reserve Bank. With so many agencies involved, it has become increasingly important to coordinate policy to avoid regulatory overlaps and gaps.

This need to coordinate with other agencies reflects the fact that:

- the global regulatory landscape has become more complex, which has increased the importance of regulatory horizon scanning
- declines in global interest rates have made it more challenging to manage the business cycle highlighted the need to coordinate financial and monetary policy, and
- the rise of globalisation, including cross-border banking, has increased the need for cooperation with other jurisdictions and to speak with one voice when doing so.

Chapter 6 discusses whether New Zealand's existing coordination arrangements are sufficient to deal with these coordination challenges, or whether legislative reform is required. Potential reforms could include:

- encouraging more coordination via a letter of expectations from the Minister, or adding formal coordination objectives and requirements to the Reserve Bank Act
- enabling Reserve Bank staff to share more information by harmonising legislative provisions across financial sector legislation

- allocating additional resources for coordination by either increasing funding for individual agencies or creating a separate funding mechanism for an existing coordination body, such as the Council of Financial Regulators (CoFR)
- taking a more proactive approach to financial system stewardship, either by formally establishing CoFR in legislation or revisiting the division of financial sector roles across government.

7. How should the Reserve Bank be funded and resourced?

The way the Reserve Bank receives its funding has a key influence on how and whether it can achieve its statutory objectives. A well designed funding mechanism combines a significant amount of budgetary independence with accountability checks that ensure that the public is getting good value for money.

The Reserve Bank's funding is currently set out in a five-year agreement between the Minister of Finance and the Reserve Bank Governor. The agreement aims to achieve a balance between budgetary independence and value for money based on the incentives of the two parties, but it has been criticised for lacking transparency and delivering what is widely seen as insufficient funding for the Reserve Bank to achieve its statutory objectives.

Chapter 7 discusses the pros and cons of options to reform the existing funding mechanism:

- **Transparency requirements** – the Reserve Bank could be required to release more details about how it spends its funding, and could be subject to checks by the Controller and Auditor-General to ensure that it spends public funds appropriately.
- **The role of the Minister** - this could change from the current 'agreement' model to either:
    - a softer requirement to 'consult' with the Minister, which would give the Reserve Bank more independence to determine its own funding level (as is the case at the Reserve Bank of Australia), or
    - an 'approval' power that would give the Minister a greater role (as is the case for government departments).
- **The source of funding** – the Reserve Bank currently receives its funding from a combination of self-generated revenue (through its balance sheet operations) and fees for providing certain services (such as registering banks). An alternative funding model could see some of the Reserve Bank's functions (such as prudential supervision) funded by a financial industry levy. While this would make the funding model more complex, it would mean that the financial firms that benefit from the Reserve Bank's supervisory service also pay for it.

Chapter 7 does not consider the level of funding, which will be considered at a later stage.

Your views are invited on all these reform options and the best balance between budgetary independence and value for money.