TE TAI ŌHANGA
THE TREASURY

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Safeguarding the future of our financial system

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

Consultation Document 2B

Phase 2 of the Reserve Bank Act Review

June 2019

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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 (i.e. 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
- 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.

Questions for consultation

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

1.A Do you agree that the broader Reserve Bank Act model strikes an appropriate balance between primary legislation and delegated powers? If not, why not?

1.B Are there any areas of the Reserve Bank Act where changes to the model are required, such as the introduction of greater safeguards?

1.C Does the chapter appropriately identify the key issues with the current framework for setting prudential rules? If not, what is missing?

1.D What are your views regarding the potential options proposed for setting the core prudential instrument? Are there any other changes to the rule-making framework that should be considered?

1.E What do you see as the costs and benefits of introducing enhanced process rights for administrative decisions? If you consider there is a case to introduce these rights, how should they be framed?

1.F Is there a case to change the breach reporting and liability models that apply to regulated entities in the Reserve Bank Act? If so, what models would be preferable?

1.G Is there a need to increase executive accountability?

1.H If so, which of these models would be most effective in doing so, and why?

Chapter 2: What role should the Reserve Bank play in macro-prudential policy?

2.A Does the Reserve Bank's framework document (Ovenden, 2019) present its expected macro-prudential strategy in enough detail to allow monitors to ensure the Reserve Bank is following the strategy and predict future macro-prudential actions?

2.B What are your views on the conduct of macro-prudential policy in the past five years? It may be useful to read the recently released framework document (Lu, 2019) and the sub-questions below:

- Are there any lessons to be learned from New Zealand's experience with loan-to-value ratios (LVRs) to date?
- Do you think LVR policies that have greater impacts on certain buyers (e.g. investors) or regions than on others are appropriate?
- Has the Reserve Bank's 'speed limit' approach reduced risks without affecting too severely buyers who may need high LVR loans owing to special circumstances?
- Would a greater use of macro-prudential tools other than LVRs have been appropriate during the recent housing boom?

2.C Is it appropriate to regulate lending standards (e.g. LVRs)? How broad should these powers be (should they include other tools such as debt-to-income restrictions)?

- Should lending standards apply only to deposit takers or to all lenders?

- Should there be special governance arrangements for these tools?
- Should the Reserve Bank reconsider its view that these tools should only be applied temporarily?

2.D Other than lending standards, when the Reserve Bank makes time-varying use of standard prudential tools such as capital ratios, are there any concerns or reasons for wider political oversight?

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

3.A What do you think are the strengths and weaknesses of the Reserve Bank's current approach to supervision and enforcement?

3.B Do you think that the Reserve Bank's planned approach to the supervision and management of climate change-related risks is appropriate and adequate? Do you think that the Reserve Bank's approach to climate change would be different if it was given a more explicit climate change objective, as considered in question 2B of Consultation Document 2A?

3.C In what areas do you think the Reserve Bank could improve its approach to supervision and enforcement? How could this be best achieved (e.g. through legislative change, resourcing, relationships with regulated entities)?

3.D Do you think the Reserve Bank should take a more intensive approach to verifying supervisory information? If so, which verification model do you favour?

3.E What are the appropriate enforcement tools for the Reserve Bank? Which tools in particular should be added to the toolkit?

3.F Is the Minister's role in issuing directions and deregistration appropriate?

Chapter 4: How should the Reserve Bank's balance sheet functions be formulated?

4.A Should more detailed principles for the Reserve Bank's LoLR function be set out in legislation? Do the principles and governance considerations in Chapter 4 seem appropriate? Would you add others?

4.B If the Reserve Bank were to launch an asset purchase programme (quantitative easing), do you believe it should be able to make its own decisions to purchase government debt, but require ministerial consent to purchase other assets? Are there other implementation issues around asset purchase programmes that should be considered?

4.C How much power should the Minister have in determining the scope and objectives of the Reserve Bank's foreign exchange interventions? Should the current arrangements – which will give some decision-making power to the Minister, the MPC and the new Reserve Bank governance board – be broadly retained, or should the Reserve Bank's autonomy be increased?

4.D Do you have any other comments on the balance sheet functions described in Chapter 4?

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

5.A What are the most important objectives for New Zealand's resolution authority? Should they be ranked in order of importance? Would the objectives suggested above strike the right balance between providing guidance and accountability for the Reserve Bank and flexibility for the Reserve Bank to deal effectively with a crisis?

5.B Is the proposed resolution authority function for the Reserve Bank specified appropriately? Do you see any alternatives to the Reserve Bank as resolution authority??

5.C Should the current requirements for ministerial consent be replaced with an ability for the Minister to direct the Reserve Bank when public funds could be at risk? Are there additional circumstances in which the Minister should be able to direct the Reserve Bank on a resolution if public funds are not at risk?

5.D Should the Reserve Bank, as the resolution authority, have resolution powers (instead of only statutory managers having these powers)?

5.E In principle, should the Reserve Bank have the power to 'bail in' specified categories of unsecured liabilities (with details of eligible liabilities to be determined and subject to creditor property rights safeguards – see below) in order to recapitalise a failing large bank after its owners have absorbed maximum losses, and to minimise the need for taxpayer support? Alternatively (or in addition), should the recapitalisation of a failing large bank be funded through industry-wide levies?

5.F Do you agree with the proposal to allow continuous disclosure-to-market requirements to be suspended temporarily, subject to conditions and safeguards? Are the suggested conditions and safeguards appropriate, or should there be others?

5.G Should the resolution authority always be required to respect property rights (including the hierarchy of creditors in liquidation)? Or should it have discretion to override property rights as long as compensation is made available to creditors left worse off than they would have been in a liquidation? Or should no change be made to the protection of creditor property rights?

5.H Should an industry-funded resolution fund be established (alongside any deposit insurance scheme fund)?

5.I Do any other aspects of cross-border resolution need to be considered in the design of New Zealand's crisis management framework?

Chapter 6: How should the Reserve Bank coordinate with other agencies?

6.A What do you see as the main pros and cons of the existing coordination arrangements, and why?

6.B What would you change about current arrangements, and why?

6.C Which, if any, of the options above for enhancing support for status quo coordination arrangements do you consider would be desirable, and why?

6.D Do you think that a high-level coordination objective would be an appropriate way to ensure that the Reserve Bank is coordinating with non-financial sector agencies (for example on climate change)?

6.E Which is your preferred option for the structure of CoFR and why?

6.F Do you agree with the analysis of the pros and cons of the different options?

6.G Are there any other specific coordination mechanisms, bodies, or transparency requirements that the Review should consider?

Chapter 7: How should the Reserve Bank be funded and resourced?

7.A Do you agree with the potential issues identified in the current funding model? Are there any additional issues with the current funding model?

7.B How should the Reserve Bank report its funding and spending? Do you have any comments on the transparency of, or accountability for, the Reserve Bank's funding and spending, including the possible channels to strengthen arrangements?

7.C Given the in-principle decisions to change the Reserve Bank's governance framework as outlined in Consultation Document 2A, what role should the Minister have in the Reserve Bank's funding model? Should it be different for prudential and non-prudential functions?

7.D Should the Reserve Bank continue to be fully funded from revenue (seigniorage and investment income) and fees, or should other funding sources be considered? In particular, should the Reserve Bank have the option to introduce an industry levy to fund the Reserve Bank's prudential supervisory function?

7.E Do you have any comments on the illustrative options in Figure 7C and Table 7B? Are there other options, combinations, or additional design features that should be considered?

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 MPC is based within 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 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 will make 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.[3] The Chair of the Independent Expert Advisory Panel is also a member of the Steering Committee.

The Capital Review and the Phase 2 Review of the Reserve Bank Act

In January 2019 the Reserve Bank issued a consultation document which proposed increasing bank capital requirements to ensure banks can withstand financial and economic shocks. Consultation on the Reserve Bank's 'review of the capital adequacy framework for registered banks' closed on 17 May and the Reserve Bank has indicated that final decisions will be made later in the year.

Some stakeholders have asked whether the review of bank capital is part of Phase 2 of the Review of the Reserve Bank Act and how decisions in this area might affect the areas under the Phase 2 Review's terms of reference. The answer is that each review is distinct.

Phase 2 is mainly focused on the Reserve Bank's legislative framework, which defines the Reserve Bank's role in regulating the financial sector. Phase 2 is a once-in-a-generation review that explores

[3] The Independent Expert 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.

whether the Reserve Bank's existing financial policy objectives, functions, tools, powers, and governance arrangements are appropriate, or whether changes are required to safeguard New Zealand's financial system for the future.

By contrast, the review of bank capital is an example of the Reserve Bank exercising one of its existing powers under the current legislation. In its day-to-day role as New Zealand's prudential regulator, the Reserve Bank has full autonomy to adjust prudential requirements, including bank capital standards. The Reserve Bank changes regulatory requirements in the context of *current* legislative settings so as to meet its existing statutory objectives of ensuring New Zealand's financial sector is 'sound and efficient'. Adjustments to capital requirements and other prudential settings have occurred multiple times under the Reserve Bank's existing legislation, which spans a period of around 30 years. During the Phase 2 Review period, the Reserve Bank continues to operate in the context of its current legislation and continues to develop its prudential policies.

Given the framework hierarchy, legislative settings (being addressed in Phase 2 of the Reserve Bank Act Review) could impact the Reserve Bank's assessment of optimal tool calibration. Conversely, decisions the Reserve Bank may make on bank capital requirements are unlikely to have material consequences on the recommendations arising from Phase 2 of the Reserve Bank Act Review.

Phase 2 is focused on the fundamental parameters of the regulatory and supervisory framework, within which the Reserve Bank will calibrate future regulatory requirements. For example, Phase 2 is considering whether changes to the structural components of New Zealand's financial safety net are required, including to the bank crisis management framework. The design of New Zealand bank crisis management framework should not hinge on any given level of regulatory bank capital requirements, which have been calibrated based on the existing legislative framework and could be subject to change.

Where do you fit in?

Phase 2 will include three rounds of public consultation, in which you and other stakeholders are invited to take part (see Figure A). The first round of consultation, released in November 2018, covered topics that are crucial in shaping the Review's overall outcome, such as:

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

First group of topics

Consultation Document 2A, which accompanies this document as part of the second round of consultation, reports back on in-principle decisions that the Minister has made on these topics and seeks further feedback on more detailed elements of these issues.

This document considers the remaining topics covered in the terms of reference, such as:

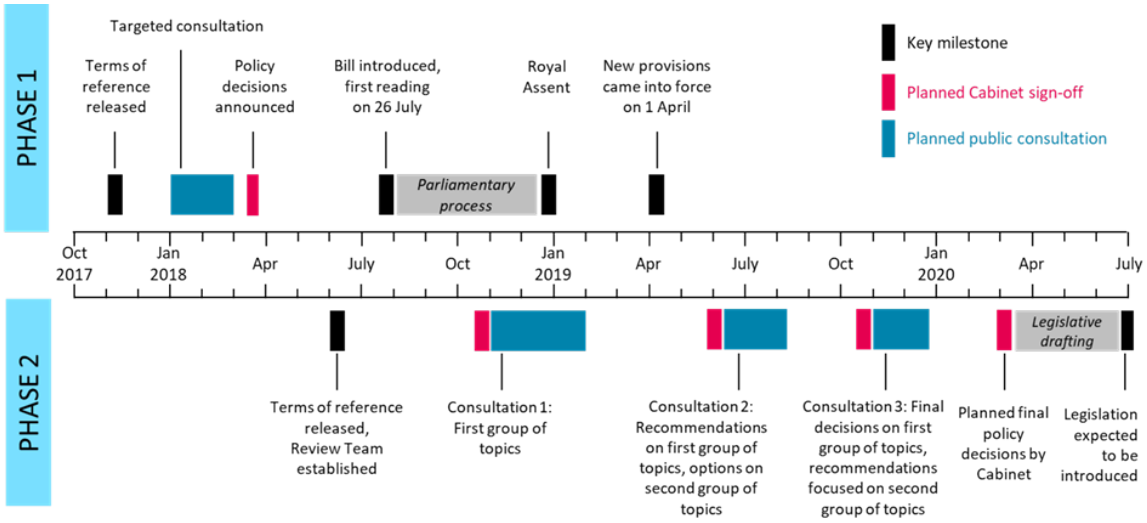
- the legal basis for bank regulation
- the approach to supervision and enforcement of bank regulation
- macro-prudential policy
- bank crisis management
- coordination with other agencies
- the Reserve Bank's resourcing and funding.

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 completion of the consultation process, 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 indicate 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 us to withhold personal information, such as names or contact details. An automatic confidentiality disclaimer from your IT system is not a reason to withhold information.

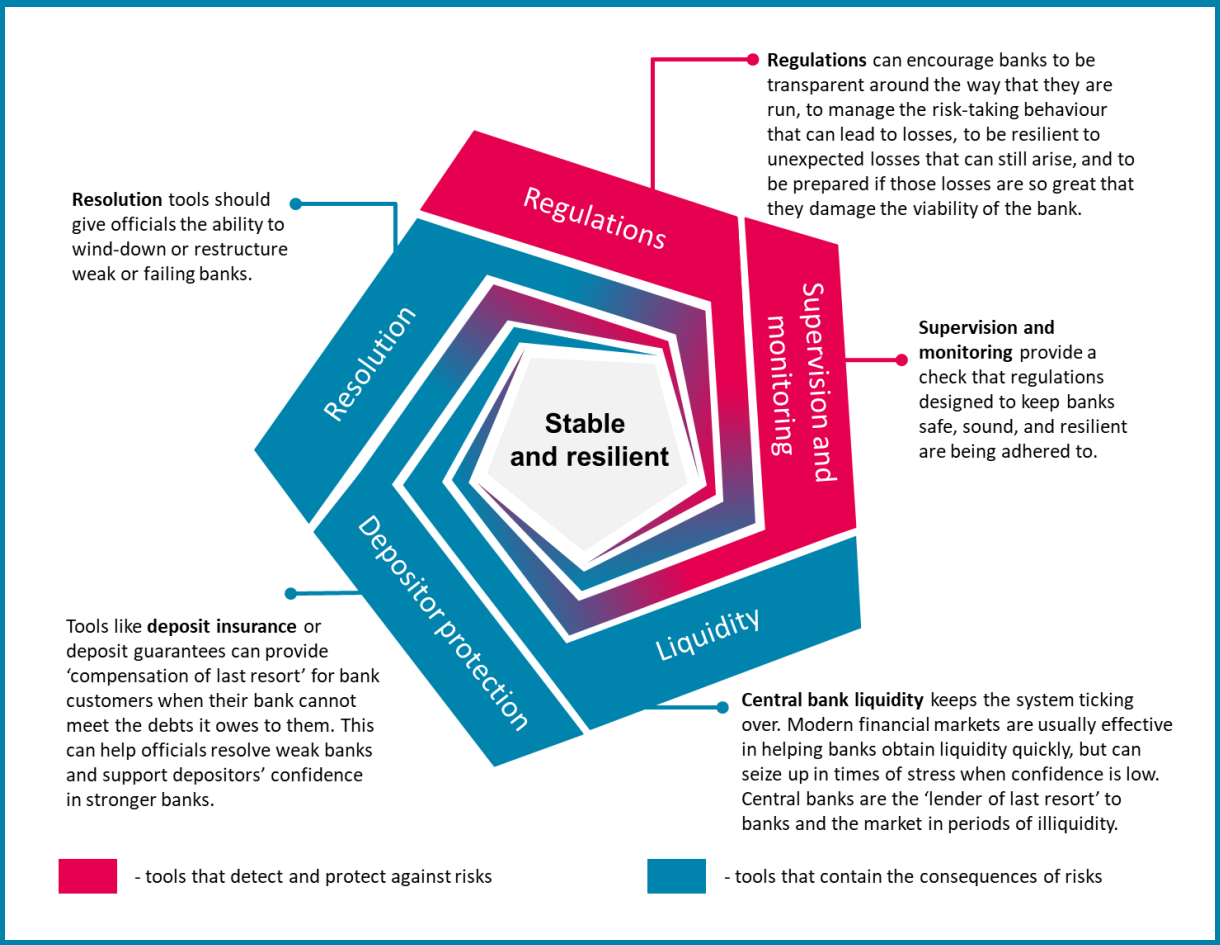
Your objections will be considered when responding to requests under the OIA.

Part A: The Reserve Bank's role in enhancing the resilience of the financial system

The Reserve Bank has been delegated a range of regulatory tools and powers by Parliament to:

- detect and protect the financial system against risks (through regulation and supervision)
- contain the consequences of financial stress (through liquidity and resolution tools).

These tools reinforce each other and together make up a 'financial safety net' to protect society from the damage caused by bank failures and financial crises. A stylised financial safety net (which in other countries also includes depositor protection) is shown below:



Part A focuses on the first two parts of the safety net – regulation and supervision – and the Reserve Bank's role in enhancing the resilience of the financial system.

Part A is structured around three Chapters:

Chapter 1 asks what prudential tools and powers the Reserve Bank should have.

In New Zealand, prudential regulation is implemented via two methods: primary legislation and instruments delegated to the Reserve Bank. Chapter 1 explores whether the right balance has

been struck between these two methods, or whether some matters currently implemented via delegated instruments – such as fit and proper tests – may be better suited to primary legislation.

Chapter 1 also explores whether the nature of the delegated instruments used to regulate the banking sector are fit for purpose. Currently, registered banks have to adhere to 'conditions of registration' in order to operate legally as a bank in New Zealand. However, these conditions may not be the ideal instrument for prudential regulation as the Reserve Bank can change them with relatively little oversight. In other jurisdictions, including Australia, it is common for 'regulatory standards' to be used instead. These face stricter accountability and transparency checks and may confer added legitimacy on the Reserve Bank.

Chapter 1 also discusses the arguments for and against New Zealand adopting a Banking Executive Accountability Regime (BEAR) framework, which would increase the responsibilities and accountabilities of a bank's senior executives and directors in important ways.

Chapter 2 asks what role the Reserve Bank should have in macro-prudential policy.

Macro-prudential policy is a subset of prudential regulation that emphasises a system-wide approach to risk assessment, rather than just focusing on the stability of individual institutions. Since the GFC, most advanced countries have adopted a macro-prudential overlay to their prudential work and have used new tools to help mitigate excessive variability in the financial cycle.

New Zealand introduced a new macro-prudential framework in 2013 and immediately made use of a new macro-prudential tool – loan-to-value restrictions (LVRs) on residential mortgage lending. The use of LVRs has attracted more scrutiny than standard prudential tools because they have affected individual borrowers more directly. Chapter 2 reviews how effective New Zealand's macro-prudential framework has been over the past five years and asks whether changes to the governance of macro-prudential decisions and the macro-prudential toolkit should be considered.

Chapter 3 asks how the Reserve Bank should supervise and enforce prudential regulation.

From the early years of its prudential regime the Reserve Bank has adopted a light-handed approach to supervision and enforcement. Rather than relying on independent verification of supervisory information itself, the Reserve Bank has emphasised the importance of creating incentives for a bank's own directors (self-discipline) and a bank's creditors (market discipline) to ensure that banks are being run in a safe and sound manner.

Although the Reserve Bank has followed the trend overseas and increased the intensity of its supervision since the GFC, by international standards New Zealand's supervisory regime remains light-handed with relatively little independent verification of supervisory information. Chapter 3 explores whether this approach remains appropriate, or whether New Zealand should intensify its supervisory approach through legislative changes to give the Reserve Bank power to undertake on-site inspections, and an increase in resources to improve supervisory capability and capacity.

Chapter 3 also considers whether the Reserve Bank has a sufficient range of enforcement powers to ensure that regulatory requirements are being met. One limitation of the current framework is that enforcement actions are mainly focused on non-public supervisory actions such as moral suasion to effect compliance or to address areas of emerging concern. Chapter 3 considers the merits of introducing a more graduated enforcement toolkit to better match enforcement actions with the severity of non-compliance.

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

Aim of this chapter

'Prudential regulation' is the process of applying a set of rules and requirements in order to meet regulatory objectives around promoting sound behaviour by an entity.[4] Prudential regulation is applied to financial firms that sit within a predefined regulatory perimeter, such as banks or insurers.

This Chapter considers the design and nature of the prudential rule-making powers available in the Reserve Bank Act.[5] After the current framework and its evolution over time are discussed, the key issues considered within the Chapter are whether:

- the right balance has been struck between the use of primary legislation and delegated rule-making powers
- the delegated rule-making powers in the Reserve Bank Act remain fit-for-purpose
- there is a case for increasing the level of executive accountability provided by prudential rules.

The Reserve Bank Act rule-making framework

Prudential regulation acts as one of what the Reserve Bank has termed the 'three pillars' of the regulatory system (Figure 1A).[6] The pillars are a useful organising framework to understand the role of actions by financial firms, market participants and the prudential regulator, which collectively contribute to financial stability.

While all prudential rule-making sits within the regulatory pillar, some rules directly help support self and market discipline, for example by reinforcing good governance practices within financial firms or through requiring disclosure of a financial firm's financial position.

Other rules address the inherent limitations of self- and market discipline. If left alone, financial firms may not appropriately take into account the costs they impose on society from their actions. Examples include capital adequacy and resolution planning. The regulatory pillar also assists the Reserve Bank's supervisory activities. The supervisory and enforcement tools available to the Reserve Bank typically rely on the existence of the legally enforceable requirements provided by prudential regulation (see Chapter 3).

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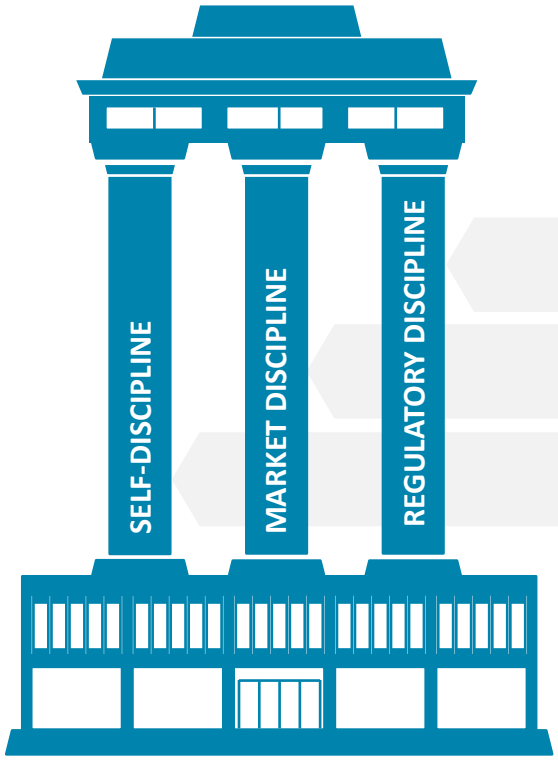
[4] This differentiates prudential regulation from the rules imposed on financial firms for other purposes, such as conduct regulation or anti-money laundering.

[5] The content of this chapter is primarily focused on the prudential regulation of deposit takers. Other financial sectors, such as insurance, are out of scope of this review.

[6] See Hunt (2016) for further explanation.

Figure 1A: The three pillars framework



Regulatory discipline
The role of mandated rules and requirements set by the Reserve Bank to support the safety and soundness of individual institutions and the stability of the financial system as a whole

Market discipline
The way in which market participants influence a financial institution's behaviour by monitoring its risk profile and financial position

Self-discipline
The responsibility of senior management and directors for an institution's own processes and risk management frameworks

The framework for the prudential regulation in New Zealand is found in primary legislation: the Reserve Bank Act. The Reserve Bank Act sets out the Reserve Bank's objectives, and the objectives for the prudential regulatory system. The Reserve Bank Act also sets out the regulatory perimeter, and provides the Reserve Bank with a number of regulatory tools:

- a framework for 'registering' banks (equivalent to licensing under other Acts such as the Insurance (Prudential Supervision) Act [IPSA] or the Non-bank Deposit Takers Act [NBDT Act])
- delegated rule-making powers that allow for rules to be made that apply to those banks
- regulatory tools that allow the Reserve Bank to monitor, supervise and – where appropriate – take regulatory action against registered banks.

To a large degree, the detailed rules applying to registered banks are not found in the Reserve Bank Act itself. Instead, they are set through delegated rule-making powers. The most notable delegated rule-making powers in the Reserve Bank Act are:[7]

- Conditions of registration (CoRs), which define most of the 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.

[7] The Reserve Bank also has the ability (by way of notice) under section 80 of the Reserve Bank Act to require registered banks to obtain a credit rating. The Reserve Bank can also apply conditions on changes of ownership under section 77A of the Reserve Bank Act.

CoRs are a form of administrative instrument, while OiCs are delegated legislation (see Box 1A).

Box 1A: Delegated rule-making tools – terminology

There are two broad types of delegated rule-making tools: delegated legislation and administrative instruments.

Delegated legislation refers to rules made under an empowering provision in primary legislation that create, alter, or remove the rights or obligations of all, or a class, of the public. [8]

Delegated legislation is often seen as synonymous with instruments made by the Governor-General in Council (hereafter 'Regulations'). Delegated legislation can, however, also be made by ministers, or agencies such as the Reserve Bank. In addition to Regulations, delegated legislation may be referred to by a variety of names, such as 'Standards', or 'Codes'. These names are not in themselves determinative: what is important is what has been delegated, who exercises the powers, and what safeguards apply (LDAC, 2018, p. 67).

Delegated legislation is subject to certain standard safeguards, including:

- review by the Regulations Review Committee and potential 'disallowance' by Parliament
- publication.

An **administrative instrument** is one that allows for the implementation, within the legal framework, of the actions or decisions of a regulatory body.

The appropriate boundary between delegated legislation and administrative tools is not always clear, as some administrative actions or decisions may have an impact on rights.

Conditions of Registration

CoRs are used to set the primary rules applicable to registered banks, such as capital, liquidity or corporate governance.

The Reserve Bank has a list of areas it is allowed to consider when registering banks or imposing CoRs.[9] The list can also be added to through Regulations.[10] The ability to add to the list is an avenue for extending the Reserve Bank's rule-making powers to new areas, should this be required.[11]

CoRs are applied to each bank individually. However, in practice the Reserve Bank prepares detailed policies that either apply to all banks, or to classes of banks. As an example, the Reserve Bank sets some rules that apply only to locally incorporated banks, or branches of foreign-owned banks.

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[8] For the purposes of this consultation document, we are using the term 'delegated legislation' to capture both 'legislative instruments' and 'disallowable instruments' under the Legislation Act 2012. A 'Legislation Bill' is currently in progress that is intended to bring greater consistency and simplicity to the classification of delegated legislation. Under the Legislation Bill it is proposed that all instruments with 'legislative effect' will be categorised as 'secondary legislation', meaning the distinction between legislative and disallowable instruments will fall away. Secondary legislation will be subject to disallowance by the Regulations Review Committee, and will be required to be published on both the Reserve Bank's website and the New Zealand legislation website.

[9] These are principally contained in sections 73-78 of the Reserve Bank Act.

[10] Section 78(2) of the Reserve Bank Act.

[11] For example, Regulations have been used to give the Reserve Bank the ability to impose conditions related to anti-money laundering practices without needing to amend the Reserve Bank Act.

The detailed policies prepared by the Reserve Bank are set out in the Banking Supervision Handbook. The Banking Supervision Handbook has not been made under a rule-making power, and does not have legal force on its own. Instead, the policies in the Banking Supervision Handbook apply as rules due to their inclusion in CoRs: this is known as 'incorporation by reference'. For example, in relation to capital, the relevant CoR for banks that use internal models notes that:[12]

> *"Total capital ratio", "Tier 1 capital ratio", and "Common Equity Tier 1 capital ratio" have the same meaning as in Part 3 of the Reserve Bank of New Zealand document. Capital Adequacy Framework (Internal Models Based Approach)"* (BS2B)

The Banking Supervision Handbook also plays a broader role beyond creating policies that are applied through CoRs. The Reserve Bank has described the Banking Supervision Handbook as "a collection of documents that sets out a range of different matters relating to the Reserve Bank's regulatory requirements for banks" (RBNZ, 2015, p. 5). Parts of the Banking Supervision Handbook provide guidance, or meet or explain requirements found in the Reserve Bank Act.[13]

In making CoRs, the Reserve Bank must meet two process requirements:

- The Reserve Bank cannot add, vary, or amend CoRs unless it has given a registered bank "not less than 7 days' notice" of the intended change.[14]
- The Reserve Bank is required to assess the regulatory impact of policies it intends to implement through CoRs, unless the policy is of a minor or technical nature.

The Reserve Bank Act did not initially make a breach of CoRs an offence. Instead, breaches were dealt with through directions (or for significant breaches, cancellation of registration). In 2003 a criminal offence was introduced for breaches of CoRs, with liability sitting with the registered bank. A breach is punishable by a fine of up to $1 million.

Orders in Council

Disclosure rules – a sub-set of the broader prudential rule-book – are set by OiCs.

OiCs are made on the advice of the Minister of Finance in accordance with a recommendation of the Reserve Bank. This means that, while the rules are drafted by the Reserve Bank, they require approval by the government.

Under the disclosure rules, registered banks are required to publish a twice-yearly 'disclosure statement'.[15] In addition to audited financial statements, the disclosure statement includes information on credit ratings, capital adequacy (both Common Equity Tier 1 and total capital ratios) and guarantees. The disclosure statement must list all CoRs that the Reserve Bank has imposed on the registered bank, as well as any non-compliance with the CoRs.

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[12] An 'internal models' bank is able to use its own estimated risk parameters to calculate capital requirements. Reserve Bank approval is required to become an internal models bank. BS2B is the policy for capital requirements for banks that use internal models.

[13] For example, section 75 of the Reserve Bank Act requires the Reserve Bank to publish a summary of the principles on which it acts in imposing or changing conditions of registration. This requirement is currently satisfied by one of the documents in the Banking Supervision Handbook (BS1). The Reserve Bank has also published guidance on market risk (BS6) and the disclosure rules (BS7 and BS7A).

[14] Any change to content in the Banking Supervision Handbook that is incorporated by reference into a CoR will also require 7 days' notice.

[15] Prior to the introduction of the Reserve Bank's quarterly Bank Financial Strength Dashboard in 2018, disclosure statements and the associated attestation were a quarterly requirement.

The disclosure rules also create an 'attestation regime' that applies to directors (and the New Zealand CEO of overseas incorporated banks). These individuals must 'attest' whether they believe, after due enquiry, that:

- the bank has systems in place to monitor and control adequately the banking group's material risks
- those systems are being properly applied
- the bank has complied with its CoRs over the period covered by the disclosure statement.

Registered banks, directors and CEOs of overseas incorporated registered banks face two forms of liability in relation to the disclosure regime:

- Criminal liability for false or misleading disclosure statements (for individuals, this is applicable only to those that sign the disclosure statement).
- Civil liability for losses suffered by persons that subscribe for debt securities in reliance on a false or misleading disclosure statement.

Evolution of the Reserve Bank's rule-making approach

While the allowable scope of rules in the Reserve Bank Act is relatively broad, the Reserve Bank has historically elected to limit the scope of prudential regulation over registered banks, at least in relation to international norms. The Reserve Bank's approach has nonetheless changed over time, as discussed in Hunt (2016).

The introduction of the Reserve Bank Act

After the passing of the Reserve Bank Act in 1989, the Reserve Bank introduced a set of rules that all registered banks were required to meet on an on-going basis. These rules were made through CoRs, and brought New Zealand closer to international practice at the time. The rules included:

- minimum capital standards (the new global 8 percent Basel I standard). These standards were phased in between June 1989 and 1992
- policies limiting the concentration of lending (related party and large exposures)
- internal risk controls
- a policy requiring the separation of banking business from other activities.

In 1996 a revised set of disclosure rules was introduced, and this included the creation of the attestation regime.[16] These changes were accompanied by the removal of a number of prudential rules, including limits on lending to individual counterparties, limits on foreign exchange exposures,

[16] The revised disclosure rules replaced the prospectus requirements that applied to banks under the then Securities Act 1978.

and internal risk control requirements. The Basel 1 minimum capital requirements were retained, albeit somewhat reluctantly, with the Reserve Bank expressing a view that:

> *"…while the Bank considers that the disclosure regime will create sufficient incentives for banks to adhere to the Basel international minimum requirements, we consider that, for the time being at least, there is a net benefit for the banking system in retaining existing regulatory capital requirements"* (RBNZ, 1994, p. 103).

The reduction in the breadth of prudential rules, alongside the adoption of a supervisory regime that relied almost solely on information in public disclosure statements (see Chapter 3), marked a clear departure from international norms.

Growth of the regulatory pillar

Over time additional rules have been developed to help support the key pillars of self- and market discipline, including the introduction of a 'fit and proper' policy in 2003 setting out suitability requirements for directors and senior executives, and amendments to the disclosure rules in 2005 and 2011.

In addition, there has been growing recognition of the more fundamental misalignment between the incentives of registered banks and desired outcomes for the financial system, reflecting the limits of the self and market discipline pillars (see Fiennes [2016] for more detail). This recognition has been partly tied to the changing structure of New Zealand's banking system and the growing importance of large banks, many of which are Australian-owned. From the early 2000s onwards, the Reserve Bank has given increased consideration to both the question of how to address the failure of a large bank (with policy development that eventually led to OBR beginning at this time), and the functions that need to be under the control of New Zealand banks (leading to an outsourcing policy in 2006). In 2003 amendments to the Reserve Bank Act expanded the potential scope of CoRs, while at the same time a local incorporation policy was introduced.

The Reserve Bank's prudential regulation responsibilities expanded to include NBDTs in 2008 and insurers in 2010.

The GFC has prompted further changes in prudential rule-making:

- Basel II capital standards were implemented in 2008 (New Zealand was a late adopter), followed by much strengthened Basel III standards in 2013. The Reserve Bank had taken a conservative approach in 2008, and was therefore well-placed to implement the new requirements some five years later, ahead of many other jurisdictions. The implementation of Basel III also illustrated the more general approach the Reserve Bank had taken to the adoption of international standards – the Reserve Bank would introduce new requirements that it considered fit for purpose and tailored to New Zealand circumstances. Regard was also had to international comparability and consistency, especially with Australia. The Reserve Bank began a review of its capital adequacy framework for locally incorporated banks in April 2017: consultation on the final stage of this process has recently closed.
- A liquidity policy was introduced in 2010 to address one of the key vulnerabilities that crystallised during the GFC – New Zealand banks' reliance on short-term wholesale market funding.
- The GFC prompted the accelerated development and implementation of the Reserve Bank's OBR policy in 2012.

- Between 2009 and 2013 the Reserve Bank explored how it might use prudential tools to address the build-up of systemic risk over the financial cycle. This culminated with the MoU between the Governor of the Reserve Bank and the Minister of Finance formalising this new 'macro-prudential' policy area (see Chapter 2). Shortly following the signing of the MoU loan-to-value ratio restrictions were implemented to address growing imbalances in the housing market.

These, and other policies introduced after the GFC, have seen both CoRs and the Banking Supervision Handbook significantly increase in scope (Figure 1B).

Figure 1B: Expansion of the Banking Supervision Handbook

	Pre-GFC	POST-GFC	
Legislation		RBNZ Act 1989	RBNZ Amendment Act 2008 (NBDTs), then NBDT Act 2013 AML/CFT Act 2009 IPSA 2010
The Banking Supervision Handbook	BS2 (Capital adequacy)	BS1 (Principles) BS3 (Bank registration)* BS4 (Audit obligations) BS5 (AML/CFT) BS6 (Market risk) BS7 (Disclosure) BS8 (Connected exposures) BS9 (Significant influence)* BS10 (Suitability assessment)* BS11 (Outsourcing)* BS12 (ICAAP)	BS2A&B (Capital – standardised/IRB*) BS13 (Liquidity) BS14 (Corporate governance) BS15 (Significant acquisitions)* BS16 (Capital recognition)* BS17 (Open bank resolution) BS18 (Covered bonds)* BS19 (High-LVR restrictions)
Monitoring	Minimal supervisory engagement with regulated entities Emphasis on public disclosure statements		More frequent supervisory engagement Increased private reporting System-wide thematic reviews
PSD Staff	**30** (June 2008)		**47** (June 2018)

* Parts of the Banking Supervision Handbook that have requirements for approvals, authorisations, and non-objections from the Reserve Bank.

Prior to the GFC the Banking Supervision Handbook consisted of about twelve documents. The Banking Supervision Handbook now consists of 22 documents and exceeds 500 pages. The detailed policies in the Banking Handbook are also supplemented by disclosure rules.[17]

[17] The Registered Bank Disclosure Statements (New Zealand Incorporated Registered Banks) Order 2014, for example, runs to 86 pages.

The 2016/17 IMF FSAP

In many areas, the blueprint for prudential regulation comes from international standards – in the case of banking from the Basel Committee's Core Principles (BCPs). The BCPs are used by individual jurisdictions to assess their own approach to prudential regulation, and are an integral part of the IMF's Financial Sector Assessment Programme ('FSAP') benchmarking exercise for member countries. An FSAP is an in-depth analysis of a country's financial sector, including the quality of financial sector regulation and supervision.

The IMF undertook an FSAP for New Zealand in 2016, with results published in May 2017. The FSAP included a detailed assessment of how both the Reserve Bank Act's rule-making framework, and the rules themselves, measured up against the principles for effective banking supervision. BCPs 14-29 are most relevant to rule-making, while 3-13 are more applicable in relation to supervision and enforcement (see Chapter 3). BCPs 1-2 (which cover powers and independence) are relevant to both.

While the regulatory pillar had been strengthened since the last FSAP in 2003, the IMF nonetheless considered that there were some shortcomings in the Reserve Bank's approach to rule-making. In particular, the IMF considered that some rules were insufficiently detailed, and identified an absence of guidance establishing supervisory expectations for 'prudent' banking in a number of areas (see Table 1A). Gaps in these areas were seen as reducing the Reserve Bank's ability to take enforcement action (see Chapter 3).

Table 1A: Basel core principles – summary of results for BCPs 14-29

Core principle	C	LC	MNC	NC
BCP 14: Corporate governance			✓	
BCP 15: Risk management process			✓	
BCP 16: Capital adequacy	✓			
BCP 17: Credit risk			✓	
BCP 18: Problem assets, provisions and reserves			✓	
BCP 19: Concentration risk and large exposure limits			✓	
BCP 20: Transaction with related parties			✓	
BCP 21: Country and transfer risks	✓			
BCP 22: Market risk		✓		
BCP 23: Interest rate risk in the banking book			✓	
BCP 24: Liquidity risk	✓			
BCP 25: Operational risk			✓	
BCP 26: Internal control and audit			✓	
BCP 27: Financial reporting and external audit		✓		
BCP 28: Disclosure and transparency	✓			
BCP 29: Abuse of financial services	✓			
Totals	**5**	**2**	**9**	**-**

Note: C = compliant; LC = largely compliant; MNC = materially non-compliant; NC = not compliant.

A number of factors will influence the extent to which the Reserve Bank retains its current approach to rule-making:

- the objectives of the both Reserve Bank and any regulatory regimes it oversees (including any remit or risk appetite statement provided by the Minister)
- the governance structure of the Reserve Bank
- the level of 'regulatory independence' provided to the Reserve Bank (meaning the Reserve Bank's ability to set rules without government approval)
- the broader set of regulatory tools available to the Reserve Bank, and the resources the Reserve Bank is permitted to devote to maintaining and using those powers.

Given this context, it may be desirable to design rule-making powers that are sufficiently broad and flexible to allow the Reserve Bank to produce a more BCP compliant regime if that is seen as necessary. Developing such a framework requires consideration of both the design and scope of rule-making, and the formal and informal tools that make rules enforceable.

Distribution of rules between primary legislation and delegated legislation

Issue summary

In assessing the Reserve Bank Act framework, an important issue is whether an appropriate balance has been struck between the use of primary legislation and delegated rule-making powers. This balance can be assessed against four criteria (LDAC, 2018, pp. 67-8):

- **Legitimacy** – important policy content should be a matter for Parliament to determine in primary legislation through an open democratic process.
- **The durability and flexibility of the law –** delegation can be important to how a law (and the regulatory system it is part of) performs over time in terms of responding to changing or unforeseen circumstances or allowing minor flaws to be addressed.
- **The certainty or predictability of the law –** if too much policy content is delegated or delegations are given to different decision makers without clearly scoped mandates, clarity about what is required by the law can be undermined.
- **The transparency of the law –** layers of delegated legislation can create complexity and fragmentation in a regime, making it difficult for readers to find and understand the law. However, too much technical detail in an Act might make it difficult to navigate.

In order to support legitimacy, it is appropriate for matters of 'significant policy' and principle to be included in primary legislation, alongside matters that have a meaningful impact on rights (for example the creation of criminal offences, or significant regulatory powers). Delegated legislation can include a policy component, but should primarily deal with matters of implementation.

What constitutes 'significant policy' in a particular regulatory system is nonetheless highly context dependent. LDAC considers that indicators of significance are that (LDAC, 2018 p. 65):

- the policy answers the key questions relevant to the problem addressed by the legislation

- the policy has the potential to give rise to controversy (whether political or otherwise), or
- without the policy decision being made, the overall implications of the legislation are unclear.

In contrast, factors supporting the use of delegated legislation include (UK Cabinet Office, 2013):

- the matters in question may need adjusting more often than it would be sensible for Parliament to legislate for by primary legislation
- the use of delegated rule-making in a particular area may have strong precedent and be uncontroversial.

Alongside good practice, a key factor determining the role of each of the layers is the intended 'regulatory style' for the system. Regulatory systems exist on a continuum between 'outcomes focused' and 'prescriptive' (Table 1B).

Table 1B: Regulatory styles

	Description	Effect	Where are the detailed rules?	Decision style
Outcome focused (example: Fair Trading Act 1986)	▪ Mandatory principles or performance requirements specified in law.	▪ Risk tolerant. ▪ Flexible.	▪ Individual firms. ▪ Regulator guidance. ▪ Codes of practice. ▪ Industry standards. ▪ Court decisions.	▪ Judicial.
Outcome focused plus an approval process (example: Health and Safety at Work Act 2015)	▪ Mandatory principles or performance requirements. ▪ Scope to develop novel and tailored 'how to' solutions, with an approval process.	▪ Risk averse. ▪ Mixed.	▪ Authorisations. ▪ Licences. ▪ Precedent.	▪ Administrative.
Prescriptive (example: Electricity Safety Regulations 2010)	▪ Mandatory and detailed rules specified in law.	▪ Risk averse. ▪ Mixed.	▪ Legislation (primary, secondary). ▪ Standards incorporated by reference.	▪ Legislative.

When applied to prudential regulation, this set of considerations suggests that there are certain rules that should unambiguously sit in primary legislation. These rules relate to:

- the objectives of the regulatory system
- the role of the regulator within that regulatory system, including its objectives and functions
- the regulator's institutional form, governance, and accountability arrangements
- the regulatory tools within the regulatory system (e.g. licensing, delegated legislation, administrative instruments, supervision tools, enforcement)
- the regulated entities to whom regulatory tools can be applied (i.e. the regulatory perimeter).

There are also potential arguments for setting more detailed prudential rules in primary legislation.[18] Core prudential rules such as capital or liquidity have significant consequences for regulated entities. These rules may also have broader economic and social impacts (for example on the capital markets, or consumers). There nonetheless appears to be a stronger case for these prudential rules to be set in delegated legislation:

- The rules are very technical.
- The rules will need to change relatively often. Rules must remain relevant and effective in the face of the changing nature of risks, and the continuous innovation seen in financial markets.
- There is value in providing flexibility in how regulated entities meet the rules.

There are also two further characteristics of the prudential regulatory system that support relatively extensive use of delegated legislation:

- Prudential regulation operates on an administrative decision-making model. Technical rules are applied to a relatively limited and well-defined set of regulated entities, typically subject to licensing. Rule-making is a core part of the Reserve Bank's broader regulatory toolkit for these licensed entities, and can be seen as complementary to supervision and enforcement.
- There is a notable need for 'credible commitment' in prudential rule-making. Rules such as capital requirements impose short-term costs on regulated entities to achieve a long-term objective. Committing to this model by providing delegated rule-making powers to an independent regulator make it more costly for government to relax the rules to achieve short-term aims. Regulatory independence over core rule-making powers is a common feature of other comparable jurisdictions, and is seen as good practice by the BCPs (see Table 1C).[19]

[18] In certain areas, detailed rules may be more suited to primary legislation, primarily due to a need for certainty or the impact on property rights (for example crisis management).

[19] For example, the prudential regulators in similar twin-peaks jurisdictions (APRA in Australia, the Prudential Regulation Authority in the UK, and De Nederlandsche Bank in the Netherlands) all have significant delegated rule-making powers.

Table 1C: BCPs relevant to delegated rule-making powers

Principle 1: Responsibilities, objectives and powers	
Essential Criteria 3	▪ *Laws and regulations provide a framework for the supervisor to set and enforce minimum prudential standards for banks and banking groups*. The supervisor has the power to increase the prudential requirements for individual banks and banking groups based on their risk profile and systemic importance.
Essential Criteria 4	▪ *Banking laws, regulations and prudential standards are updated as necessary* to ensure that they remain effective and relevant to changing industry and regulatory practices. These are subject to public consultation, as appropriate.
Principle 2: Independence, accountability, resourcing, and legal protection for supervisors	
Essential Criteria 1	▪ The operational independence, accountability, and governance of the supervisor are prescribed in legislation and publicly disclosed. There is no government or industry interference that compromises the operational independence of the supervisor. *The supervisor has full discretion to take any supervisory actions or decisions* on banks and banking groups under its supervision.

Potential options for change

It can be argued that the foundational choices in the current prudential regulatory system remain valid. Namely, it appears appropriate that the Reserve Bank has a high degree of autonomy to make prudential rules through delegated regulatory legislation and administrative instruments. Out-of-date rules are a consistent feature of regulatory failures. Providing the Reserve Bank with a high degree of regulatory independence limits the risk of a 'set-and-forget' prudential regime (Productivity Commission, 2014, p. 237).

Nonetheless, while many prudential rules appear amenable to delegated legislation, this places greater focus on the design of the objectives, functions, and powers of the Reserve Bank, as well as the safeguards around those powers. In this respect, the current approach in the Reserve Bank Act no longer reflects good practice: more modern regulatory regimes (such as the Financial Markets Conduct (FMC) Act 2013) provide clearer guidance to the regulator and a more fully developed set of checks and balances. Searancke *et al* (2014) note that:

> *"In relation to regulatory design, some of the biggest shifts are in relation to how statute law mandates, guides, directs and empowers the regulator. We observe much more specific and comprehensive statutory provisions in the areas of purpose and principles, functions and duties, and powers."* (p. 58).

In order to ensure an appropriate balance is maintained between the legitimacy and accountability of the regime, and the need for the Reserve Bank to be empowered with sufficient regulatory independence to discharge its role effectively, there is a case to consider several changes to the Reserve Bank Act. These changes would:

- Increase the specification of objectives (discussed in Chapter 2 of Consultation Document 2A). There is also a case, reflecting the broader economic impact of prudential rules, to allow the government to provide the Reserve Bank with a remit or risk appetite statement. Such a mechanism would enhance legitimacy, while not removing Reserve Bank decision-rights.
- Modernise the Reserve Bank Act in areas where the framing of functions and powers would benefit from improved safeguards. Examples include the procedural requirements that apply in areas such as registration of banks or changes of ownership. Similarly, fit and proper requirements currently sit within a CoR.[20] The CoR requires that, before a registered bank can appoint a person as a director or senior executive, the Reserve Bank must advise that it has no objection to the appointment. Given the potential impact of a Reserve Bank objection on an individual, there is a strong case for any fit and proper regime to be more fully empowered in primary legislation, including the potential for review through a court process.[21]
- Provide greater clarity on the intended scope of delegated legislation and administrative instruments. The Reserve Bank has used CoRs in ways that were not directly contemplated at the time the Reserve Bank Act was passed. There is value in clear empowering provisions that do not unnecessarily restrict the Reserve Bank in making rules related to its core functions, and that allow the Reserve Bank to meet new risks.[22] This would allow the Reserve Bank to develop the prudential rulebook so that it is more BCP compliant (as recommended by the IMF FSAP), should the Reserve Bank consider this appropriate. At the same, it is also important to ensure that the scope of these rule-making powers is sufficiently clear, and that appropriate checks and balances apply to *extensions to the nature* of prudential rule-making (LDAC, 2018, p. 71). A recent practical example of this challenge can be seen in macro-prudential policy (see Chapter 2).

Questions for consultation

1.A Do you agree that the broader Reserve Bank Act model strikes an appropriate balance between primary legislation and delegated powers? If not, why not?

1.B Are there any areas of the Reserve Bank Act where changes to the model are required, such as the introduction of greater safeguards?

[20] And within the Banking Supervision Handbook in BS10. Note, as an administrative decision, appeals against any decision would be limited to judicial review.

[21] See for example section 16 of the NBDT Act or section 39 of IPSA. Both the NBDT Act and IPSA also provide stronger ability for the Reserve Bank to remove directors if new information comes to light about their suitability. However these powers are, appropriately, also subject to being challenged in court (see section 62 of the NBDT Act and section 42 of IPSA).

[22] For example, Australia's Banking Act allows APRA to make rules designed to keep deposit takers "in a sound financial position" This would empower a broad set of rules related to capital, liquidity and risk management practices.

The design of delegated rule-making powers

Issue summary

Alongside the broader principles of regulatory design, it is important that delegated rule-making powers are subject to appropriate safeguards. The level of safeguards considered appropriate will increase with the significance of the delegated power. In relation to delegated legislation, the purpose of safeguards is to promote:

- a good law-making process (through, for example, requirements to have regard to certain matters or being satisfied that a test is met)
- transparency (through publicly disclosed processes and decisions)
- participation (through consultation or requiring confirmation, concurrence, or consent)
- accountability (through, for example, thorough review and potential 'disallowance' by the Regulations Review Committee).

Administrative law and regulatory practice both have a role to play, for instance in requiring procedural fairness.

Design of rule-making powers also needs to reflect the specific needs of the regulatory system. This is to ensure the powers are sufficiently broad and flexible to be effective. In relation to prudential regulation, the following factors are relevant:

- Prudential rules tend to apply to classes of firms, not individual firms.
- There is a need in some circumstances to tailor requirements to account for specific risks and business models.
- There is need for discretion on the part of the regulator (e.g. for example to allow for approvals in relation to the use of internal models or particular capital instruments).

There are elements of the current Reserve Bank Act delegated rule-making framework that perform strongly when considered against these criteria.

CoRs are durable and flexible. The current model has provided the Reserve Bank with the ability to move quickly and adapt to changing risks or circumstances. As an administrative instrument, CoRs are also able to provide discretion to the Reserve Bank where required (for example to provide approval processes). As discussed earlier in this chapter, having the Reserve Bank draft and make technical rules also appears appropriate (Table 1D).[23]

[23] There is some delegated legislation that is less appropriate for the Reserve Bank to make, for example rules extending the Reserve Bank's powers, or setting levies and fees.

Table 1D: Who should make the rules?

Factors in favour of rules being set by Governor-General in Council or Minister	Factors in favour of rules being set by an independent regulator
▪ Matters that significantly affect the population, a large number of people or human rights. ▪ Decisions which involve value judgments which are more appropriately made by elected representatives. ▪ Where political control is necessary to guard against 'regulatory capture' by the regulated sector. ▪ Decisions with significant fiscal implications or that are otherwise integral to the Government's economic strategy. ▪ Creation of criminal sanctions or pecuniary penalties. ▪ Decisions involving significant exercise of the coercive powers of the state (for example, taxation or expropriation of property).	▪ Decisions where the costs are long term, and likely to be undervalued due to a focus on electoral cycles ▪ Issues where a credible commitment to a stable long term framework is important. ▪ Matters that require more consistent and stable decision-making. ▪ Subject matter is highly technical or specialised. ▪ Decisions which impact on particular interests should be made impartially (e.g. where government-owned and other entities are under the same framework). ▪ Independent decision-making may be important for public confidence in the regime. ▪ Decisions that may need to be taken urgently.

Source: Productivity Commission, 2014, p. 218.

The IMF did not raise specific issue with CoRs during their most recent FSAP. A particular priority for the IMF is that prudential rules should be enforceable: a breach of a CoRs can be enforced through actions like directions, albeit with a requirement for ministerial consent. Breaching a direction is grounds for placing a registered bank into statutory management.

When compared against the principles of good legislative design, there are nonetheless reasons to consider whether the current framework remains appropriate. These issues primarily relate to legitimacy, transparency, and proportionality.

Legitimacy

The nature of prudential regulation has changed materially over time. The breadth and depth of requirements imposed through CoRs have expanded significantly. The processes, safeguards, and accountability mechanisms in the Reserve Bank Act were not designed with an expectation that prudential rules would have such a significant impact on the conduct of banks, or broad economic and social implications.

As an administrative instrument, CoRs are not subject to parliamentary oversight or publication requirements. The Reserve Bank Act also has relatively limited formal consultation requirements.[24] In

[24] In practice Reserve Bank consultation has been far more extensive on matters such as the recent review of the capital adequacy framework.

a report commissioned by the Treasury in 2017, James Every-Palmer QC identified an "accountability deficit" with the CoR model (Every-Palmer, 2017, p. 1).[25] Through the scoping of Phase 2 of the Review, a number of stakeholders expressed concerns of this nature.

While the degree of regulatory independence held by the Reserve Bank in setting CoRs is broadly consistent with a number of other comparable jurisdictions, those jurisdictions also have more developed frameworks in relation to regulatory practice and accountability.

Transparency

Elements of the regulatory system can be difficult to navigate. The Banking Supervision Handbook does not feature in the Reserve Bank Act. As discussed earlier in this Chapter, the detailed policies in the Banking Supervision Handbook are incorporated by reference into CoRs. Incorporation by reference can generate risks (for example around accessibility and good process), and should therefore only be used if there are clear benefits from doing so.[26] These benefits are not immediately evident in prudential rule-making, given rules could be set in a more direct way (e.g. setting out the detailed policies themselves in delegated legislation). Through the scoping of Phase 2, several stakeholders wanted clarification of the relationship between CoRs and the Banking Supervision Handbook.[27]

The Reserve Bank has also acknowledged that "[i]n various places the Handbook is unclearly drafted and hard to navigate, and the distinction between binding requirements, definitions and guidance is not always clear" (RBNZ, 2015, p.5). While the Banking Supervision Handbook records the rules that apply on a class-basis, there is no central registry of CoRs that includes the tailored or individual rules that have been applied to particular banks: this runs counter to the broader focus across government on providing access to legislation.[28]

Beyond the Reserve Bank Act, there is also a degree of inconsistency across the prudential regulatory system that seem difficult to justify. There is variation in the key design features of the regulatory tools (including delegated rule-making powers) that apply to banks, insurers, and NBDTs (Figure 1A):

- Prudential rules for banks are made by the Reserve Bank through an administrative instrument, and for insurers through delegated legislation. Rules for NBDTs and disclosure rules for banks are made by government (Governor-General in Executive Council) through delegated legislation.
- The liability that flows from breaches of rules are different across all three regimes, including meaningful differences in liability for individuals.
- Different frameworks apply in areas like fit-and-proper or information sharing.

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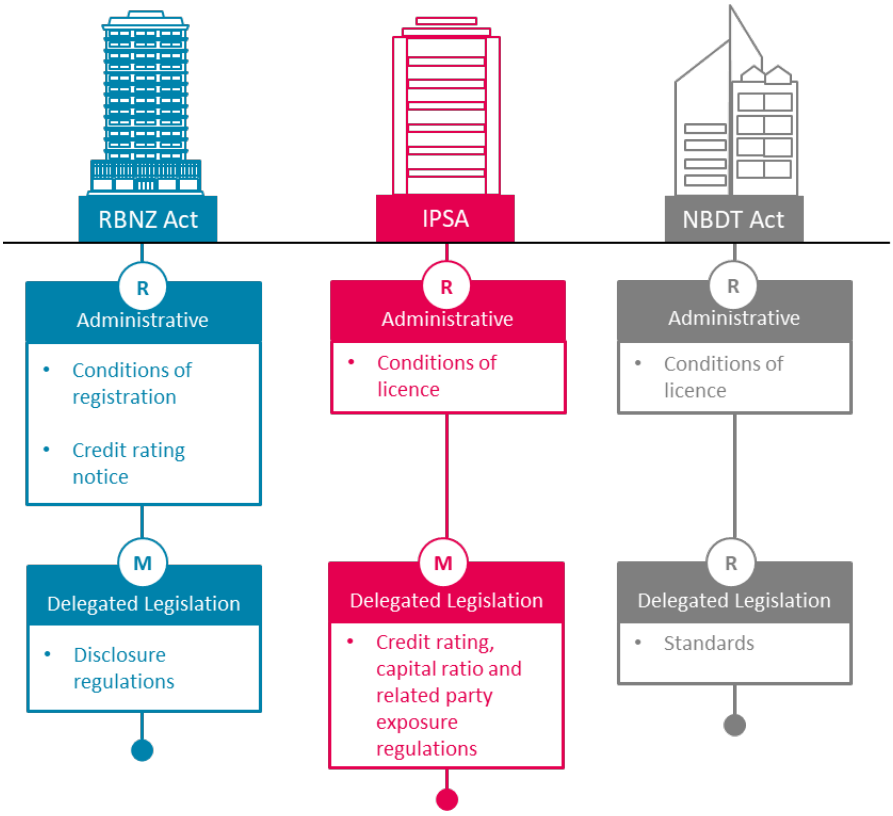
[25] While Every-Palmer QC supported retaining a model where prudential regulation was set by administrative instrument, he also recommended a number of meaningful changes to current settings. These changes included introducing rights of review, more tightly controlling the scope of prudential regulation, and providing a vehicle for the Minister to signal a government policy view.

[26] For example, while Reserve Bank practice has been to reference particular versions of the Banking Supervision Handbook in CoRs, and consult on changes to the versions, this is not required in the Reserve Bank Act.

[27] Some stakeholders also noted that they perceived there was a lack of clarity in some areas of the CoR regime.

[28] For example through the Parliamentary Counsel Office's Access to Legislation project.

Figure 1A: Delegated rule-making in the banking, NBDT, and insurance regimes



Note: M = instruments controlled by the government/Minister, R = instruments controlled by the Reserve Bank.

Proportionality

There are elements of the current rule-making regime that are arguably not proportional. The potential consequences that flow from breaches of either CoRs or the disclosure rules are significant.

Breaches of CoRs can arise from minor or technical issues. Currently, a breach of a CoR can serve as grounds for the Reserve Bank to take enforcement action against a registered bank under a criminal liability regime.

The disclosure rules (including the attestation regime) expose directors to criminal liability without proof of a fault element, unless directors can establish a defence. The disclosure rules also currently operate without materiality thresholds around breaches of CoRs. The lack of materiality thresholds can place directors and CEOs in a challenging position given they need to attest to the correctness of all information disclosed. From an operational standpoint, registered banks have indicated that the absence of materiality thresholds can require a meaningful investment of time on minor breaches at both a board and senior manager level that is difficult to justify.

These issues (and particularly those relating to materiality thresholds) were raised by a number of stakeholders during the scoping for Phase 2.

Possible reform options

Based on the discussion above, there are arguments to make three changes to the regime.

Reframe the core prudential rule-making power

There are several potential options that could create an enhanced framework for making prudential rules. Changes should only be considered where they can address the issues of legitimacy, transparency, and proportionality identified in this Chapter, without unnecessarily impacting on flexibility.

It is important to recognise that no model will guarantee good process. That is something that is closely linked to resourcing, objectives, and governance (as discussed elsewhere in the consultation) and through those matters, capability and culture.

Option 1: Enhanced CoRs

This model would retain the current CoRs rule-making framework, supplemented by greater specificity in relation to both objectives and the scope of CoRs. There would also be a broader refresh of safeguards such as consultation requirements, and potentially oversight of decisions (discussed later in this Chapter). As part of this refresh, the Banking Supervision Handbook could receive statutory recognition (Every-Palmer, 2017, pp. 27-8).

This option acknowledges that there are ways to address some of the issues identified with the current model without changing the rule-making instrument. For example, the transparency of the current regime could be improved through enhanced regulatory practices, such as the clearer separation of rules and guidance, and through a centralised register of CoRs. Work is underway to address a number of these process issues as a follow-on from the Reserve Bank's 2015 'Regulatory Stocktake'. Progress has been relatively slow, largely due to Reserve Bank resourcing constraints.

Under an enhanced status quo, rules would nonetheless not be subject to oversight from Parliament, or to publication requirements. As has been discussed, this is generally seen as inconsistent with good practice for the types of rules currently made through CoRs (being rules that regulate conduct, and that apply to all banks, or to classes of banks).

Option 2: Standards

Alongside the refresh of safeguards noted above, this model would seek to enhance legitimacy and accessibility by replacing CoRs with delegated legislation. The rule-making power would then be subject to parliamentary oversight, as well as publication requirements. Rules would continue to be made by the Reserve Bank, but in a manner more akin to IPSA's 'solvency standards', or (in the Australian context) APRA's 'prudential standards'.

Standards would be subject to scrutiny by the Regulations Review Committee and could be 'disallowed' on certain technical grounds (for example, on the basis that they were not made in accordance with the general objects and intentions of the empowering legislation). The Regulations Review Committee does not consider matters of policy.

While disallowance is unlikely to occur in practice, parliamentary scrutiny would serve as a useful discipline, particularly given current issues with the Banking Supervision Handbook. Shifting to

Standards would also ensure greater certainty of process, for example by discouraging the inclusion of guidance-type materials within rule-making instruments.

As a starting point, the same flexibility is not available for Standards as under CoRs. It is nonetheless possible to build in this flexibility through the empowering provision.[29] Standards can be designed to allow for discretionary variations, modifications, and approvals on the part of the Reserve Bank, subject to appropriate safeguards. This would allow the Reserve Bank to, for example, set a range in which a tool like an LVR or a capital buffer could operate, and then vary the level through time using the process set out in the relevant Standard.

The use of Standards would in some cases be more efficient than CoRs (by avoiding the need to update CoRs for all banks), and would also be more reflective of the nature of rule-making (with rules made for classes of entities and developed through public consultation processes).

Option 3: Regulations

Shifting from CoRs to a system of Regulations would improve legitimacy by giving the government a role in approving rule changes.[30] As has been discussed in this chapter, prudential rules can have meaningful broader impacts, supporting a case that the government should have a voice in rule-making.

As delegated legislation, Regulations would also enhance transparency. Regulations are disallowable. Regulations are also subject to further safeguards: they must be drafted and certified by the Parliamentary Counsel Office (PCO), receive Cabinet scrutiny, and are subject to the 28-day rule (meaning that there is a minimum 28 day exposure period before they come into force).

A Regulations model nonetheless appears inconsistent with the degree of regulatory independence seen as best practice in prudential rule-making, and could introduce political risk into the prudential regulatory process. The content of prudential rules is also highly technical: while government may have an interest in the broader impact of certain rule settings, the elements of rules that could be considered 'significant policy' are not readily separable from the detail. This suggests that a government voice in rule-making (if considered appropriate) may be more effectively expressed through other channels, such as a remit or risk appetite statement.

Additional consideration: setting disclosures rules through the core prudential instrument

Disclosure rules are currently set in a different way than other prudential rules. Disclosure rules are also subject to a different liability framework.

These differences appear difficult to justify. The disclosure rules operate as an element of the broader prudential rulebook. From a transparency perspective, having multiple forms of delegated legislation can also create fragmentation in a regime, making it harder to understand.

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[29] As an example, the empowering provision in section 11AF of Australia's Banking Act 1959 provides that "[a] standard may provide for APRA to exercise powers and discretions under the standard, including (but not limited to) discretions to approve, impose, adjust or exclude specific prudential requirements".

[30] Regulations are used in a number of other delegated rule-making models. For example, detailed disclosure rules for conduct regulation are found in the Financial Markets Conduct Regulations 2014.

There is a case to expand the scope of rules addressed through the core prudential instrument (e.g. a Standard) to cover disclosure: this would cover financial information and reporting to the Reserve Bank's Financial Strength Dashboard.[31]

Questions for consultation

1.C Does the chapter appropriately identify the key issues with the current framework for setting prudential rules? If not, what is missing?

1.D What are your views regarding the potential options proposed for setting the core prudential instrument? Are there any other changes to the rule-making framework that should be considered?

Provide for enhanced process rights on administrative decisions

The importance to financial firms of both Reserve Bank rule-making and administrative decisions has increased in recent years. During the scoping process for Phase 2 of this Review, a number of stakeholders supported the introduction of enhanced process rights that would provide them with the ability to appeal these decisions. There was no firm view from these stakeholders on the type of process rights that should be in place.

Prudential rules applied to classes of entities appear poorly suited to appeal rights. As has been noted in this chapter, prudential rules make the law. The most appropriate form of accountability for these types of decisions comes from a combination of parliamentary oversight and a robust policy process (including consultation, regulatory impact analysis and stakeholder engagement). Choices around the design of delegated legislation (including the distribution of decision-rights between government and the independent regulator) are also relevant. This view also reflects the potentially serious implications of delays, the technical subject matter, and the need for finality.

The case is more nuanced in relation to decisions made about individual regulated entities. These decisions apply the law, rather than making it: they therefore require different safeguards than apply to delegated legislation. For example, registered banks require Reserve Bank approvals or non-objections in order to undertake certain activities (such as issuing particular capital instruments). LDAC considers that the "starting point is that legislation should provide a right of appeal if the rights or interests of a particular person are affected by an administrative decision" (LDAC, 2018, p. 130).

Judicial review serves as an important and appropriate right of appeal in relation to Reserve Bank administrative decision-making. Judicial review helps to ensure that "regulators follow a proper process consistent with the statutory framework under which they operate and the requirements of natural justice" (Goddard, 2006, p. 3). In contrast, merits reviews are appeals that consider the correctness of a decision. While in theory merits review may sharpen the incentives faced by the Reserve Bank around administrative decision-making, it is not clear that this is the case in practice. For technical decisions, the Productivity Commission considers "merits review does not offer additional safeguards to ensure decision makers followed good processes, beyond those offered by judicial review" (Productivity Commission, 2014, p. 310).

[31] This is the approach taken in Australia, where disclosure rules are set through the same instrument as for capital rules (see APS 330).

There are also other options available that fall short of formal court-based processes that may substantively address natural justice concerns. Examples from other regulatory systems include:

- process requirements, such as the right to receive reasons, and to provide submissions (as is available in the FMC Act), or
- an independent or arms-length review body (e.g. the Rulings Panel under the Electricity Industry Act).

More broadly, some of the practical concerns raised by stakeholders about the current model relate to Reserve Bank resourcing and governance. The Reserve Bank is arguably under-resourced in terms of legal and regulatory policy expertise. As a result, there is an argument that many of the concerns being raised by stakeholders (and driving a desire for changes to the legal framework) could be more effectively addressed through greater funding and improved Reserve Bank processes. Changes in Reserve Bank governance, for example, may more easily allow significant regulatory decisions to be made by individuals that have not been previously involved in the matter to which the decision relates.

Questions for consultation

1.E What do you see as the costs and benefits of introducing enhanced process rights for administrative decisions? If you consider there is a case to introduce these rights, how should they be framed?

Responding to breaches of rules

In the event of a breach of prudential rules, it is important that the Reserve Bank has access to a sufficiently broad and proportionate set of regulatory tools to achieve its desired outcomes and meet its statutory objectives.

In considering the use of regulatory tools, the Reserve Bank faces a delicate balancing act. On the one hand, there is value in encouraging voluntary compliance and maintaining a close relationship with regulated entities. On the other hand, the Reserve Bank must credibly be able to take stronger action when appropriate (see Chapter 3).

There are elements of the Reserve Bank Act that do not support the Reserve Bank as it undertakes this balancing act.

Breach reporting

The Reserve Bank Act does not require registered banks to report breaches of CoRs to the Reserve Bank. Under the disclosure rules, a registered bank has to publish details of the nature and extent of any breaches of its CoRs in its next six-monthly disclosure statement. This risks limiting the ability of the Reserve Bank to make proactive and timely use of its regulatory tools.

The Reserve Bank has recently consulted on options that would require public and private reporting of breaches, potentially subject to a materiality threshold (RBNZ, 2018a). These options involve the use of the existing information gathering powers under the Reserve Bank Act.

In line with these proposals, it may be desirable to more fully empower this approach in the Reserve Bank Act itself, through a requirement for registered banks to report material breaches of rules to the Reserve Bank as soon as practicable. A provision of this nature applies to licensed entities under the FMC Act.

Liability framework

The emphasis on criminal liability for rule breaches in the Reserve Bank Act is arguably disproportionate to the nature of the underlying conduct it seeks to address. In most cases, criminal enforcement action will not be the most fit-for-purpose regulatory response. Indeed, the Reserve Bank has not taken enforcement action against a registered bank to date.[32]

While preserving the Reserve Bank's ability to take regulatory action, it may be preferable that criminal liability is removed for breaches of prudential rules that do not involve a fault element. Australian prudential rules are enforceable (for example through directions) but a breach of the rules is not itself an offence. An alternative model would be to provide for civil liability (such as pecuniary penalties) for material breaches of rules that do not involve knowing or reckless misconduct.

Such a shift would be consistent with a potential move towards a broader set of tools to allow the Reserve Bank to respond to breaches, including directions not subject to ministerial consent, enforceable undertakings, warning letters, and infringement notices. These tools are discussed further in Chapter 3. Reflecting the Reserve Bank's role as a risk-based regulator, it may also be possible to justify the use of regulatory tools (including the use of rule-making itself) in cases where no breach of rules has occurred (see Box 1B).

[32] In contrast to IPSA, individual liability under the Reserve Bank Act does not extend to breaches of CoRs – a breach of a CoR cannot be attributed to a director.

Box 1B: Rule-making as a regulatory response

While prudential rulebooks tends to apply on a class basis, many prudential regulators internationally use their discretion to calibrate those broader settings for individual entities. This use of discretion (often referred to as a 'supervisory adjustment' or 'Pillar 2') occurs where supervision suggests that the regulated entity has characteristics that create enhanced risk.

When supervisory review reveals a regulated entity has shortcomings in relation to guidance issued by the prudential regulator, the entity would normally be given an opportunity to remedy these shortcomings. If unaddressed, the prudential regulator may form a view that the shortcomings increase the risk profile of the regulated entity.

The prudential regulator could then elect to impose a larger institution-specific capital buffer, for example. The use of discretion is typically supported by a more detailed set of rules and guidance that provide regulated entities with transparency regarding the supervisor's expectations for good practice.

Where the gap between a regulated entity's practice and the practice expected by the regulator escalates to material non-compliance with the rules themselves, more significant regulatory tools may come into play (see Chapter 3).

The differences between the Australian and New Zealand FSAPs (with Australia demonstrating greater compliance with the BCPs) suggests that the use of supervisory judgement in rule-making is seen by the IMF as an appropriate and effective way to ensure prudential rules deliver risk-based outcomes. This suggests it is important (if the regulatory toolkit is being designed to facilitate a more BCP compliant rule-making and supervision framework) that the delegated rule-making powers available to the Reserve Bank are flexible enough to allow for discretion in calibrating the appropriate settings for individual entities.

Questions for consultation

1.F Is there a case to change the breach reporting and liability models that apply to regulated entities in the Reserve Bank Act? If so, what models would be preferable?

Executive accountability

'Executive accountability' refers to the accountability of individuals for meeting legal obligations relating to a regulated entity (for example, taking reasonable steps to ensure that a particular function within a regulated entity is controlled effectively). Despite the use of the term 'executive' these regimes may apply to both directors and senior executives. The obligations are distinct from the obligations that apply to the regulated entity itself.[33]

Following the GFC, a number of jurisdictions have introduced relatively detailed executive accountability regimes. Examples include the UK's Senior Managers regime, Hong Kong's Manager in Charge regime, and APRA's Banking Executive Accountability Regime (BEAR) (see Box 1C below). In part, the introduction of these regimes has reflected a view in these jurisdictions that previous approaches to providing self-discipline proved ineffective.[34]

In theory, executive accountability regimes can reinforce the incentives on individuals to avoid regulatory issues emerging within their area of oversight. An executive accountability regime may also:

- provide clarity and formalise regulatory expectations regarding accountability and governance within regulated entities
- improve the ability of the regulator to take regulatory responses, by allowing supervisory or enforcement action to be more targeted.

At the same time, executive accountability models reflect a departure from the standard liability framework (both in New Zealand and internationally) for prudential regulation, which focuses on the regulated entity, and are supported by broader legal duties on directors (such as those under company law). This can have a number of drawbacks:

- While the duties applied through executive accountability regimes are difficult to argue with in the abstract, there can be challenges in determining what certain duties may mean in practice.
- Depending on the form of the regime, executive accountability models can impose significant costs to regulated parties and the regulator.
- The introduction of individual liability can create risk-averse behaviours, particularly in larger firms where direct oversight is more challenging. This may encourage a 'tick-box' approach on the part of executives, rather than the shift in risk culture that executive accountability seeks to provide. In some cases current and future directors and senior managers may be discouraged from taking on roles.

[33] Although under some models the duties may be linked, for example with the regulated entity as the primary contravener.

[34] The UK's Parliamentary Commission on Banking Standards, for example, took the view that directors and senior managers "dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision-making". Parliamentary Commission on Banking Standards, 2013, p. 8).

Box 1C: Executive accountability

The executive accountability regimes introduced in Australia, the UK, and Hong Kong are oriented around a number of key features. These features are the following:

- A **registration or approval regime** for directors and senior managers.
- The **application of duties** to the firms, executives and senior managers. Under the Australian BEAR regime, for example, these duties include:[35]
  - acting with honesty and integrity
  - acting with due skill, care, and diligence
  - dealing with APRA in an open, constructive and cooperative way.
- **Accountability maps**. These maps set out the specific responsibilities for directors and senior managers subject to the accountability regime.
- A **liability regime** that:
  - provides consequences for individuals in the form of deferred remuneration. These consequences are applied by the firm itself: their remuneration framework must provide for a reduction in variable remuneration should an accountable person fail to comply with their obligations, and the firm must exercise the provision if necessary
  - provides civil liability to the entity for breaches. These penalties can potentially be quite large: 'large' ADIs in Australia can be subject to civil pecuniary penalties of up to AU$250 million[36]
  - allows for the regulator to potentially remove an accountable person from their role, and in some cases prevent them taking on any similar role in future.

The role of the attestation regime

The Reserve Bank Act creates a form of executive accountability for registered banks through the 'attestation regime'. As discussed earlier in this chapter, the regime applies to directors of all registered banks and to the New Zealand CEOs of overseas incorporated banks. The Reserve Bank considers that individual director accountability is an important element of the prudential framework, being an integral part of the self-discipline pillar.

In 2017 Deloitte completed a review of the regime (the 'Deloitte Review') at the request of the Reserve Bank. This thematic review was partly in response to the 2016/17 IMF FSAP. The IMF assessors were concerned that the Reserve Bank did not undertake independent verification of banks' internal risk management practices and board effectiveness. Moreover, in the absence of any prudential rules or expectations from the Reserve Bank on what constitutes effective risk management, it was unclear on what basis directors were making their attestations.

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[35] In Australia, see for example section 37CA of the Banking Act 1959.

[36] With a large ADI defined as one having total resident assets greater than or equal to AU$100 billion on a three year average basis.

The Deloitte Review reflected positively on the risk culture created by attestations. The Deloitte Review found that directors "appeared unanimously aware and mindful of their personal responsibilities under the attestation regime. This extended beyond a purely legal view to embrace the substance of their attestations" (Deloitte, 2017, p. 5).

However, the Deloitte Review also identified several potential vulnerabilities with the attestation regime, including an absence of guidance around risk culture, and a degree of inconsistency and uncertainty regarding what registered banks were attesting to in practice.

Options for change

The following paragraphs provide a high-level overview of the options that could be considered for enhanced executive accountability.

These options need to be considered in light of the existing attestation regime, and the broader rule-making powers available to the Reserve Bank in relation to individuals (such as fit and proper requirements, discussed earlier in the chapter). Broader changes to the Reserve Bank Act could also help support executive liability, such as changes to the fit and proper regime, or the introduction of 'accessory liability' for breaches. Accessory liability can be used to capture those persons 'involved in' a contravention, even if they do not have direct liability.[37]

Account also needs to be taken of the potential interaction between executive accountability and other liability regimes that could impact on the prudential regulatory system. The Government has recently consulted on the option of introducing executive accountability in conduct regulation.

Option 1: Enhanced status quo

An 'enhanced status quo' model would retain the broader attestation framework, while seeking to address the potential vulnerabilities of the attestation regime through operational changes, such as:

- using the Reserve Bank's prudential rule-making power to further set out its expectations in relation to risk management, and perhaps requiring disclosure of accountability arrangements within registered banks[38]
- providing further guidance and increasing supervisory engagement in areas such as board composition and performance.

The model would have the benefit of using an existing regime that is well understood by regulated entities.

The weaknesses of the attestation regime relate to the proportionality of the liability framework. The attestation regime is implemented through the disclosure rules. These rules provide for criminal liability of directors (and the New Zealand CEO of overseas incorporated banks) for false or misleading statements, even when there may have been no fault element. This is not consistent with

[37] An example can be found in section 533 of the FMC Act. Under IPSA the Reserve Bank is able to attribute a conviction against the entity to a director where they consented to the breach occurring, or ought to have known it would occur and failed to prevent it.

[38] For example, via a standard equivalent in substance to APRA's CPS 220. CPS 220 requires the board of an APRA regulated entity to provide an annual declaration on risk management.

current good practice for criminal offences (LDAC, 2018, pp. 112-3), and may make it harder for the Reserve Bank to take regulatory action.[39]

Option 2: A reframed attestation regime

A reframed attestation regime would decouple the attestation regime from the disclosure rules, but would retain the existing focus on directors. This could be achieved by, for example, creating high-level duties that applied to the registered bank, under a civil liability framework. Duties could then be applied to directors in a number of ways, including:

- a '**positive accountability**' regime that requires individuals to take certain actions separate to those of the regulated entity (for example, to take reasonable steps to ensure that the entity is being run in a prudent manner), or
- a '**deemed liability**' regime. Under a deemed liability approach, if an entity has contravened a relevant provision then the directors of that entity are also treated as having contravened that provision.

In general, the former model would seem most appropriate in an environment in which the duties on individuals are ongoing, rather than existing at a specific point in time (as is the case for disclosure under the FMC Act).[40]

These changes would more clearly focus the attestation regime on the key underlying conduct (being director oversight of risk management and risk culture). Shifting the liability framework would also allow for the application of a more proportionate set of enforcement tools, such as civil pecuniary penalties for the regulated entity.

Such a regime would nonetheless need to be enforced through the courts, and there will need to be protections for individuals, such as rights of review or appeal. There are also risks around the alignment of obligations with existing company law duties.

Option 3: A 'senior managers' regime

Option 3 would represent an extension on Option 2 to something closer to the executive accountability arrangements recently introduced in other countries (See Box 1C).

A senior managers regime would extend beyond directors (a clearly identifiable group of individuals), and capture senior managers involved within certain control functions or business lines. Introducing such a regime would require a high degree of clarity around:

- the senior managers that sit within the scope of the regime
- the obligations that fall on those senior managers, and the steps they need to take to discharge them.

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[39] In a recent finance company case based around liability framework that applies for disclosure rules in the Reserve Bank Act, the Supreme Court noted that "It is not easy to think of cases from any area of the criminal law in which imprisonment has been seen as an appropriate response to offending where culpability arises out of a misjudgement by people who took their responsibilities seriously and where the consequences have been economic and have not involved physical injury or death". See *Graham v R* [2014] NZSC 55 at paragraph 30.

[40] Deemed liability exists for directors in sections 533-536 of the FMC Act, covering disclosure breaches for product disclosure statements.

A senior managers regime would provide the Reserve Bank with a broader toolkit for regulatory responses.[41] Introducing a regime would mean a clear shift towards a more intrusive supervisory model with a greater focus on the actions of individuals, rather than the regulated entity as a whole. Given the UK, Australian, and Hong Kong models have been enacted in the near past, there is not yet sufficient experience to derive lessons for New Zealand on their effectiveness.

Questions for consultation

1.G Is there a need to increase executive accountability?

1.H If so, which of these models would be most effective in doing so, and why?

Summary

This chapter has identified a number of potential issues with the Reserve Bank Act framework for rule-making, and presented several options for reform:

- 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.
- Increasing process rights for administrative decisions.
- Adjusting the liability model from criminal to civil, alongside changes to breach reporting.

[41] For example, the Bank of England consider that the Senior Managers regime "provides a valuable supervisory tool where new market practices and risk emerge. In such cases, the PRA can remind firms of the need for appropriate oversight by one or more Senior Managers" (Bank of England, 2018, p. 6).

Chapter 2: What role should the Reserve Bank play in macro-prudential policy?

Aim of this chapter

This chapter examines the Reserve Bank's powers and approach in the area of macro-prudential policy. Macro-prudential policy has been used in New Zealand since 2013, and was a topic of interest to stakeholders when this review was scoped. The terms of reference for this review includes an examination of how policy has been conducted over that period. The key forward-looking questions are firstly how broad the powers should be in this area, and secondly whether special governance arrangements are appropriate for some macro-prudential tools (such as LVRs).

The role of 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. After the GFC, when some countries' problems in particular institutions or markets led to a full blown financial crisis, most countries have taken a more macro-prudential approach. However, the extent of change varies by country.

In New Zealand, the main change since the GFC has been an increased willingness to vary regulatory controls on banks over time, in order to lean against periods of instability, where 'credit, asset price, or liquidity shocks' mean credit is being originated in ways that could worsen future risks or imbalance the economy. There has also been a willingness to use relatively intrusive tools (such as LVRs), which can directly affect individual borrowers.

The Reserve Bank and the Minister of Finance agreed that a time-varying macro-prudential approach to bank regulation was appropriate in a 2013 MoU. This identified a toolkit of time-varying tools and a set of intermediate objectives for their use, and involved the Reserve Bank agreeing that special consultation requirements would apply to those tools.[42] It was also agreed that the macro-prudential framework would be reviewed after five years. That review has become part of this wider Phase 2 Review of the Reserve Bank Act.

The Reserve Bank has recently produced two documents that provide useful background for this chapter. They describe the Reserve Bank's current framework for macro-prudential policy actions (Ovenden, 2019), and a view of how that policy approach has evolved over the last five years (Lu, 2019).

The current macro-prudential framework is based on the current legislation, which specifies who is responsible for the policy (the Governor) and the available powers and high-level objectives. The 2013 MoU supplements this. As the high-level changes proposed elsewhere in this consultation

[42] The Reserve Bank has taken or proposed other actions (such as more stringent capital rules for systemically important banks) which would be seen as macro-prudential in the sense the term is generally used internationally. However, they are not time-varying, so are not subject to the MoU and are not in the scope of this chapter.

document are made (e.g. to the Reserve Bank's high-level objectives, governance structure and prudential powers), it is appropriate to consider whether further specific changes to the legislative framework for macro-prudential policy are needed. This discussion is organised around four key potential issues:

- **Objectives** – how broad should the macro-prudential policy objectives be? In particular, should macro-prudential policy aim only to keep lending institutions solvent in a downturn, or should it more actively lean against the credit cycle? Chapter 2 of Consultation Document 2A suggests a set of objectives related to financial stability that includes broader considerations such as "mitigating excessive variability in the financial cycle".
- **Extent of powers** – in particular, is it appropriate to regulate 'lending standards' (e.g. LVR and DTI restrictions) to help ensure financial stability? This chapter considers why there may be a case for this, and looks at international data on the use of these tools. Whether it is appropriate to regulate lending standards depends partly on whether the macro-prudential policy objectives are sufficiently broad, so this issue is dealt with alongside the consideration of objectives.
- **Governance** – should the Reserve Bank, as an independent prudential regulator, make macro-prudential decisions using the group-decision-making model outlined in Consultation Document 2A? For certain tools, the Reserve Bank could be required to involve the Minister and relevant agencies, as provided for under the existing MoU.
- **Accountability and clarity** – currently, the Reserve Bank's powers to undertake macro-prudential actions stem from the Reserve Bank Act. However, under the MoU the Reserve Bank agreed to limits on the use of those powers; for example, it is envisaged that the MoU will be renegotiated before additional macro-prudential instruments are used. This chapter considers whether it would be clearer to put key components of the macro-prudential framework in primary and secondary legislation instead. This could also set out additional accountability and governance arrangements. For example, the Reserve Bank might be obligated to consult other agencies and publish the reasons for its decisions, particularly for more controversial tools such as lending standards.

While macro-prudential policy is a special case of prudential policy more broadly, the focus on time-varying tools means it also has some similarities to monetary policy. A background paper accompanying this consultation considers the arguments for policy independence in macro-prudential policy, comparing macro-prudential policy with monetary policy and broader prudential policy (Davies, 2019).

The rest of this chapter summarises the Reserve Bank's current macro-prudential approach and the history of its use since 2013. It then considers the above issues in some detail, before outlining options and recommendations.

The existing macro-prudential framework and its use

Table 2A summarises the Reserve Bank's powers to use macro-prudential policy, and the associated processes it has adopted. It draws on a recent framework document produced by the Reserve Bank (Ovenden, 2019).

Table 2A: Summary of the Reserve Bank's macro-prudential approach

Purpose and powers	▪ Part of a statutory mandate to "promote the maintenance of a sound and efficient financial system". ▪ Uses powers to impose conditions on banks, with scope as defined in the Reserve Bank Act (see Chapter 1). ▪ MoU defines a specific toolkit for time-varying tools, which has created an expectation that it would be renegotiated before additional cyclical tools were used. ▪ Defined in MoU to have a particular focus on "actively leaning against time-varying systemic risk" (e.g. excessive credit growth or asset price volatility). ▪ The framework document (Ovenden, 2019) provides a detailed description of sources of systemic risk and how macro-prudential policy can help to alleviate them.
Approach	▪ Identify risks to the financial system – the framework document includes a list of relevant indicators of risk and more general considerations, but also makes it clear that macro-prudential decisions are likely to remain less rule-based (i.e. require more judgement) than decisions in areas such as monetary policy, where targets are clearer. ▪ Based on the nature of the risk, consider whether a macro-prudential response is warranted (and what sort – see Table 2B). ▪ Evaluate the impacts of the proposed policy, including its likely effects, potential unintended consequences, and impacts on monetary policy objectives. ▪ If policy is enacted, continue to monitor its impact and consider potential policy adjustments.
Accountability and transparency	▪ Consult Minister and the Treasury on the proposed policy (as required by MoU), then consult public. ▪ Explain policy and its assessed impact, including in consultation documents and the semi-annual *Financial Stability Report* (FSR).

Table 2B summarises the specific tools listed in the MoU.

Table 2B: Existing macro-prudential toolkit

Tool	Short description
Countercyclical capital buffer (CCYB)	Additional capital that banks must maintain or face dividend restrictions. Allows losses to be absorbed in a downturn, putting banks in a better position to continue lending.
Sectoral capital overlay	Additional capital that banks must maintain for lending to a particular sector (e.g. mortgages). Can be removed in a downturn.
Core funding ratio (cyclical adjustment)	Adjustment to the limits on a bank's short-term wholesale funding. Can encourage prudent funding during booms and reduce 'rollover' problems for banks in downturns.
Loan-to-value ratio restriction (LVR)	Limits the proportion (the so-called 'speed limit') of mortgage loans that are to borrowers with small deposits (high LVRs).

The first three tools primarily affect banks (controlling capital and liquidity). LVRs, in contrast, are transactional instruments that have a more direct impact on borrowers. They are the only transactional instrument in the current toolkit, but the Reserve Bank discussed the possibility of adding serviceability controls (controls on the size of mortgages relative to borrowers' incomes, such as DTIs) with the Minister during 2017. This led to a public consultation and increased statistical reporting, but DTIs were never introduced or added to the list of tools in the MoU.

The more that the objectives and strategies for a policy area can be made clear, the stronger the case for delegating those tools to an independent regulator. The framework document (Ovenden, 2019) is a step towards systematically describing macro-prudential strategy, and has some similarities to the 'policy statements' produced by the Bank of England's FPC for each of its macro-prudential policy tools. The Reserve Bank is also considering developing policy statements for particular tools in the future.

Overall, these framework documents should help the public to understand how the Reserve Bank plans to use the powers to support its prudential objectives. The framework document is likely to evolve over time, especially as this Review leads to changes to governance, objectives and other legislative arrangements.

However, in comparison with monetary policy, macro-prudential policy has a less well-specified quantitative target and a less well understood transmission mechanism (i.e. how the tools achieve the desired outcomes is less clear). This means that cyclical macro-prudential policy is unlikely to be as predictable as monetary policy, even if the framework becomes better understood over time (see also Davies, 2019).

Question for consultation

2.A Does the Reserve Bank's framework document (Ovenden, 2019) present its expected macro-prudential strategy in enough detail to allow monitors to ensure the Reserve Bank is following the strategy and predict future macro-prudential actions?

The Reserve Bank decided to introduce LVRs in 2013, and has adjusted them several times since, but has not used any other time-varying macro-prudential tools. The lessons learned from this experience are discussed in Lu (2019). This Review invites feedback on that experience and its implications for the appropriate future use and governance of macro-prudential policy.

Lu describes the implementation (and tightening) of the LVR policy between 2013 and 2016. This analysis also covers the policy's estimated impacts on core objectives such as the proportion of high-LVR mortgages outstanding, and ancillary issues such as the impacts on first home buyers. Points made by Lu's review include:

- LVRs mitigated financial stability risks by reducing the number of borrowers who would have defaulted in a severe housing downturn, thereby reducing the losses for banks in that scenario. The reduced borrower defaults would be due to:
  - households having deeper equity buffers at the time they took out their mortgages
  - the restrictions reducing house purchases during the boom, and so reducing the peak level of house prices.
- There was some confusion resulting from the LVR policy being justified as a way to lean against house prices. While this is part of the way that LVRs safeguard financial stability, there is a risk that communicating the 'stopping house price rises' effect will lead to it becoming wrongly interpreted as the policy's core goal – which could have adverse effects on the Reserve Bank's credibility. The impact of LVRs on house prices is relatively small; it will limit surges rather than stop them entirely.
- LVRs can create distortions and be counterproductive in correcting housing market imbalances (e.g. if they limit new construction). The Reserve Bank considers that the adopted speed limit approach (which limits rather than banning high LVR mortgages, and has helped first home buyers to continue purchasing despite the ongoing restrictions), and the selected use of exemptions for activities such as new construction have helped to limit these distortions.
- The Reserve Bank's tightening of LVR restrictions in 2015 specifically targeted the Auckland investor market. While this appeared to have an impact, it may have also contributed to the fuelling of housing market activity outside Auckland. In any event, when restrictions on investors were tightened further in late 2016, the regional distinctions were removed.

Instead of using LVRs, or as a supplement, the Reserve Bank could have:

- Required banks to maintain, temporarily, deeper capital buffers in response to the emerging housing risk. This would not have materially limited banks' potential losses on mortgage lending, or affected credit or the housing market, but it would have allowed those losses to be absorbed if housing risks crystallised.

- Tightened core funding requirements during the housing boom, which would have given the banks fewer concerns about rolling over funding during a future downturn.

However, neither of these alternatives would have had material effects on the resilience of household balance sheets. Lu (2019) outlines why this factor led the Reserve Bank to adopt LVRs as the key response to the booming housing market.

Since it tightened the LVR policy, the Reserve Bank has consulted further on prudential capital policy, including the idea of running a macro-prudential countercyclical buffer (CCYB) that, instead of being used only during periods of elevated risk, would be maintained at a non-zero level (perhaps 1.5 percent) and only turned off to support lending during financial crises. The buffer could also be increased beyond its standard level during periods of elevated risk, using the indicators discussed in the framework document.

However, it is not clear that the Reserve Bank would choose to use cyclical changes to the CCYB more actively (as a substitute for or complement to policies like LVRs) if similar circumstances to 2013 arose again.

Questions for consultation

2.B What are your views on the conduct of macro-prudential policy in the past five years? It may be useful to read the recently released framework document (Lu, 2019) and the sub-questions below:
- Are there any lessons to be learned from New Zealand's experience with loan-to-value ratios (LVRs) to date?
- Do you think LVR policies that have greater impacts on certain buyers (e.g. investors) or regions than on others are appropriate?
- Has the Reserve Bank's 'speed limit' approach reduced risks without affecting too severely buyers who may need high LVR loans owing to special circumstances?
- Would a greater use of macro-prudential tools other than LVRs have been appropriate during the recent housing boom?

Potential issues with the current macro-prudential framework

Issue 1: Breadth of objectives, and what macro-prudential powers should be available

The Reserve Bank's existing prudential powers under the Reserve Bank Act (currently, the power to impose CoRs on banks) provide the statutory basis of macro-prudential policy. For example, LVRs are imposed as part of the Reserve Bank's legislative power to regulate the 'risk management' systems used by banks. Most of its prudential powers could potentially be used in macro-prudential ways – for example, the BoE regards a portion of the permanent capital requirements of its large banks as a 'macro-prudential' overlay (see Brazier, 2016). On top of that, the CCYB provides an additional time-varying macro-prudential overlay.

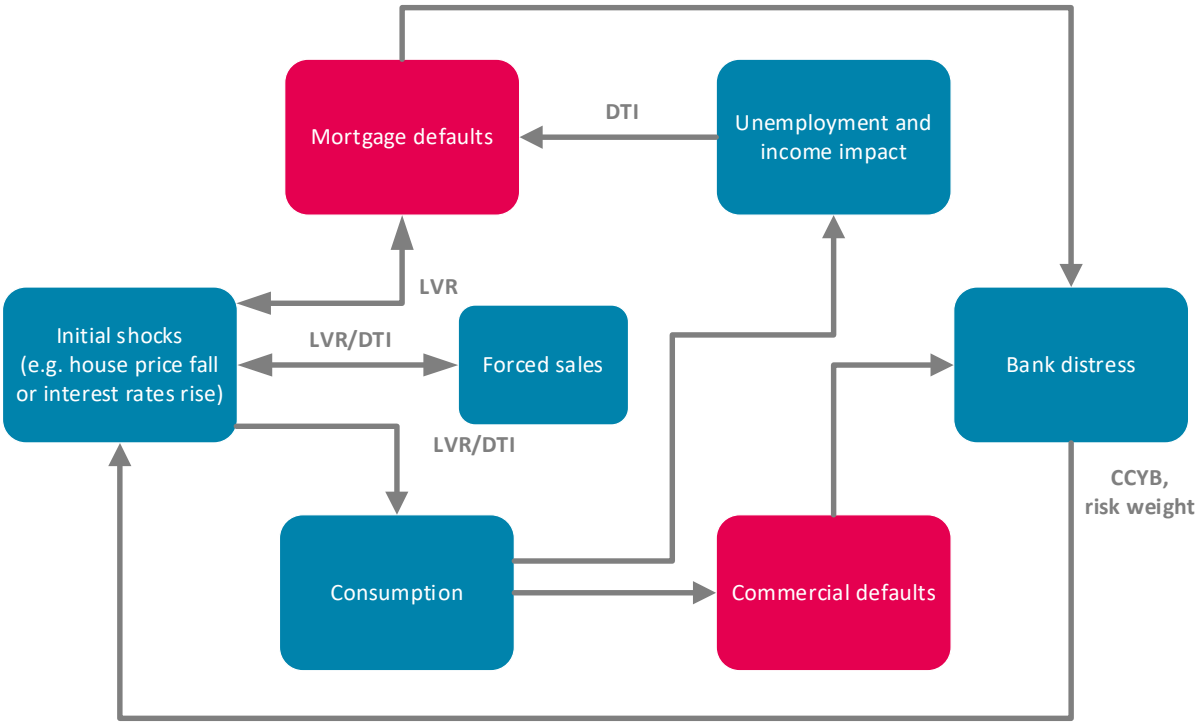
The macro-prudential use of core prudential tools like capital requirements seems relatively uncontroversial. In contrast, there are questions about whether tools that are more purely macro-prudential, such as lending standard restrictions, are appropriate. This section discusses the purpose of lending standard restrictions, their special features and the extent to which they are used internationally.

Addressing market failures using lending standards

As LVRs and DTIs for households get larger (borrowing increases), the number of households that will be pushed into default or forced to sharply reduce spending in a downturn increases. This can have important 'amplification' effects and make the downturn significantly worse.

However, it is not rational for individual households or lenders to consider the risk of increased amplification when they take on a mortgage, as their personal contributions to the risk are very small. As Figure 2A shows, LVRs and DTI policies have the potential to reduce amplification effects, while policies such as CCYB or boosting risk weights help to keep banks solvent but do not directly address the 'externalities' at the household level. These issues are discussed further in Ovenden (2019).

Figure 2A: How lending standards policies can affect the economy



The Reserve Bank suggested that DTI restrictions would be a useful addition to the macro-prudential toolkit (RBNZ, 2017). LVRs and DTI restrictions both aim to reduce the risk of borrowers getting into difficulty during an economic downturn, in different but complementary ways:

- Through DTI restrictions most borrowers have mortgages that are not unusually large relative to their incomes, so they are more resilient to periods of reduced income or rising interest rates.
- Through LVR restrictions borrowers are less likely to see their equity in property disappear when house prices fall. This makes it easier for them to manage house price declines and provides an ongoing incentive to keep servicing their mortgages.

Distributional consequences of lending standard (LVR and DTI) policies

Most prudential policies affect the decisions of a financial institution without creating a bright line that prevents or limits its ability to undertake certain sorts of business.

For example, capital regulation requires a bank to fund a proportion of its lending with equity. Riskier loans may require a higher level of equity funding, but are not normally prohibited. In contrast, a binding LVR or DTI limit is likely to prevent certain borrowers' borrowing. So while all prudential policies have the potential to generate efficiency costs (especially if they are mis-calibrated), lending standards have greater intrusiveness and 'distributional consequences' for individuals. This is a significant reason for society being potentially hesitant to maintain this sort of macro-prudential control.

International practice compared with New Zealand's

LVRs are increasingly common internationally. In a cross-country dataset produced by Edge and Liang (2017), around two-thirds of the sample (39 out of 58) use formal LVR requirements. In addition, some countries that do not have formal requirements still have regulators that issue

'recommendations' on LVRs to banks and other deposit-taking institutions (e.g. Czech Republic, Slovenia, and Denmark – see ERSB, 2018). Overall, it appears that having some sort of LVR policy is becoming quite common. DTIs are also fairly common (see RBNZ, 2017, section 4).

Restrictions like LVRs are also often applied as a complement to other prudential requirements and supervision efforts related to mortgage origination. For example, APRA's Prudential Practice Guide APG 223 Residential Mortgage Lending (discussed further below) guides mortgage origination by Australian banks. System-wide restrictions are only introduced if they appear to be a necessary complement to this supervisory process. The Reserve Bank does not commonly apply this 'enforceable standard' approach, as the IMF FSAP noted in 2017, so LVRs are more central to managing systemic risk from the mortgage market in New Zealand.

The MoU envisages macro-prudential policies being applied temporarily. While this is uncontroversial for tools such as the CCYB, which overlay permanent capital requirements, most countries that apply LVRs and DTIs do so on an ongoing basis (although they may strengthen settings during credit booms).

The New Zealand expectation that these tools would be used only during credit booms is relatively unusual. This suggests that if the Reserve Bank retains legal powers to apply lending standards, those powers (and associated governance arrangements) should not be limited to temporary applications only.

Extent of powers should match breadth of objectives

As discussed earlier, the question of whether the Reserve Bank should have the power to control lending standards relates to whether the Reserve Bank should have an objective such as 'mitigating excessive variability in the financial cycle'. Most prudential tools have little impact on financial cycle upswings, so the Reserve Bank may need tools like controls over lending standards to achieve this sort of objective.

Consultation Document 2A also suggests that, in using prudential powers, the Reserve Bank could be required to consider the MPC's economic objectives. This would be very much a secondary consideration, but as described in Ovenden (2019), macro-prudential policy (especially lending standards) could potentially provide a useful complement to monetary policy in some circumstances.

Issue 2: Governance: Who should decide on macro-prudential policy?

Edge and Liang (2017) summarise international practice on macro-prudential decision-making. Some key observations from that paper and the accompanying dataset include:

- Macro-prudential powers are not always assigned to central banks, but if a central bank is the prudential authority for the banking sector, it is usually in charge of macro-prudential decision-making.
- Twenty two countries assign LVR decision rights to the central bank. By contrast, in five countries the central bank is listed as a bank regulator but another party makes LVR decisions:
  - In the UK, decisions are made by the FPC, which is a separate decision-making body closely associated with the BoE.
  - In the US, LVR decisions are made by the regulators of mortgage insurers.

  - In Slovakia, Spain and the Netherlands, LVR policy is listed as being a decision for the Ministry of Finance or the government.

- In 31 countries the central bank makes CCYB decisions. In only three the central bank is listed as a bank regulator but another party makes CCYB decisions: the UK (where decisions are made by the FPC); and Germany and Austria, where the central bank is one of a number of bank regulators, and another party makes CCYB decisions.

Generally, most countries' laws imply that a central bank or separate prudential authority with macro-prudential powers can use these powers independently. However, this is not always the case:

- In some countries the Minister may have a substantial influence on decisions (e.g. because there is less tradition of prudential policy being undertaken independently).
- With macro-prudential policy specifically, it is fairly common to have an interagency committee to discuss policy. This may have an agency chair linked to a minister (e.g. the Treasury). The committee often has the power to recommend policy actions to the agency that implements macro-prudential policy (sometimes with a requirement for the agency to either 'comply or explain'). Arrangements like these may build legitimacy, but they could also put pressure on the central bank, for example to not act if the government does not favour action.
- Some countries have relevant statutory committees (with external members who are not members of related agencies), like the UK's FPC. However, this governance arrangement is relatively rare and these committees are not always fully in charge of policy. In Malaysia's case, for example, the committee has the power to recommend extensions to the regulatory perimeter, but not to make decisions about policy within the existing perimeter.

The chapter next considers conceptual arguments for and against delegating macro-prudential powers to an independent regulator. This draws on a conceptual background paper (Davies, 2019) that accompanies this consultation.

A reason to not delegate: distributional consequences

Some commentators have suggested that policies directly affecting lending decisions (e.g. LVR and DTI restrictions) may be too strong a power for the government to delegate them to the central bank or separate prudential authority. For example, Edge and Liang (2017) quote the Belgian central bank as saying that it did not think it appropriate for the central bank to control 'mortgage debt ceilings'. The exact boundaries are open to debate: Tucker (2018) agrees that a hard ceiling is too intrusive to delegate, but suggests that a speed limit on high LVR or DTI lending may be delegated.

As well as being a strong power to delegate, the policies' controversial nature may be detrimental to the central bank; the use of policies like LVR and DTI could require substantial management attention or weaken the central bank's reputation in other policy areas.

On the other hand, it has long been accepted that prudential supervisors may impose rules restricting the assets that banks can hold (see, for example, Mishkin 2000), and/or discourage certain assets with the threat of supervisory sanction. In this sense prudential policies that have distributional consequences are not really new, but they may have been implemented more transparently in recent years. For example, APRA's Prudential Practice Guide APG 223 Residential Mortgage Lending guides banks' mortgage origination practices, and APRA has publicly said that since the guide's release, supervisory assessments of bank practice have led to behaviour changes

among banks and reduced the size of loans available to average borrowers (Richards, 2016). Given that independent regulatory actions like these are well accepted, it could be argued that macro-prudential tools like LVR limits could also be appropriately delegated.

The 'distributional consequences' argument applies most strongly to lending standards, as the other key macro-prudential tools (capital and liquidity buffers) have less significant distributional consequences.

A reason to not delegate: difficulty specifying goals

Some analysts have noted that the goals of macro-prudential policy are difficult to state objectively and monitor. With monetary policy the central bank can be delegated an inflation target, and the public and the government can monitor its achievement of that target. It is harder to specify a desired prudence level in setting prudential requirements, including macro-prudential policy settings. It is also difficult to monitor what has been achieved; for example, it is hard to know if macro-prudential policy prevented a crisis if one did not occur.

This argument also generally applies to broader prudential policy, but despite this it is considered international best practice for prudential policy settings to be developed independently of government (see the second core principle of the Basel Committee's international standards for effective banking supervision [BCP 2]). In the absence of a quantitative target, the BCPs stress the delegation of broad objectives from government, and that the supervisor should then be "accountable through a transparent framework for the discharge of its duties in relation to those objectives". Chapter 2 of Consultation Document 2A sets out proposed enhancements to the Reserve Bank's objectives and the framework for their discharge.

A reason to delegate: time inconsistency

This appears to be the strongest argument for delegating macro-prudential policy to an independent authority. Decisions to lean against the financial cycle, like decisions to tighten monetary policy, have visible short-term costs (e.g. restricting lending and reducing near-term economic growth). The long-term benefits are harder to quantify and not immediately apparent. This can make the decisions difficult for elected representatives, as they may have heightened concerns about near-term public opinion, leading to potential for 'inaction bias'.[43]

As a related point, there is some evidence that policies tend not to be very strict in the countries where they are clearly out of the central banks' hands. For example, Edge and Liang (2017) note cases where the central bank was keen to see a CCYB put in place, but it did not happen (or happened later) because the Minister did not initially accept that recommendation.

A reason to delegate: technical nature of decision

Some analysts have noted that macro-prudential policy decisions require a lot of technical judgements, including in relation to regulatory aspects (designing a policy that is effective and enforceable) and economic analysis (e.g. working out a policy's impact on macroeconomic aggregates and default risk). As Tucker (2018) notes, this is arguably not a strong argument for

[43] This is also a reason to delegate broader prudential powers to an independent authority, as discussed in Chapter 1. But the case is probably even stronger for cyclical tools, as the short-term consequences of tightening during a boom will be more readily apparent than they would for permanent prudential tools.

delegation as experts can prepare policy advice for a final ministerial decision (as is common in other areas such as tax and debt management). However, this could lead to delays.

Table 2C: Summary of arguments for and against independent macro-prudential policy

Reasons to delegate decision to regulator	Reasons for elected representatives to decide
▪ Time inconsistency.	▪ Difficulty in specifying goals.
▪ Technical nature of policy assessment.	▪ Distributional consequences of policy.*

* Applies mainly to lending restrictions like LVRs.

Issue 3: Clarity and accountability

As described above, the Reserve Bank has used long-standing prudential powers to implement macro-prudential policy. The MoU supports this approach, and its development involved the Reserve Bank identifying a particular suite of macro-prudential tools, and committing to consult in additional ways before implementing macro-prudential policy.

Every-Palmer (2017) noted that the MoU had sometimes been interpreted as constraining the Reserve Bank's legal powers, but that it inherently could not override those legislated powers. To make things clear, it seems appropriate as part of this Review to put any additional consultation and accountability provisions that should apply to certain macro-prudential tools into legislation or a secondary instrument like a remit (see Chapter 2 of Consultation Document 2A). This would make the MoU unnecessary.

As argued above, and using the international definition of macro-prudential policy, most of the Reserve Bank's prudential powers can be used in macro-prudential ways. The tools listed in the MoU are all time-varying, and as a result the New Zealand definition of 'macro-prudential' has tended to be limited to time-varying tools, which is not the way the term is commonly used internationally. Eliminating the MoU should allow the term 'macro-prudential' to be used in the internationally accepted way without creating confusion. The Reserve Bank's powers to impose prudential and macro-prudential regulations (and any special safeguards for certain tools, such as lending standards) would be defined by the Reserve Bank Act and remit.

The Reserve Bank Act contains the baseline accountability and transparency arrangements for prudential powers, including obligations to consult (see Chapter 1), relate functions to objectives in the *Statement of Intent* (SOI) (see Chapter 2 of Consultation Document 2A), and other obligations such as publishing an FSR.

It may be appropriate to include additional accountability or transparency arrangements for certain macro-prudential tools (e.g. all explicitly time-varying tools, or lending standards). These could be required by primary legislation or the remit, or be voluntarily agreed to by the Reserve Bank. For example, it may be appropriate to list the current settings of all time-varying tools in the FSR every six months, and justify them based on current risk assessments.

Box 2A: Macro-prudential policy assessment from the IMF's FSAP

The IMF (2017d) included an assessment of New Zealand's macro-prudential framework and policies in its 2016/17 FSAP review. In terms of the time-varying tools considered in this chapter, it generally approved of New Zealand's framework: "The clear mandate…, independent decision making (by the Reserve Bank), transparent communication and external accountability form the basis of the strong framework put in place" (p. 5).

If expanding the toolkit requires Ministerial approval, the IMF favoured this happening through a transparent process: "RBNZ advice and the opinions of the Minister on the need for adjustment should be publicly disclosed" (p. 5).

Finally, it favoured broadening the range of lending standard tools available to the Reserve Bank: "Limits on debt to income (or measures of a similar nature) should be part of the toolkit" (p. 6).

Options

Should the Reserve Bank have a sub-objective that relates to mitigating excessive variability in the financial cycle? Should lending restrictions remain an available tool? If so, how broadly should they be defined?

LVRs were a new policy to New Zealand in 2013. They are more intrusive than most prudential policies used in New Zealand, but have become common internationally and appear to have had a role in limiting the build-up of housing market-related risks during the recent housing boom. Retaining the Reserve Bank's power to impose LVRs would give it more scope to achieve a 'mitigating variability' sub-objective, if it is seen as appropriate (this issue is also discussed in Consultation Document 2A).

The Reserve Bank's power to apply LVRs is currently part of a broader power to direct the design of 'risk management systems'. If powers to control lending standards were written in a more specific way, there would be questions about the precise design. For example, a power to 'regulate the size of lending relative to customer income and collateral' would allow for LVRs to be applied to other sectors (e.g. commercial property) and also allow for DTIs. This would be quite broad (although still more specific than the existing power); a different wording could give a narrower power.

The Reserve Bank's power to apply LVRs is currently contained in the powers to regulate banks in the Reserve Bank Act. While lending standards could continue to be empowered alongside other prudential controls over banks (and other deposit-takers, as proposed in Consultation Document 2A), an alternative could be to make lending standards applicable to all relevant lenders (even if they do not take deposits).

This could be desirable, because lending restrictions can potentially be undermined if non-deposit taking lenders are willing to offer the loans that the Reserve Bank has restricted. In many other countries, lending restrictions are applied to all lenders by default, rather than simply to deposit takers, but it would be a significant change in New Zealand. A compromise may be to apply the restrictions to deposit takers only by default (as in recent changes in Australia) but retain the option of extending the perimeter (as discussed in Consultation Document 2A).

If the Reserve Bank retains powers for time-varying prudential tools, should any special governance or other arrangements apply to those tools?

The options here would range from Reserve Bank independence to a fully non-independent process (e.g. requiring Ministerial sign-off for changing time-varying policies).

However, it appears that there are not particularly strong arguments for limiting the Reserve Bank's operational independence in macro-prudential setting of capital and liquidity buffers (over and above the arrangements that apply to permanent changes to those settings, discussed in Chapter 1). These policies do not have strong distributional consequences, and there appear to be few reasons for the governance of cyclical changes to be different from that applying to permanent changes to these policies. Other changes proposed by this Review (e.g. more tightly specified objectives, the possibility of a financial policy remit, and the proposed governance changes) will also boost these tools' legitimacy.

There may be a stronger case for 'special' controls for setting lending standards (LVR and DTI policies). LVR and DTI policies have important distributional consequences, which allow them to lean against the financial cycle more effectively than capital buffers, but are also prone to be controversial. When LVRs were first envisaged in New Zealand, they were only intended to be used during rare periods of heightened risk. While the Reserve Bank currently has a legal power to apply DTI policies, the MoU does not list them as one of the tools appropriate for cyclical improvements to financial stability.

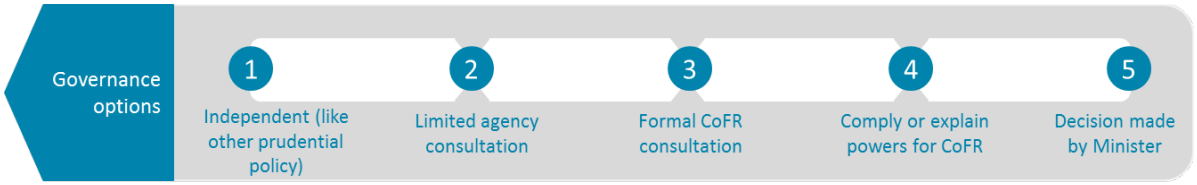
Internationally, special arrangements for macro-prudential policy do not usually involve removing powers from the relevant regulators. Instead, they often involve an advisory role for an interagency committee, which often includes representatives of the relevant Ministers (the Treasury, in New Zealand). This advisory role can be made quite formal and central to the process (e.g. obligating the macro-prudential agency to 'comply or explain' once the interagency committee has issued a recommendation). Alternatively the body can have a less rigid role, but with an expectation that most macro-prudential policy decisions would be taken to the committee for discussion, and the views of the committee would be considered, before the decision was implemented.

In New Zealand, CoFR (or a division of CoFR) could potentially be the relevant interagency committee. While CoFR agencies have different objectives, they include a variety of stakeholders administering related policy functions. For example, the Commerce Commission and the FMA will have views on the mortgage market, and the Treasury is involved in other housing market functions, such as tax policy. This would allow the agencies to consider the relationships between their policies and the Reserve Bank's tools, such as the potential impact of LVRs on any government policies designed to promote home ownership. An expectation that consulting this committee would be part of the macro-prudential decision-making process could be contained in a remit from the Minister.

As well as having a role in the use of certain macro-prudential powers, CoFR could be involved in advice, or decisions on extending the perimeter to which the tools apply, or assigning new powers to the Reserve Bank. Chapter 1 suggests that assigning new powers to the Reserve Bank should continue to involve the Minister agreeing to pass a Regulation. By convention, the Minister could seek the views of other CoFR agencies as part of this, and requests for powers and responses could be public (as the IMF FSAP recommended).

Figure 2B shows a number of options for the governance of LVR and similar transactional tools. They range from no formal roles for any agencies outside the Reserve Bank (1), to a more formal role for CoFR or a similar agency (2-4) and a formal decision-making role for the Minister (5).

Figure 2B – Governance options for macro-prudential decisions



In general, moving right on the continuum increases the democratic (and/or multi-agency) oversight of the policy decision. It adds legitimacy, but is likely to make the threshold for action higher (a potential 'inaction bias', as discussed above). Moving right also complicates the regime, since it means the macro-prudential decision areas subject to special safeguards need to be carefully distinguished from standard prudential policy and the safeguards need to be designed.

Views on the need for safeguards on lending standard rule-making may be affected by respondents' other design preferences. For example, it could be made clear to the proposed new governance Board that it is expected to make (rather than delegate) decisions to tighten lending restrictions. Alongside other changes (e.g. to objectives, and the possible introduction of a remit), this could be considered a sufficient safeguard, implying that it would not be necessary for an interagency committee to have a formal role.

Questions for consultation

2.C Is it appropriate to regulate lending standards (e.g. LVRs)? How broad should these powers be (should they include other tools such as debt-to-income restrictions)?

- Should lending standards apply only to deposit takers or to all lenders?
- Should there be special governance arrangements for these tools?
- Should the Reserve Bank reconsider its view that these tools should only be applied temporarily?

2.D Other than lending standards, when the Reserve Bank makes time-varying use of standard prudential tools such as capital ratios, are there any concerns or reasons for wider political oversight?

Summary

This chapter has described New Zealand's experience with macro-prudential policy since 2013, and considered options for the future, principally concerning the future scope of macro-prudential powers assigned to the Reserve Bank, and whether special governance arrangements are appropriate for tools like LVRs.

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

Aim of this chapter

Supervision and enforcement activities have an important role in the broader prudential framework; the component parts all work together to help achieve financial stability and the prudential authority's mandate. Taken together, they define the jurisdiction's financial safety net (see the introduction to Part A).

In developing the terms of reference for Phase 2 of the Review, the Treasury and the Reserve Bank met with a number of stakeholders early in 2018 to hear their views on the Reserve Bank's financial system-related responsibilities, including its approach to supervision and enforcement. During these discussions some stakeholders identified a number of issues with the current approach. They related to:

- the current resourcing level and a perceived lack of capacity and capability for specialised supervisory tasks
- the light-handed nature of the model, and its being out of step with international norms
- a culture in the Reserve Bank that does not encourage a healthy industry and regulator relationship.

The IMF's 2016/17 FSAP also identified a number of gaps in relation to the Basel core principles for effective banking supervision (the BCPs).

In light of these concerns, the terms of reference asked the Review Team to "consider the IMF's recommendations with respect to the supervisory model…[and]… the flexibility under the current Act, supervisory objectives, and the compliance and enforcement regime" (p. 4).

This chapter begins by defining 'supervision' and 'enforcement', then outlines the Reserve Bank's approach to these prudential activities and how international practice has evolved since the GFC. It also considers options that may improve the New Zealand approach.

The options have both legislative and non-legislative dimensions. In relation to the latter, the choice of the appropriate supervisory model is largely based on the choices the Reserve Bank could have in the intensity of its supervisory approach, subject to addressing the current constraint around funding (see Chapter 7 on the proposals for the Reserve Bank's funding model and level of budgetary autonomy). In addition, Chapter 2 of Consultation Document 2A considers how a government could influence how the Reserve Bank performs its statutory duties. A 'government policy statement' or 'remit' could include an ability to reflect on the intensity of supervision and the supervisory approach's alignment with international norms.

Please note:

- this chapter considers the approach to supervision and enforcement primarily with respect to the Reserve Bank Act, and the framework provided for registered banks in Part 5 of the Act. The Review's scope does not include legislative frameworks for other sectors such as insurance (IPSA) and NBDTs (the NBDT Act). However, as the Minister has made an in-principle decision to integrate the registered bank and licensed NBDT regimes (see Chapter 4 of Consultation Document 2A), most of the discussion in this chapter will be relevant to a future integrated 'deposit-takers' regime
- there is often intense supervision activity undertaken when a financial institution is close to insolvency and this is considered separately, in Chapter 5's discussion of bank crisis management and resolution. Chapter 3 therefore largely focuses on business-as-usual supervision and enforcement activities.

The role of supervision and enforcement

An agency with a prudential mandate, such as the Reserve Bank, has a comprehensive and almost continuous relationship with its regulated population that reflects the breadth of prudential activity.[44]

As described by Pazarbasioglu (2014), a prudential agency is a "midwife, cop, judge and undertaker in one for the institutions under supervision" (p. 15). That is to say, it defines which entities may undertake certain activities, polices them against a defined set of prudential rules, adjudicates in the event of any contravention of these rules, and manages the exit of firms where appropriate.

Definition of supervision

Supervision in a broad sense is the "delivery mechanism" for regulation (Blanc, 2013, p. 7). Wayne Byres, the Chair of APRA, describes it as "translating prudential policy into prudent practice" (Byres, 2019).

Chapter 1 considers the way the Reserve Bank sets prudential requirements. To translate this policy into practice, supervision encompasses a range of activities including:

- **licensing** (or registering) potential bank entrants against pre-defined criteria (and delicensing)
- **collecting and analysing information** about banks, including their business models, financial positions, risk management frameworks, and internal control systems, and using this information to **monitor** their financial health
- **assessing banks' compliance** with formal regulatory requirements, the extent to which they are managing risks effectively or acting prudently, and any other matters relevant to their soundness
- **cooperating and coordinating** with other domestic and international agencies[45]
- other activities such as **responding to individual bank-initiated requests** for approvals, authorisations, and non-objections so that they can undertake the business of banking.

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[44] Supervision is not unique to the financial sector. However, the relationship between the supervisor and industry – the supervisor's near 'continuous involvement' in the birth, life, and death of institutions – separates financial sector regulation in general, and prudential regulation in particular, from other regulatory regimes (Viñals *et al*, 2010, p. 6).

[45] Chapter 6 looks at the way the Reserve Bank cooperates and coordinates with other agencies.

Supervision is typically 'risk based', recognising that resources are finite and that a degree of prioritisation is essential for the prudential authority to achieve its statutory mandate. Risk-based supervision is flexible and proactive, focusing on areas of highest risk, which are typically the largest and most systemically important financial firms. It is characterised by discretion in judging what information to collect, how to assess the information and decide whether firms can manage risks, and making decisions on allocating supervisory resources. It is typically formalised with an explicit risk identification and assessment methodology. Risk assessment is part of a continuous supervisory cycle (Figure 3A), in which it is used to establish the nature and depth of engagement with regulated entities.

Figure 3A: The supervisory cycle

Note: Adapted from APRA (2018) and OSFI (2010).

Supervisors have choices in how they implement their risk assessment approach, undertake their monitoring role, and check compliance. For most prudential authorities this is a combination of on-site and off-site tools (BCBS, 2012, p. 30):

- **On-site supervision** involves going to banks' premises. The tool is used to:
  - obtain independent verification that the banks have adequate policies, procedures and controls
  - determine that information reported by banks is reliable
  - obtain additional information on banks and related companies
  - monitor banks' follow-up on supervisory concerns.
- **Off-site supervision**, or desk-based monitoring, is a tool used to:
  - review and analyse banks' financial condition
  - follow up on matters requiring further attention
  - identify and evaluate developing risks
  - help identity priorities and the scope for further off-site and on-site work.

Definition of enforcement

Ensuring effective compliance with regulatory requirements creates trust in a well-functioning financial system. At a high-level, the objectives of enforcement are to:

- promote effective risk management and constrain excessive risk-taking
- generate a credible deterrent
- punish wrongdoing, or ensure that injured parties are provided with adequate compensation (Armour *et al*, 2016, p. 578).

Enforcement in the broadest sense involves taking **corrective action** if a bank does not comply with regulatory requirements, or to address emerging risks before any formal non-compliance.

The potential tools available include 'supervisory tools' such as:

- moral suasion
- increased supervisory scrutiny
- changes to licence/registration conditions
- business restrictions
- suspension or revocation of license.

Other tools include more public-facing action such as public warnings and civil and criminal prosecution through the courts. This set of tools often carries the narrower label of 'formal enforcement' activity.

The choice of tools and the enforcement action taken are influenced by two broad approaches (although in practice enforcement actions sit along a continuum):

- ***Ex ante* preventive actions** – generally speaking, prudential authorities' corrective actions focus on *ex ante* risk prevention, based on a forward-looking approach to risk assessment.[46] This implies the authority's willingness to work with regulated entities to ensure their compliance with regulatory requirements or to address areas of emerging concern (via persuasion).[47]

  If this does not work to the supervisor's satisfaction, a number of other supervisory tools can be applied to achieve the desired change in behaviour. However, their use is not necessarily made public, and this can reduce the broader public 'deterrence' value of such sanctions. Non-public supervisory actions also prevent commercially sensitive information entering the public domain.

- ***Ex post* enforcement actions** – these actions can, in addition to 'punishing' the financial institution or individual for non-compliance, have a wider preventive purpose in deterring similar behaviour by other firms (PRA, 2016, p. 60). They can also ensure that there is clear public information on what is seen as (un)acceptable behaviour by regulated entities.

Whatever tools are chosen, they should be used in a way that is proportionate to the nature of the contravention or the desired behavioural change. There should generally be a continuum of potential

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[46] In contrast, in the area of financial market conduct regulation, *ex post* public enforcement action will typically have a greater role.

[47] Moral suasion as a supervisory tool is often more effective in influencing individual institutions' behaviour than making changes at the sectoral level or across multiple institutions.

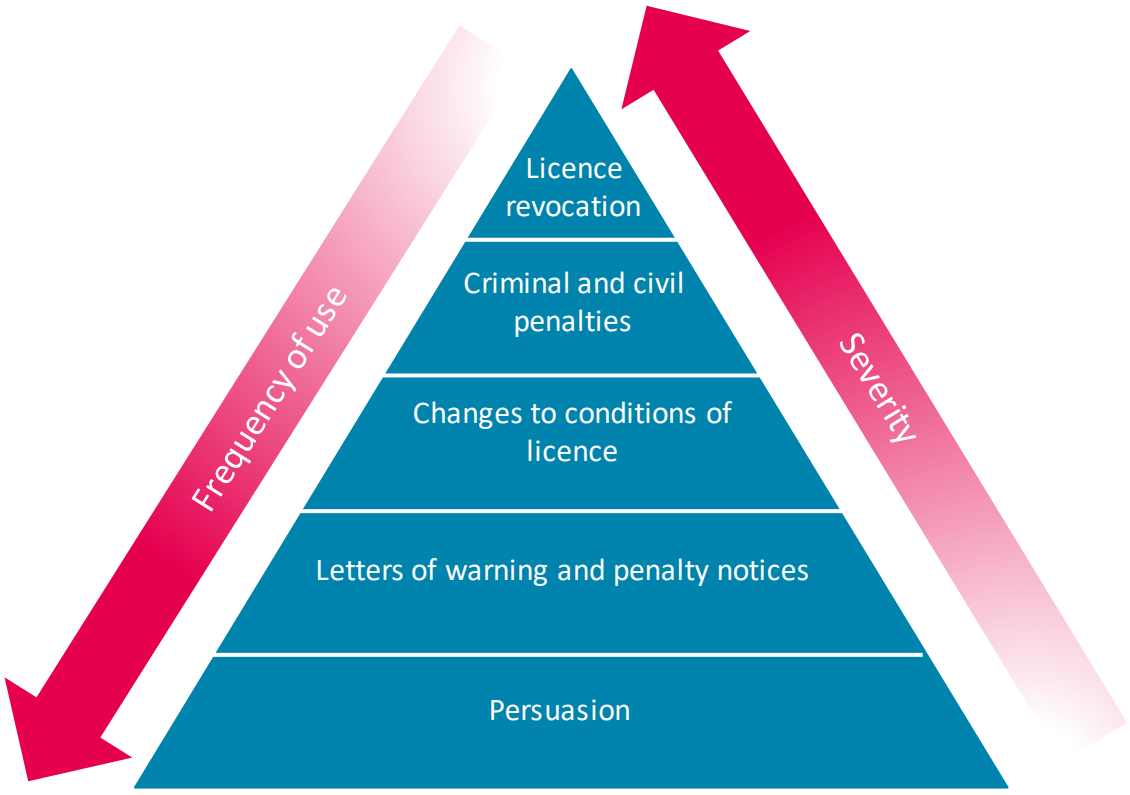
actions, with each penalty along the continuum having some form of due process attached. However, having graduated actions does not mean the regulator always has to work their way through them; there may at times be a need to take immediate and significant enforcement action. Having a range of tools:

- enables a proper differentiation between minor and major violations, with the option of punishing more severely the most serious violations that create the most social harm
- enables a supervisor to tailor actions based on an entity's behaviour – for example, if it has a history of non-compliance or is cooperating and serious about taking remedial action
- allows for appropriate escalation
- provides incentives for firms to take remedial or corrective action if the threat of subsequent escalation and enforcement action is seen as credible (Armour *et al*, 2016, p. 591).

There is also an important operational dimension for enforcement action, including timeliness and cost. For example, court-based enforcement can take years, outcomes are uncertain, and costs can be very significant.

Figure 3B illustrates the actions' seriousness in a pyramid. Less serious or inadvertent violations, or emerging concerns, are addressed with less punitive 'sanctions' at the bottom of the pyramid, while more serious non-compliance or concerns can be addressed with more punitive measures. The pyramid also aligns with the observation that most prudential authorities tend to adopt approaches to corrective action based more on persuasion than court-based enforcement actions (MacNeil, 2015, p. 286).

Figure 3B: Indicative sanctions pyramid



Note: Adapted from MacNeil (2015), p. 286, and Monk (2013), p. 44.

The challenge for supervision and enforcement

Effective supervision increases the likelihood that activities such as excessive risk-taking in financial institutions, or potential risks to the financial system, will be identified quickly. Effective enforcement helps to deter or punish improper conduct, and aims to ensure that market participants 'internalise the externalities' generated by their activities by sanctioning those found to have violated substantial rules and obligations.

However, the size and complexity of financial markets and institutions mean it can be challenging to detect undesirable conduct and practices, monitor institutions' risk-taking, or identify potential systemic risks. This is compounded by "entrenched asymmetries of information and expertise that often pervade relationships between regulators and market participants. Constrained by the costs, regulators must inevitably confront difficult questions about how best to allocate their finite resources in pursuit of different regulatory objectives" (Armour *et al*, 2016, p. 578). This finding by Armour is particularly relevant for the Reserve Bank and its prudential function, which has traditionally been lightly resourced.

While it may not be possible to fully overcome this informational disadvantage, there are two choices for addressing it:

- The supervisory model could accept the asymmetry to a certain degree and place greater reliance and trust in regulated entities for financial system outcomes.
- The prudential authority could try to mitigate this asymmetry by increasing supervision intensity through developing a deeper knowledge of entities' business models, risk-management and internal control frameworks, and general financial condition.

The more intensive and intrusive a supervisory approach, the higher the regulatory burden on regulated entities. It is also sometimes argued that a more intrusive approach runs the risk of diluting, or undermining, any emphasis placed on the entity to manage its own risks. This situation is termed moral hazard, but is not a perspective supported by the BCPs or international practice in general, at least post-GFC.

Supervisors also have choices in how best to manage relationships with regulated entities when trying to change or constrain their behaviour. As described above, the choices here are largely between *ex ante* preventive actions and *ex post* enforcement actions.

However, there is a delicate balance between encouraging voluntary compliance (and ensuring that regulated entities notify the regulator when they make mistakes or get into difficulty, which is critical given the entrenched asymmetries mentioned above) and sending a credible signal that the supervisor is able and willing to take more aggressive enforcement action when appropriate.

The Reserve Bank's approach to supervision and enforcement

Overview

As described in Chapter 1, the Reserve Bank's prudential framework can be described by three pillars: self-, market, and regulatory discipline. These pillars have also helped to frame the way the Reserve Bank undertakes its supervisory and enforcement activities.[48]

The prudential framework is based on a comparatively light-handed approach, aiming to ensure that risks are well understood by market participants through disclosing key bank-related information (market discipline), and with primary responsibility resting with bank boards (self-discipline). The emphasis on boards is facilitated through the bank director attestation regime, which places accountability for prudential outcomes squarely on the shoulders of bank directors (see Chapter 1). This emphasis on the two pillars is tied to a long-standing concern with moral hazard and the implications of a more intrusive approach.

The prudential framework is anchored by legislative constraints on how powers can be used – to promote the maintenance of a sound and efficient financial system and minimise the damage to the financial system caused by individual bank failures. There are no specific objectives aimed at ensuring the soundness or resilience of individual banks per se; Chapter 2 of Consultation Document 2A discusses the merits of adding such an objective.

Most regulatory requirements for the banking sector are set by CoRs. In addition, OiCs are used for disclosure requirements, while credit rating requirements are set by notices issued by the Reserve Bank (see Chapter 1). Breaching these requirements is an offence under the Act, although the Reserve Bank has discretion in addressing any non-compliance. There is no current requirement for banks to report breaches or potential breaches to the Reserve Bank, but there is an expectation from the Reserve Bank that they do so. Banks must, however, report breaches of CoRs in their public disclosure statements.[49]

The rulebook for banks in New Zealand is not as broad in scope, or as detailed, as rulebooks are in some other jurisdictions. This reflects a principles- or outcomes-based approach to rule-setting, and a belief that banks are in a better position to understand and assess the less easily quantifiable aspects of the business (risk management and internal control systems). This approach to rule-setting reflects a view that a comprehensive or prescriptive rulebook potentially undermines the primary focus that board directors should have on prudential outcomes (although there are requirements that support the self- and market discipline pillars). Most of the hard-wired rules relate to areas where, in the Reserve Bank's view, banks' incentives are more likely to be misaligned with the public interest (in particular, holding adequate capital and liquidity, and managing periods of financial stress). Rules in these areas can be very detailed.

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[48] For a short history of prudential regulation and supervision at the Reserve Bank, and the evolution of the three pillars, see Hunt (2016).

[49] The Reserve Bank is currently considering requiring banks to formally notify it of any CoRs breaches, and drawing on this reporting to publish information on bank breaches on its website – subject to a materiality threshold. See the consultation page on the Reserve Bank website for more information.

The Reserve Bank's supervisory 'model'

The Reserve Bank does not take a hands-on approach to the independent testing or verification of the information that banks provide to it, or any routine 'second guessing' of director attestations. This means it does not undertake on-site inspections – a typically resource-intensive supervisory activity.[50]

However, the Reserve Bank does check banks' compliance with prudential requirements (using the information they provide) through a desk-based approach, and mandated public disclosure statements are vetted by the banks' internal auditors.[51] Verification largely comes from different sources corroborating information provided to the Reserve Bank, and through insights gained through face-to-face meetings with banks' boards and senior management. There are few legislative constraints on the Reserve Bank's ability to undertake more verification (outside of an inability to go 'on-site' – see below); the main constraint is the Reserve Bank's 'philosophical approach' to supervision and the way this has been historically reflected in the degree of resourcing for the supervision function.

The Reserve Bank defines itself as a 'relationship-led' regulator that aspires to build and maintain the best regulator/regulated supervisory relationships possible across all regulated sectors. Its supervisors try to use these relationships to provide effective and credible challenges to the risk management and behaviours of the regulated entities they supervise. In order for this to happen, supervisors need to be respected for, and knowledgeable in their understanding of the prudential rules and the entities' business models and associated risks.

Conversely, the Reserve Bank is not an 'enforcement-led' regulator; if a regulated entity makes a mistake or a risk arises, it focuses as a first step on using moral suasion to develop forward-looking solutions.

The Reserve Bank aspires to build and maintain relationships based on open and effective communication, insight and scrutiny. However, without a credible deterrent (an effective enforcement regime), supervisors will lack ways to take action if a regulated entity does not respond appropriately to the prudential policy framework and associated requests, or supervisors' use of moral suasion.

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[50] Note the Reserve Bank undertakes on-site inspections for the 96 reporting entities under the Anti-Money Laundering and Countering Financing of Terrorism (AML/CFL) Act 2009. AML/CFT supervision is underpinned by a risk-based approach. Low-risk reporting entities are monitored via off-site baseline monitoring and may also be subject to targeted or thematic reviews. Medium- and high-risk reporting entities are subject to regular on-site inspections, the frequency and scope of which vary according to the entities' risk profiles. An AML/CFT on-site visit involves AML/CFT supervisors attending the premises of a reporting entity to review documents and records, test controls, and meet with employees, including senior management. The number of on-site visits is 12-16 per year, and usually two supervisors (of the four-person AML supervision team) are involved in each visit. Preparation starts at least three months before the on-site visit and a feedback report is issued within six weeks after it. During on-site inspections the Reserve Bank also looks at risk management frameworks, governance, resourcing, compliance culture, capabilities etc., and findings are often linked to wider compliance issues (or strengths) within an organisation, and therefore are of interest to prudential supervisors.

[51] The Reserve Bank meets with a registered bank's internal and external auditors annually. However, experience has shown that the value of these meetings can be variable. Some provide very useful information on a bank, while some auditors are reluctant to openly disclose matters to the Reserve Bank. This places some limits on the Reserve Bank supervisors' ability to consistently use the work done by a bank's audit functions.

Evolution of the model

The Reserve Bank's approach has evolved since the Reserve Bank Act was introduced in 1989, albeit within this largely non-intrusive model.[52] This evolution reflects its experience in implementing and maintaining the supervisory model, and insights from the experience of other jurisdictions – including some of the lessons from the GFC.

For example, the introduction of the disclosure and director attestation regime in 1996 confined supervisory activity to monitoring (quarterly) disclosure statements to assess institutions' compliance with the prescribed regulatory requirements and their financial health. The banks did not provide additional 'private reporting'.

Since then the pillars have been rebalanced, with less emphasis on full public disclosure and a greater reliance on private prudential information.[53] In particular, the GFC illustrated that there were some key limitations and inadequacies in the depth, breadth, and timeliness of information in public quarterly disclosure statements that Reserve Bank supervisors were using to assess emerging risks and vulnerabilities. As a result, an enhanced private reporting role has been complemented by a more engaged approach to supervision that includes:

- increased engagement with bank executives and directors
- an increase in the visibility from supervisors of banks' internal risk reporting (e.g. reports to a bank's Audit and Risk Committee)
- general improvements in the Reserve Bank's supervisory analysis and outputs, such as the introduction of a formal risk assessment framework – the Proportionate Risk Evaluation Surveillance System (PRESS)
- the introduction of thematic, or horizontal, reviews to assess risk and other issues across the banking sector (often with institution-specific findings and insights).

These developments have enabled the Reserve Bank to be more probing and challenging of banks' boards and senior management.

In addition, the post-GFC expansion of prudential requirements for banks (the 'rulebook') has been accompanied by an increase in supervisory activity tied to authorisations, approvals, and non-objections. Examples include requirements tied to internal capital models and the outsourcing policy (see Box 3A). For example, banks must receive a notice of non-objection from the Reserve Bank to use certain capital instruments to meet regulatory requirements, and this process requires significant Reserve Bank resource.

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[52] The Reserve Bank's website has information on its approach to regulation, supervision, and enforcement. However, there is no statutory requirement to publish a statement of supervisory or enforcement strategy, aside from a requirement to publish the principles the Reserve Bank uses to determine applications for bank registration, and how it imposes, varies, removes, or adds to CoRs.

[53] Disclosure statements were modified in 2011, and since the Regulatory Stocktake undertaken in 2015/16, disclosure statements and director attestation have shifted to a six-monthly reporting cycle. A Bank Financial Strength Dashboard was introduced on the Reserve Bank's website in early 2018; it reports registered bank prudential and financial information on a quarterly basis.

Supervisory and enforcement powers

The Reserve Bank Act confers various powers on the Reserve Bank to carry out its supervisory and enforcement role for registered banks.

- **Power to (de)license banks** – the Act empowers the Reserve Bank as both the licensing authority and the supervisor. However, it is the Minister of Finance that can ultimately cancel a bank's registration, albeit based on a recommendation from the Reserve Bank, rather than the Reserve Bank directly. (Note the Minister has no role if a bank wishes to deregister voluntarily.)
- **Power to obtain information from banks** – the Reserve Bank can use a written notice to request information from a bank on almost any matter, and require this information to be audited by a person it approves. However, it does not have the power to routinely go on-site and collect this information, or compel bank directors or staff to provide information orally. Nevertheless, the Reserve Bank expects to have access to boards and senior management in the normal course of supervisory practice and regularly holds meetings with directors, senior management, and auditors.

  The Reserve Bank can also:

  - require a bank to appoint a person to carry out an independent report (a skilled person report). This can enable third-party verification of any aspect of a bank's business, including concerns about compliance, although, to date, these reports have been used sparingly.[54]
  - authorise on-site inspections by home-country prudential authorities. It does this to allow APRA to inspect the New Zealand operations of the Australian-owned banks, which account for just over 85 percent of the New Zealand banking sector. The Reserve Bank participates in these visits – another means of gaining information on banks.
- **Enforcement** – the Reserve Bank has a range of powers and tools to facilitate corrective action. These include:
  - requiring a disclosure statement to be corrected
  - varying, removing, or adding to a CoR
  - issuing a direction in specific circumstances, with the Minister's consent. This power covers circumstances where the Reserve Bank believes a bank might be behaving imprudently, through to situations of financial stress and bank crisis management (see Chapter 5). These powers of direction include forcing a bank to replace any of its directors and senior management
  - removing, replacing, or appointing directors directly (with the consent of the Minister)
  - recommending to the Minister of Finance that they deregister a bank
  - undertaking prosecution, which can result in court-based penalties for various offences.[55] A failure to comply with a requirement of the Act is, in most cases, a criminal offence (although criminal proceedings for non-compliance have never been taken against a bank or its

[54] The Reserve Bank also has the power to appoint a person to enter and search a bank's premises as part of an investigation, in the context of considering whether to issue a direction, or in the crisis management context, the recommendation of the appointment of a statutory manager.

[55] These penalties are detailed in sections of the Act dealing with miscellaneous offences, offences related to supplying information, and regulatory requirements and disclosure.

directors). The range of formal sanctions is somewhat limited, in that financial penalties can only be imposed by taking criminal, rather than civil, action against a bank and/or its directors.

The Reserve Bank has also developed informal enforcement and compliance mechanisms alongside the formal consequences specified in the Act. To date these have been used mainly in relation to other sectors regulated by the Reserve Bank. They include:

- **a conditional waiver** – the Reserve Bank waives its right to prosecute as long as a registered bank meets certain conditions
- **a private warning** – this is a non-statutory censure indicating that the entity may have breached a requirement but the Reserve Bank does not consider it appropriate to take punitive action (for example, where the breach is not significant, or where imminent remediation is taking place)
- **a public warning** – this is used as a broader deterrent or where it is needed in the interests of the public at large (such as Part 4 violations, where an entity may be intentionally or inadvertently passing itself off as a registered bank by using the word 'bank' in its name). Public warnings can have both statutory and non-statutory bases (there is no statutory basis in the Reserve Bank Act). The Reserve Bank lists any public warnings on its website.

These informal mechanisms are in addition to the obligation on banks to disclose breaches of CoRs in their disclosure statements, which helps to support the market discipline pillar.

Box 3A: Lessons from the bank outsourcing policy

The Reserve Bank introduced an outsourcing policy (BS11) in 2006 (the '2006 Policy') to ensure: "that a large bank's outsourcing arrangements do not create risk that the operation and management of the bank might be interrupted for a material length of time" (BS11, January 2016 version, paragraph 10). Outsourcing occurs when a bank uses another party to perform business functions that would traditionally have been undertaken by the bank itself. Common examples of outsourced activities include IT processing, accounting, and call centres. The risk associated with outsourcing is if a supplier of certain outsourced functions was unable to provide that function for any reason. This could result in an unacceptable risk to the bank's ability to operate, and therefore the wider financial system.

The 2006 Policy was outcomes-focused, and required large banks to structure their business so that each bank's board of directors had the legal and practical ability to control and execute all functions needed for the bank to continue to provide and circulate liquidity to the financial system, following the failure of a third party supplier or parent entity.

Under the Reserve Bank's approach to supervision, responsibility for ensuring compliance with the 2006 Policy lay with the directors of each bank. The Reserve Bank relied on the directors' attesting that their bank was complying with its CoRs, for confirmation that this was indeed the case. The Reserve Bank did not, and still does not, validate attestations unless specific concerns are raised or it commissions a compliance review.

In 2014, the Reserve Bank decided to undertake a 'stocktake' of banks' compliance with the 2006 Policy. An external consulting firm was engaged to assess the degree of effectiveness of each bank's compliance with the 2006 Policy. All five banks that were subject to the 2006

Policy voluntarily agreed to this stocktake so the Reserve Bank did not need to use its formal power to undertake this third-party review. The stocktake highlighted a wide variation between banks in respect to the degree of the legal and practical control they exercised over outsourced functions.

The finding from the stocktake was that while the five banks had practical and legal controls in place to exercise control over outsourced functions, it was uncertain in some instances if these controls were appropriate. It was also observed that the means and standards applied by the individual banks to achieve the specified outcomes resulted in wide variations in the interpretation and application of practical and legal controls.

Overall, the assessed degree of BS11 compliance between the five banks ranged from 65 to 90 percent overall effectiveness of practical and legal controls. This was despite the fact that the directors of each bank had attested that their bank was fully compliant with the 2006 Policy, on a quarterly basis.

The degree of variation suggested there was a material risk to the financial system, from a possible failure of a supplier to one of the large banks, resulting in that bank being unable to continue to operate. Given the size of the large banks in the New Zealand financial system, an issue for one of them could result in an issue for the entire system.

Given these findings the Reserve Bank decided to focus on addressing the risks that were posed to the financial system, rather than investigating individual banks for possible compliance breaches. The decision was ultimately made to strengthen the 2006 Policy so that it included a regulatory approval process for certain outsourcing arrangements and other safeguards, such as independent reviews of compliance. A revised outsourcing policy was introduced in September 2017.

While it is not possible to know how much earlier a supervisory model based on routine independent verification would have identified the degree of non-compliance with BS11, the probability of such identification occurring would likely have increased significantly.

Supervisory independence

Generally speaking, the Reserve Bank has a reasonable ability to take actions against individual banks, free from political interference. Its supervisory independence is buttressed by legal protection for supervisors and there are tightly prescribed criteria for removing the Governor (which help to insulate the Governor from any arbitrary interference). However, there is no formal requirement to disclose the reason for a Governor being removed.

There are no powers for the Minister of Finance to intervene in supervisory actions, but there are requirements for ministerial involvement when the Reserve Bank seeks to:

- issue, modify, replace, or revoke a **direction** to a registered bank – this is inconsistent with the treatment of insurers and NBDTs under IPSA and the NBDT Act respectively, under which the Reserve Bank does not need ministerial consent. In a recent case, where direction powers were used against CBL Insurance Ltd, the Reserve Bank noted that using those powers without ministerial approval resulted in swifter action
- **deregister a bank** – the Minister of Finance directs the Reserve Bank to cancel the registration, on the Reserve Bank's recommendation

Resourcing for supervisory and enforcement activities

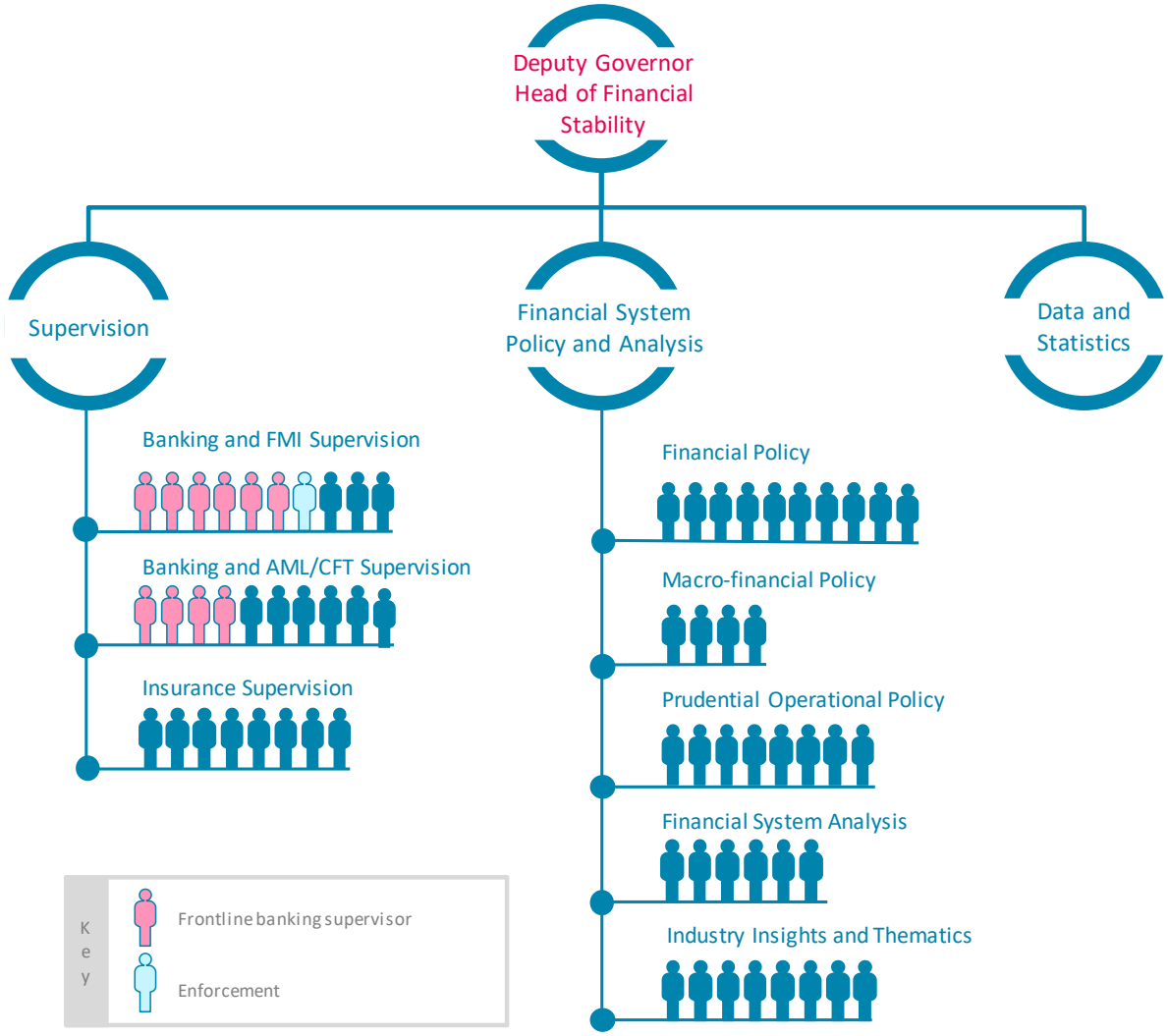
In 2017/18 the Reserve Bank spent $24 million on its financial stability-related responsibilities (macro- and micro-prudential regulation and supervision) out of a total operating expenditure of $76 million (Table 3A).

Table 3A: Expenditure by function, 2017/18 ($m)

Function	2017/18	2016/17
Currency operations	20	21
Prudential supervision	15	12
Monetary policy formulation	10	9
Macro-financial stability	9	8
Foreign reserves management	8	6
Settlement services	7	7
Domestic market operations	7	5
	76	**68**

Source: Reserve Bank, Annual Report 2017-18, p. 90.
Note: These figures include an apportioned component of the cost of corporate and other overheads (IT, HR, and statistics).

Figure 3C: Organisational structure for financial stability



Notes: Figures include current vacancies. The new Data and Statistics Department also services the data requirements for the Reserve Bank's other functions, including economic and monetary analysis.

In late 2018, the Reserve Bank's financial stability function was restructured (Figure 3C):

- The major change for supervision and enforcement was the creation of a streamlined Supervision Department. Previously, frontline supervision and prudential policy were housed together in the Prudential Supervision Department (PSD).
- Systemic risk analysis and macro-prudential policy – previously part of the Macro-financial Department – were brought together with the former PSD policy teams in a new Financial System Policy and Analysis Department (FSPAD).

The new Supervision Department has five managerial and support staff and an additional 25 staff with responsibilities allocated as follows:

- Ten frontline supervisors for New Zealand's 26 registered **banks**. The four largest banks have one full-time equivalent (FTE) staff member nominally assigned to each of them, reflecting their systemic importance. However, in practice it is often less, due to staff turnover and the need for these more senior supervisors to help with ad hoc priorities as they arise.

- Seven frontline supervisors for New Zealand's 89 licensed **insurers**. Three staff are allocated to 22 'designated' insurers (the relatively larger insurers) and the other four to 67 smaller insurers ('portfolio insurers').
- Four Anti-Money Laundering/Countering Financing of Terrorism (**AML/CFT**) supervisors for 96 reporting entities (26 banks, 24 NBDTs, 11 life insurers and 35 designated business groups).
- One staff member responsible for monitoring 24 licensed **NBDTs** and processing applications for new NBDT licences (note the Reserve Bank does not have formal responsibility for supervising this sector – this is undertaken by trustees who are licensed by the FMA). The in-principle decision to integrate registered banks and licensed NBDTs will likely include the Reserve Bank assuming formal responsibility for supervising these entities.
- One staff member responsible for **enforcement** activities in all the sectors that the Reserve Bank regulates and/or supervises for prudential and AML/CFT purposes (banks, insurers, and NBDTs).
- Two staff for **financial market infrastructures (FMI)** – largely a monitoring role, as the Reserve Bank does not have any formal regulatory or supervisory powers for this sector. Assuming the passage of the FMI Bill, policy and supervisory resources will likely be increased to reflect additional responsibilities in this area.

Now housed in FSPAD, the Industry Insights and Thematic (IIT) team supports frontline supervision by undertaking the lead role in thematic reviews. This team was created in response to the recommendations of the IMF's 2016/17 FSAP. It also led the Reserve Bank's participation in the joint Reserve Bank-FMA Conduct and Culture Review in 2018.

Frontline supervisors are expected to monitor regulatory returns (i.e. the data and information that regulated entities send to the Reserve Bank), facilitate engagement between the Reserve Bank and regulated entities, keep up-to-date on prudential policy changes, and undertake a range of administrative activities related to the prudential regime, such as applications for the suitability of directors and senior executives.

Supervisors use the information they receive through these monitoring activities to assess whether there are any failings in the entities' risk management and controls, and take action where appropriate. Supervisors also undertake or participate in thematic reviews and other periodic initiatives (such as the recent Conduct and Culture Review) and deal with institutional issues as they arise. Each activity is scalable to the amount of time/resources available.

The current resource model requires supervisors to regularly make risk-based trade-offs between competing priorities. This sometimes means that they cannot address every risk or potential weakness observed. The extent of this is governed by the Reserve Bank's supervisory risk appetite.

Box 3B: Resourcing – comparison with other prudential authorities

Given the absence of on-site inspections, which is tied to a long-standing emphasis on self- and market discipline, the Reserve Bank's supervisory model is lightly resourced relative to those of prudential authorities in other jurisdictions.

Unfortunately it is not easy to make robust comparisons with other prudential authorities, and it is difficult to support this observation of relative under-resourcing with concrete data.

- There is no good cross-country database comparing staff numbers or resourcing.
- The annual reports and other publicly available information produced by individual prudential authorities rarely provide useful and detailed information on how a supervision and enforcement function is organised (e.g. the number of frontline supervisors per bank).
- Headline numbers of frontline supervisors, where available, can be misleading in that these do not necessarily capture how frontline supervision is organised on a risk-based approach; e.g. the number of supervisors allocated to large and systemically important entities versus those directed to smaller entities, or the extent to which frontline supervision is supported by specialist teams (e.g. experts in credit risk).
- Some jurisdictions have a single financial regulator responsible for both prudential and financial market conduct supervision, which can further complicate comparison.
- In Europe, the European Central Bank (ECB), not the national authorities, supervises large, systemically important institutions.

That said, it is unlikely that the number of Reserve Bank staff tasked with supervising New Zealand's 26 registered banks would compare favourably with those in most prudential authorities on any metric, except perhaps very small jurisdictions.

In Australia, **APRA** employs 630 staff to regulate and supervise banks and other deposit-takers (collectively termed 'authorised deposit takers' – ADIs), and the insurance and superannuation sectors (APRA has no responsibility for AML/CFT supervision or FMI regulation and supervision). There are 135 frontline ADI supervisors covering 143 institutions (Byres, 2019). This number excludes staff involved in licensing and regulatory approvals.

The UK's **Prudential Regulation Authority** (PRA) employs about 1,300 staff (out of the BoE's overall 4,300 head count). It supervises around 300 banks and 45 building societies, with about 150 staff responsible for supervising international banks and another 250 for supervising UK deposit-takers, supported by close to 200 supervisory risk specialists.

The **Central Bank of Ireland** is an integrated financial regulator (i.e. responsible for both prudential and financial market conduct regulation). It employs about 1,000 staff in financial sector regulation, with a roughly even split between two directorates: Prudential Regulation (responsible for supervising credit institutions, insurance, and asset management) and Financial Conduct (responsible for consumer protection, securities and

market supervision, and enforcement). A Policy and Risk department supports both pillars but is formally part of the Financial Conduct pillar.

In Canada, the **Office of the Superintendent of Financial Institutions** (OSFI) supervises 400 federally regulated financial institutions (including 88 banks) and 1,200 private pension schemes. It employs around 700 staff.

The Reserve Bank's resources for its prudential functions was a key focal point for the IMF's 2016/17 FSAP for New Zealand. The main report noted that more resources would "support the highly qualified RBNZ staff in improving the effectiveness of the supervisory process, enhancing their knowledge of financial institutions' operations, and deepening risk assessment of supervised entities – and strengthening their ability for early preventive action" (p. 7). Furthermore, the IMF argued that the Reserve Bank would be under-resourced even if the "low-intensity approach" were retained.

The IMF's formal assessment of the Reserve Bank's approach to banking supervision against the BCPs underscored the observation in its main report. The Reserve Bank received a 'materially non-compliant' grading for BCP 2 – Independence, accountability, resourcing and legal protection for supervisors – largely on the basis of a "critical deficiency" in the number of staff and the size of the budget allocated to bank regulation and supervision (p. 37).

Box 3C: Supervision and climate change

The terms of reference for the Phase 2 Review state that the Review will "include consideration of monitoring and managing the risk that climate change poses to New Zealand's financial stability, in light of the recommendations of the Task Force on Climate-related Financial Disclosures."

The Reserve Bank is already taking action on climate change risks, publishing a climate change strategy in December 2018. As part of that strategy, the Reserve Bank indicated that it would engage with regulated entities in order to assess current industry practices, evaluate the New Zealand financial system's awareness of climate risk, and identify opportunities to enhance climate-related disclosures in New Zealand.

To the extent that climate change is a material source of financial risk for the entities that the Reserve Bank regulates, climate change should be embedded within the supervisory framework.

Reserve Bank supervisors contacted registered banks and licensed insurers in early 2019 requesting information about how they currently identify, manage and disclose climate risk. The high-level findings of this survey were published in the May Financial Stability Report. All banks and 90 percent of life insurers thought climate change poses a risk to their business, while 60 percent of the non-life insurance sector thought so.

Internationally, there are several initiatives underway to improve how climate-related risks are disclosed and managed. Central banks and supervisors of many developing and advanced countries, including New Zealand, have formed a Network for Greening the Financial System

(NGFS), an international forum to build understanding, share experiences, and develop good practices around the supervisory and macro-financial dimensions of climate-related risks. Elsewhere, the Financial Stability Board's Taskforce on Climate-related Disclosures (TCFD) has been leading the development of consistent and effective climate-related financial disclosures for organisations (both financial and non-financial firms) to help their customers, investors, and the public measure and respond to climate change risks. In 2017, the TCFD released recommendations for climate-related financial disclosures that have been widely endorsed by industry and officials alike, including the NGFS.

The Task Force has structured its recommendations around four thematic areas that represent how organisations, including financial firms, operate (TCFD, 2017, p. iv-v):

- **Governance** – the financial firm's governance around climate-related risks and opportunities.
- **Strategy** – the actual and potential impacts of climate-related risks and opportunities on the firm's business, strategy, and financial planning.
- **Risk management** – the processes used by the firm to identify, assess, and manage climate-related risks.
- **Metrics and targets** – the metrics and targets used to assess and manage relevant climate-related risks.

In New Zealand, the Ministry of Business, Innovation and Employment (MBIE) and the Ministry for the Environment (MfE) are jointly exploring the possibility of developing a climate-related disclosure regime for a wide range of entities. The Reserve Bank may wish to support the development of this disclosure framework, and supplement with further requirements for registered banks and licensed insurers as appropriate.

For more information on climate-related financial risks and potential opportunities available to the Reserve Bank to help manage those risks, see the paper on 'Climate Change and Prudential Regulation: Issues in New Zealand' which accompanies this consultation document. Box 2A of Consultation Document 2A also discusses options for the objectives underpinning the Reserve Bank's actions on climate change.

Questions for consultation

3.A What do you think are the strengths and weaknesses of the Reserve Bank's current approach to supervision and enforcement?

3.B Do you think that the Reserve Bank's planned approach to the supervision and management of climate change-related risks is appropriate and adequate? Do you think that the Reserve Bank's approach to climate change would be different if it was given a more explicit climate change objective, as considered in question 2B of Consultation Document 2A?

Supervision after the GFC – a global perspective

The GFC was a watershed moment for the global economy and financial system, and prompted a major rethink of the approach to financial sector regulation around the world. While the reasons for the crisis were multidimensional, and the way it played out in various countries differed, there is a general consensus that supervisory frameworks were inadequate in those jurisdictions that experienced severe financial distress. These failings include:

- **supervisory architecture** – in the US for example, financial institution supervision was very fragmented, with gaps in effective coordination across the many agencies tasked with the role. In some countries where financial regulatory authorities were responsible for both financial market conduct and prudential regulation (e.g. the UK), the former was often prioritised over the latter. There was also a general lack of focus on macro-prudential supervision – an understanding of how risks and vulnerabilities were evolving at the financial system level – with little ability to relate this analysis to firm-level risks

  > *"The erroneous belief that financial markets were inherently stable, and that the Basel II capital adequacy regime would itself ensure a sound banking system, drove the assumption* [by the UK Financial Services Authority] *that prudential risks were a lower priority than ensuring banks were 'treating customers fairly'"* (FSA, 2011, p. 10)

- **supervisory independence** – in some jurisdictions there was weak supervisory independence and accountability. In others, financial regulators with formal or *de jure* independence nevertheless lacked *de facto* independence reflected in a degree of political and regulatory capture. In some jurisdictions (e.g. UK and Ireland), financial regulators were given inappropriate objectives, which diluted their focus on achieving financial stability

  > *"Although management of the FR* [the Irish financial regulator] *would not accept that their 'principles-based' approach ever implied 'light-touch' regulation, the approach was characterised as being user-friendly in presentation aimed at expanding the export-oriented financial services sector"* (Honohan *et al*, 2010, p. 9)

  > There was an *"undue emphasis on fears of upsetting the competitive position of domestic banks and on encouraging the Irish financial service industry even at the expense of prudential considerations"* (Central Bank and Financial Services Authority of Ireland, 2010, p. 9)

- **supervisory methods** – in some jurisdictions supervisors stayed largely on the side line and didn't intrude into the affairs of regulated institutions. They were deferential to management, often taking an 'incentive compatible' approach to supervision that relied on trusting regulated entities – with an assumption that the regulators' and regulated entities' goals aligned. Some supervisory frameworks were too 'light touch' and in hindsight lacked sufficient resources to dig deeply enough into firm-level risks, or uncover and understand firms' business strategies or the inner workings of their risk management and internal control processes. In addition, the effectiveness of market discipline may, in hindsight, have been overstated:

  > There was *"too much trust being placed in the competence and capabilities of firms' senior management and control function, with insufficient testing, and challenge by the FSA* [Financial Services Authority]*"* (FCA and PRA, 2015, p. 15)

> *"A political philosophy where all the pressure on the FSA was not to say: 'Are you looking more closely at these business models?', but to say: 'Why are you being so heavy and intrusive? Can you not make your regulation a bit more light touch?'"* (Lord Turner testimony to the UK Treasury Select Committee, 25 February 2009 [Q2145])

> *"Sentries were not at their posts, in no small part due to the widely accepted faith in the self-correcting nature of markets and the ability of financial institutions to effectively police themselves"* (US Financial Crisis Inquiry Commission, 2011, p. xviii)

- **enforcement approach** – in terms of corrective action, some supervisors were not proactive in dealing with emerging risks and adapting to a changing environment. They often lacked a robust, forward-looking approach and did not try to anticipate emerging risks. Those that did were often unable or unwilling to react strongly enough, did not dig deeply enough to assess implications or satisfy themselves that boards understood risks, or did not take matters through to conclusion. This observation extended to jurisdictions that were relatively well resourced (by pre-GFC standards), including in the US context, where supervisors were 'embedded' in larger firms. Here supervisory activity was heavily focused on compliance checking against existing prudential requirements, rather than being forward-looking or attuned to new and evolving business risks

  On the Irish financial regulator's approach to enforcement: *"… walk softly and carry no stick"* (Honohan *et al*, 2010, p. 56)

  "Supervisors understood that forceful and proactive supervision, especially early intervention before management weaknesses were reflected in poor performance, might be viewed as i) overly intrusive, burdensome, and heavy handed, ii) an undesirable constraint on credit availability, or iii) inconsistent with the Fed's public posture" (US Financial Crisis Inquiry Commission, 2011, p. 54).

These observations were made with a generous amount of hindsight, and distilled across a number of countries that had to deal with significant institutional failures. It should also be noted that there was no one single approach to supervision that failed. The fairly light-touch and hands-off approaches in the UK and Ireland fared badly, as did the intrusive and heavily resourced 'bank examiner' model in the US.[56] For example, the major review into the causes of the UK banking crisis – the Turner Report – concluded that, "…the distinction between supervisory styles is not clearly correlated with relative success. The US system of resource-intensive bank examinations has been no more successful than the UK's approach in preventing bank failures" (FSA, 2009, p. 90).

Conversely, the absence of a systemic banking crisis in many jurisdictions does not necessarily imply that supervisory frameworks were inherently more robust. Almost all countries have applied the lessons from the GFC in some way, to improve both regulatory frameworks (the breadth and depth of prudential rules and requirements) and approaches to supervision and enforcement.

New Zealand had a benign GFC – the banking sector did not experience a major deterioration in asset quality, and non-performing loans remained low by international standards. Economic activity did contract in 2008/09 due to a decline in the fortunes of New Zealand's trading partners. Turbulence in

[56] The US-style 'bank examiner model', pre-GFC and relative to the UK approach, was more rules based. More resources were devoted to on-site inspections (with a higher ratio of supervisors per bank, and with supervisory staff permanently on-site), with direct examinations of specific procedures down to the level of individual loan files (termed 'transaction-based testing' of individual loans or other transaction files).

offshore funding markets exposed a long-standing risk – the banking system's reliance on wholesale market funding. This prompted the Reserve Bank to provide emergency liquidity to the banking system and subsequently develop a liquidity policy.

While New Zealand's banking system was generally resilient during the GFC, it is difficult to attribute this to the supervisory model alone. New Zealand may have weathered the crisis *in spite of* the supervisory approach, rather than because of the light-handed approach.

Characteristics of 'good supervision'

What does an effective supervisory framework look like in the post-GFC context? Internationally, there has been a concerted effort to learn from the GFC and improve supervisory frameworks. According to the IMF (Viñals *et al,* 2010), 'good supervision' should be:

- intrusive
- sceptical, proactive and forward looking
- comprehensive
- adaptive
- timely and conclusive.

The next section defines these principles and compares them with the New Zealand model. They have also been hard-wired into international standards, including the 2012 revised BCPs.

To support the development of an effective and robust supervisory and enforcement framework, supervisors require an *ability* and a *willingness* to act (Viñals *et al*, 2010):

- An ability (in both law and practice) to undertake intrusive monitoring
- The authority to challenge management judgements
- The capability to respond and adapt to a changing financial landscape
- An ability to follow through issues to their conclusion.

The conditions that underpin the ability and willingness to act include:

- **supervisory independence** and an ability to make decisions on individual institutions without political interference. Supervisory independence is supported by legal protection for supervisory staff, robust processes for appointing and dismissing senior staff, stable funding sources, and robust accountability arrangements
- a prudential authority with the **legal power** to monitor entities, undertake investigations, react swiftly to emerging issues, and start legal action where necessary
- **adequate resources** for inherently resource-intensive supervisory processes. Off-site and on-site supervision requires access to data sources, robust systems, and significant human capital. Robust supervision also requires constant skill development to keep pace with dynamic market developments
- **a constructive but arm's-length relationship** with regulated entities. A good relationship with board directors and senior management can ensure a cooperative approach to addressing emerging areas of concern and remediating non-compliance. At the same time, arm's length is

needed so that a supervisor can be probing, challenging of management and the board, and able, where necessary, to escalate the supervisory and enforcement response. A cosy or 'captured' relationship with industry risks regulatory forbearance

- other attributes such as effective working relationships with other agencies and clear internal supervisory strategies and processes.

Simply having the ability to act as set out in legislation, for example, is not sufficient to ensure effective banking supervision. A will to act requires a prudential authority to use the degree of operational independence and resources it has been given, and to leverage off its relationships with regulated entities in order to take timely and effective preventive actions in normal times, and assertive action in time of stress.

Potential issues with the Reserve Bank's existing approach

This section benchmarks the Reserve Bank's approach to supervision and enforcement against the IMF's principles for 'good' supervision noted in the previous section.

Intrusive

A deep understanding of the supervised entity is required. Supervision should not be 'outsourced' or rely solely/mainly on 'off-site' monitoring. Supervision should be 'continuous', albeit at an intensity that reflects the different risk profile of entities in any regulated sector.

- By design, the Reserve Bank's approach is hands-off and non-intrusive. This is founded on the assumption that those who create risks should bear the ultimate responsibility for managing them. It also rests on a large degree of supervisory pragmatism that assumes banks are best placed to understand the risks they face.
- No on-site inspections are undertaken to verify or validate the information that regulated entities provide to the Reserve Bank. This significantly lowers baseline prudential resourcing requirements.
- However, the Reserve Bank works with APRA, and attends its on-site inspections of the New Zealand subsidiaries of Australian banks.
- All banks participate in an annual engagement plan set by the Reserve Bank. This involves scheduled, formal meetings between the banks' directors and executives, and senior members of the Reserve Bank. The number of meetings each year depends on the Reserve Bank's assessment of their systemic importance. The meetings provide an opportunity for the Reserve Bank to enquire about the banks' strategies, financial positions and risks.
- The Reserve Bank uses statutory information requests to ensure that the banks send regular risk-related reports. The requests are sent annually, cover the coming 12 months, and give the supervisors regular and up-to-date risk information on the banks.

Sceptical, proactive and forward-looking

Supervision must be intrinsically countercyclical, probing and questioning regulated entities in apparently benign periods. Supervision must be forward-looking, identifying and responding to emerging risk. "Prudential supervision is most valuable when it is least valued; restricting reckless banks during a boom is seldom appreciated but may be the single most useful step a supervisor can take to reduce failures" (Viñals *et al*, 2010, p. 13).

- Bank directors are primarily responsible for ensuring that their banks comply with regulatory requirements intended to ensure prudent outcomes. This accountability is reinforced through disclosure statements, which help to support market discipline. However, a lack of routine, independent verification by the Reserve Bank limits its scepticism and ability to challenge the director attestation process, except where there is clear evidence of non-compliance.
- While the Reserve Bank's risk assessment framework (PRESS) has a forward-looking dimension, there are practical limits to how proactive this approach can be in the absence of on-site inspections.

Comprehensive

Supervision should not be confined to entities within any formal regulatory perimeter. Supervisors must be vigilant to emerging risks at the edge or outside the perimeter. Supervision needs to link firm-level risk analysis and monitoring (micro-prudential) with analyses at the sector or financial system level (macro-prudential).

- The Reserve Bank has a systemic risk-monitoring function (macro-prudential analysis and policy) that is guided by a systemic statutory objective. There are synergies between the Reserve Bank's off-site monitoring of individual banks and this macro-level analysis, although like micro-prudential supervision, this macro-prudential function is relatively under-resourced by international standards.
- Given resource constraints, there are practical limits to the Reserve Bank's ability to monitor developments outside the formal banking (and NBDT) perimeters.

Adaptive

The financial system is constantly evolving and innovating. Supervision must be in a constant learning mode, alert to new products, markets, services, and emerging threats.

- The Reserve Bank keeps an eye on new and emerging market trends and potential risks, such as FinTech, cyber risks and climate-change implications for the financial system. It also participates in international forums to discuss the implications of new developments for its prudential responsibilities.
- However, being lightly resourced affects the Reserve Bank's ability to address some of these issues in any depth. This can result in a reactive, rather than proactive approach to some issues.

Timely and conclusive

Issues identified in the supervisory process should be followed through to a satisfactory outcome – either confirmation of remediation efforts by entities of identified problems, or a timely response to inaction or non-compliance by regulated entities.

- The Reserve Bank has an internal process for responding to issues of non-compliance or areas of emerging prudential concern, and a range of supervisory and formal enforcement tools to undertake corrective action.
- However, a lack of independent verification could mean delays in problem identification (e.g. noncompliance with the outsourcing policy – see Box 3A).
- To date there has been limited use of formal enforcement powers directed at registered banks, and the range of formal enforcement powers is somewhat limited.

The 2016/17 IMF FSAP and the Reserve Bank response

The IMF's 2016/17 FSAP for New Zealand[57] included a detailed assessment of how the Reserve Bank's approach to supervision compared with the BCPs.[58] On the plus side, the IMF noted that since the previous FSAP in 2003 the Reserve Bank had installed PRESS, upgraded private statistical and prudential reporting requirements, undertaken a number of thematic reviews, and established an AML/CFT supervisory process. The assessors also praised the high quality of supervisory and policy staff at the Reserve Bank.

However, its overall assessment was that "… the Reserve Bank approach is in conflict with the BCP requirements, which expect granular guidelines and on-site verification work by the supervisor" (IMF, 2017a, p. 5). The Reserve Bank received a 'materially non-compliant' grade for four of BCPs 1-13, which deal with the preconditions for effective supervision (independence, resourcing, and certain supervisory powers) and supervision techniques and tools (see Table 3B below). See Chapter 1 for a discussion of the IMF's assessment of the Reserve Bank's prudential framework against BCPs 14-29, which cover the rules and expectations that should be required of banks.[59]

The FSAP report noted that the effectiveness of the Reserve Bank's current approach is limited by the heavy weight placed on market discipline, and the absence of independent testing of prudential returns and risk management practices for prudential purposes via on-site inspections. The IMF is inherently sceptical of the Reserve Bank's view that regulators' goals and regulated entities' approaches to managing risks and internal governance can generally align. The IMF argues that, while primary responsibility for firm-level outcomes rests with boards and senior management, it is not sufficient to simply trust what banks say – robust verification is required.

The IMF also believes that enhanced regulatory benchmarks (a more comprehensive rulebook, including rules for and expectations of regulated entities in relation to key risks such as credit risk)

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[57] For a summary of the 2017 FSAP recommendations, see Hunt (2017a).

[58] First released in 1997, the BCPs were revised in 2012 to reflect the lessons from the GFC. There has been an increased focus on effective risk-based supervision and the need for early intervention and corrective actions.

[59] Across the full set of 29 BCPs, New Zealand's framework received 13 materially non-compliant, eight largely compliant, and eight compliant grades.

and increased validation should provide the basis for a more proactive enforcement strategy that is better aimed at addressing imprudent behaviour.

More generally, the IMF argues that the Reserve Bank is under-resourced, even for the current relatively hands-off approach (see Box 3B).

Table 3B: Basel Committee on Banking Supervision's Core Principles for Effective Banking Supervision – summary of results for BCPs 1-13

Core principle	C	LC	MNC	NC
BCP 1: Responsibilities, objectives and powers		✓		
BCP 2: Independence, accountability, resourcing and legal protection for supervisors			✓	
BCP 3: Cooperation and collaboration		✓		
BCP 4: Permissible activities		✓		
BCP 5: Licensing criteria	✓			
BCP 6: Transfer of significant ownership	✓			
BCP 7: Major acquisitions	✓			
BCP 8: Supervisory approach			✓	
BCP 9: Supervisory techniques and tools			✓	
BCP 10: Supervisory reporting			✓	
BCP 11: Corrective and sanctioning powers		✓		
BCP 12: Consolidated supervision		✓		
BCP 13: Home-host relationships		✓		
Totals	**3**	**6**	**4**	**-**

Note: C = compliant; LC = largely compliant; MNC = materially non-compliant; NC = not compliant.

In response to the FSAP results, the Reserve Bank has committed to consider some of the recommendations that would improve its three-pillar model but not necessarily be a significant departure from the current approach. In this vein the Reserve Bank has committed to considering potential modifications to its current approach, including:

- undertaking more (third-party) independent verification
- developing clearer, simpler, and more enforceable policies, supported by a greater range of enforcement tools
- deepening the understanding of best practice across the banking (and insurance) industry via targeted thematic reviews.

The Reserve Bank has subsequently reallocated resources to support more thematic reviews but decisions on the further increases in resources, which would be necessary to implement more of the FSAP recommendations, have been deferred to the next funding agreement, which will come into force on 1 July 2020 (subject to any changes in the funding model – see Chapter 7).

Questions for consultation

3.C In what areas do you think the Reserve Bank could improve its approach to supervision and enforcement? How could this be best achieved (e.g. through legislative change, resourcing, relationships with regulated entities)?

Options for more intensive supervision

The Reserve Bank's director attestation regime does not guarantee that a bank's systems and controls are adequate. Instead, it makes the bank's directors responsible for ensuring that controls are adequate, but without the Reserve Bank routinely verifying or getting assurance that this is the case.

Options

Four options (described below) would facilitate greater verification, lying along a continuum of supervisory intensity and intrusiveness.

All the options require more baseline funding for supervision activities, substantially so in the case of more comprehensive on-site inspections. This could be facilitated by giving the Reserve Bank more autonomy to determine its resourcing requirements, subject to appropriate checks and balances. (Chapter 7 considers the Reserve Bank's current funding model and options for change.)

The Reserve Bank's decisions on resource allocation and supervision intensity would reflect its view of how best to achieve its statutory objectives (operational independence). They should also, ideally, align with society's 'risk preferences' as indicated by the Government's views on how the Reserve Bank should undertake its financial system responsibilities. Chapter 2 of Consultation Document 2A explains how the Government could express its risk tolerance through a 'government policy statement' or 'remit'.

Some of the options would require a legislative provision to allow the Reserve Bank to undertake on-site inspections. Such a provision could be structured to either:

- allow the Reserve Bank to require a bank to supply or provide certain information at the bank's premises,[60] or
- to provide a broader power that would allow the Reserve Bank to turn up and inspect any aspect of a bank's business at its premises (with some notice), but without the need to pre-specify the scope or nature of the information required by the Reserve Bank.[61]

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[60] See section 25 of the FMA Act 2011.

[61] Akin to that in sections 168-174 of the Health and Safety at Work Act 2015.

Given New Zealand operates under a twin peaks model where some entities may be subject to supervision by both the Reserve Bank and the FMA, it would be desirable on efficiency and effectiveness grounds that the on-site powers of both regulators were aligned.[62]

In addition, and given the importance of the trans-Tasman home-host relationship, all the options entail a continued close working relationship with APRA. However, there are some choices in how this relationship could apply to the different models.

Option 1: Enhanced status quo

The Reserve Bank has already committed to gaining a better understanding of cross-cutting sectoral issues through thematic reviews undertaken by the new IIT team. Further enhancements to the supervisory model could include a general increase in resourcing to enable:

- a recalibration of the off-site monitoring of larger banks and more engagement with individual firms. This could include a more comprehensive analysis of firm data and stress testing (to help in identifying future risks), more crisis scenario exercises and more regular and/or a wider array of meetings with the firms' senior management (e.g. this could include more engagement with senior executive teams as a group or regular one-on-one meetings with independent directors)
- the supervisory teams to engage with regulated entities to learn how they are preparing to implement *new* prudential requirements ahead of the implementation date. This could include more proactive and structured conversations with key executives to gain comfort that the entities understand what is required of them and are prepared to meet those requirements. Subsequent verification of compliance would involve further interviews and information requests etc., which would enable supervisors to assess whether the entities were indeed meeting the new requirements
- the IIT team to produce a 'suitable number' of high-quality thematic reviews that would support a continued emphasis on desk-based monitoring for individual firms
- a more active engagement with APRA on its on-site visits to the New Zealand subsidiaries
- other activities that are not currently explicitly resourced. This includes resources to develop or improve supervisory systems and processes, or to monitor and help develop 'recovery and resolution plans' for each regulated entity (see Chapter 5).

Another enhancement could be the routine commissioning of independent (skilled person) reports to obtain additional assurance of individual banks' compliance with prudential requirements. This could be on an ad hoc basis if the Reserve Bank had concerns as a result of its off-site monitoring or engagement programme, or possibly made a more regular feature of the supervisory framework.

Option 2: Spot-check inspections of individual banks

Empowered by a new legislative provision to go on-site, the Reserve Bank would have the discretion to inspect any aspect of a registered bank's affairs, including regulatory compliance and areas of emerging concern. The threat of spot-check inspections could enhance the current disciplines imposed on bank directors, and could be used to complement or substitute for a more frequent use of independent reports. The decision to undertake a spot-check would be guided by issues raised in

[62] This alignment could be achieved by either providing the Reserve Bank with the same powers as the FMA, or amending the FMA Act to align with any more expansive powers conferred on the Reserve Bank.

the Reserve Bank's off-site monitoring of individual banks and through thematic reviews. The number of spot-checks would be tied to risk-based assessments of the entities and decisions on resource allocation.

The power to go on-site would also complement the Reserve Bank's thematic review programme. It would enable the Reserve Bank to undertake a review like the recently completed Conduct and Culture Review with the FMA, but without the need for regulated entities' expressed consent to go on-site. This option would also enhance the depth of and insights gained from thematic reviews.

As in Option 1, the Reserve Bank could take a more active role in the APRA-led on-site inspections of the big four banks.

Option 3: Regular on-site inspections of individual banks

This option would entail a verification approach that is broadly consistent with those of prudential authorities such as APRA, the UK's PRA, and Canada's OSFI, all of which inspect firms on a periodic cycle.

The inspections' frequency and depth would be guided by the impact and risk assessment process, with larger and more systemically important banks visited more frequently. This approach would:

- make independent reports less relevant as the primary vehicle for verification (although these could still provide additional assurance in some circumstances)
- require a more significant upscaling of the Reserve Bank's supervisory capabilities and capacity
- require empowering legislation.

In terms of the home-host relationship with APRA, several sub-options could be considered:

- The Reserve Bank could undertake on-site inspections of the **four Australian-owned subsidiary banks** (and their New Zealand branch operations) alongside inspections of other banks, while continuing to participate in APRA's on-site visits. This would enhance the Reserve Bank's specific understanding of Australian-owned subsidiaries, over and above the insights already gained from attending the APRA-led inspections.

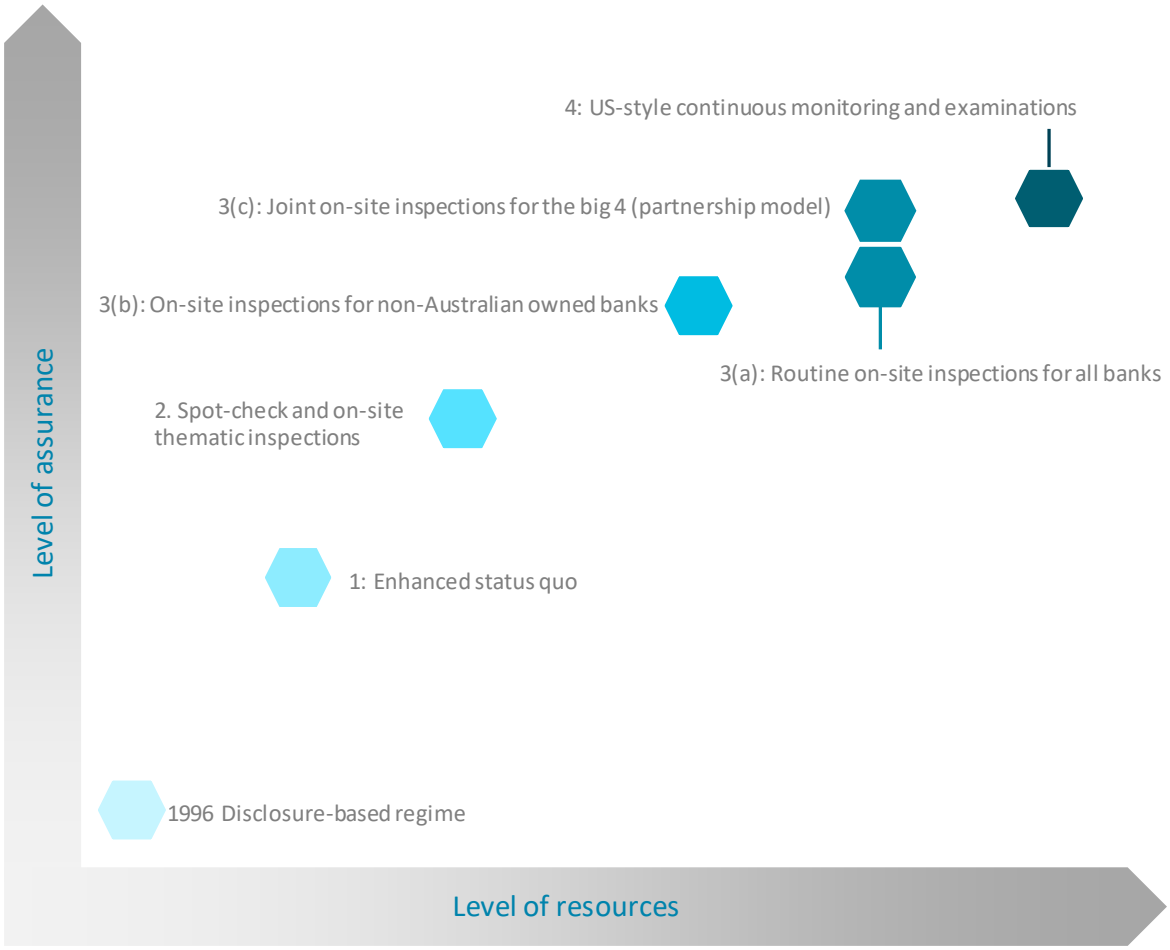
  A dual inspection regime for the New Zealand subsidiaries would require further coordination with APRA to avoid an unnecessary duplication of efforts (e.g. APRA supervisors could also participate in the Reserve Bank-led inspections). However, the banks themselves may view a dual regime as an unnecessarily onerous imposition, although if the Reserve Bank did adopt this approach, APRA might be able to reduce its on-site activities in New Zealand.
- The Reserve Bank's on-site inspections could be confined to the **domestically-owned banks** (or the non-Australian-owned banks), with the Reserve Bank continuing to gain insights from participating in the APRA-led on-site inspections. The downside of continuing to defer to APRA in inspecting the big four banks is that APRA's focus and priorities may be different from the Reserve Bank's perspective, focus and priorities. APRA inspects the New Zealand subsidiaries because of the potential risks of their activities for the parent banks, rather than to promote the soundness of the New Zealand financial system.
- A single, **joint on-site inspection regime** for the New Zealand operations of the Australian-owned banks could be implemented through a trans-Tasman partnership model between the Reserve Bank and APRA. This would reduce the cost for the Australian banks of potentially separate on-site inspection programmes.

Option 4: A continuous monitoring and examination model

This 'examination' approach to inspections would be similar to the US approach for the largest, most complex institutions.[63] It is characterised by very detailed 'transactional testing' of almost every aspect of a bank's business. The model could include locating supervisors in regulated entities (i.e. permanently on-site) to monitor and assess the entities continually, and meet management. It would be the most intrusive and resource-intensive approach of all the options for enhancing independent verification.

Figure 3D provides an indicative mapping of the four options against their potential assurance levels (comfort to the Reserve Bank and society that the banks are managing their businesses prudently) and their supervisory intensity as indicated by resources.

Figure 3D: Options for verification



[63] Note for smaller and less complex banks, the US approach entails an annual full scope on-site examination (which typically lasts two weeks) and a reliance on off-site monitoring to identify any deterioration in the institution's financial health or emerging trends between examinations.

A few points are worth mentioning in relation to supervisory intensity and verification:

- The choice of any model is somewhat contingent on the prudential authority's statutory objectives. A systemic objective would typically result in resources being directed towards the larger and more systemically important banks in the system, relative to smaller institutions, thereby influencing the baseline calibration of monitoring and verification across the range of banks. The addition of an objective directed towards the soundness or resilience of individual banks, however, might necessitate a recalibration of resource towards smaller banks, even in a risk-based framework.
- The choice of any model will reflect a prudential authority's interpretation of its statutory goals, and how it interprets the 'risk tolerance' of society to certain financial system outcomes. Post-GFC there has been a recalibration of society's risk appetite for bank failures and government bailouts. As the Dutch central bank explains, reflecting on changes to its approach to prudential supervision, "Given the pronounced reaction to the problems at financial institutions and the provision of government support, this risk tolerance appears to be significantly lower than the risk assurance that can be delivered with the current level of supervision" (DNB, 2010, p. 25).
- In a world where resources are finite and risk-based decisions are required, it is not possible to overcome completely the information asymmetries between the prudential authority and regulated entities. The supervisor cannot give itself (or society) absolute assurance that a bank is sound and there will be some residual role for trust in any model, even in the most intrusive and resource-intensive ones. In addition, as the BCBS explains, "Banking supervision cannot, and should not, provide an assurance that banks will not fail. In a market economy, failures are part of risk-taking" (2012, p. 13).
- The approach to supervision is one, albeit important, factor in contributing to a prudential authority's statutory objectives. There are other, equally important, elements in the financial safety net (see the introduction to Part A), which together help to achieve financial stability: the nature of the regulatory rules, the bank crisis management and resolution framework, and any depositor protection scheme. There is also a question about the appropriate weight that any model gives to self- and market discipline in contributing to financial stability.
- Measuring the effectiveness of any supervisory model is a challenging process, although it is integral to promoting accountability and assessing whether the prudential authority is achieving its desired outcomes (Hilbers *et al*, 2013). It can be difficult to link supervisory actions to statutory objectives – that is, differentiate supervision from other parts of the financial safety net, or from the broader macroeconomic environment. A supervisory model's flaws can be laid bare, as was the case in the GFC – but on the other hand the absence of a systemic banking crisis or failure of an individual institution does not necessarily signal an effective supervisory approach. In the absence of a robust approach, risks and vulnerabilities may be building up in the interim.

Potential advantages of more independent verification

On the upside, independent verification:

- increases supervisors' depth of understanding of registered banks
- improves supervisors' situational awareness and horizon scanning for new financial products and technologies, and emerging risks

- improves the Reserve Bank's preparedness to deal with periods of crisis, through enhanced business-as-usual monitoring and understanding (for instance, more intensive supervision may provide a knowledge base for recovery and resolution planning)
- addresses limitations in self- and market discipline
- provides confidence to domestic and international investors that banks are sound and managing risks appropriately, with the supervisory approach closer to global norms
- provides some banks with additional assurance from the Reserve Bank to support their internal processes (e.g. smaller banks with less mature risk management and internal control functions)
- enables non-compliance at registered banks to be identified and corrected, earlier
- could enable better working relationships between registered banks and supervisors (e.g. more face-to-face and in-depth conversations with a wider range of bank staff).

Potential drawbacks of more independent verification

On the downside, independent verification could:

- undermine due diligence incentives for directors (i.e. self-discipline) and the incentives for external monitoring by market participants (i.e. market discipline), by giving the impression that the Reserve Bank is the first line of defence for the financial system
- increase the direct costs imposed on banks (in preparing for on-site visits, staff time during inspections etc.)
- increase the upfront costs to society of prudential supervision, substantially so in more intrusive approaches
- erode trust and the working relationships between banks and the Reserve Bank if not properly managed.

Question for consultation

3.D Do you think the Reserve Bank should take a more intensive approach to verifying supervisory information? If so, which verification model do you favour?

Options for changes to the enforcement regime

The Reserve Bank has a number of supervisory and court-based tools that can be used to prompt corrective action. The threat of using the court-based tools (which have powerful penalties) is meant to reinforce the Reserve Bank's emphasis on self-discipline, and this is tied to accountability arrangements that are based on directors' role in attesting to the veracity of disclosure statements.

However, no formal court-based actions have been taken against either firms or directors to date under the Reserve Bank Act, so it is unclear whether this is a credible threat; self-discipline without a demonstration effect is possibly naïve. Most supervisory actions to effect corrective action are largely undertaken out of public sight – a situation that reduces the deterrence benefit of potential enforcement actions, and may reduce clarity around the Reserve Bank's expectations of good conduct.

Enforcement could be made more effective by expanding the formal toolkit (including its public-facing dimension).

That said, there is a difficult balance between working with an entity to effect voluntary compliance and using more formal enforcement powers to deter non-compliance and encourage corrective action. Such action, if it is seen as punitive, can potentially damage the Reserve Bank's relationships with individual institutions, prompting them to be less open, while deterring potential directors who feel at serious risk of court action. There are also resource implications from undertaking more formal enforcement action.

Options for changes to the enforcement regime set out below are tied to broadening the suite of formal enforcement tools. Note that Chapter 1 covers options for reconsidering how individual liability for any breaches of prudential rules is specified in legislation (i.e. the director attestation regime).

Box 3D: APRA's enforcement strategy review

APRA has recently released a report reviewing its enforcement strategy. The review was prompted by several factors, including the introduction of the Banking Executive Accountability Regime (BEAR) last year, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, and initiatives stemming from APRA's 2018-22 *Corporate Plan* on increasing supervision intensity and transparency.

The review noted that, in most circumstances, non-formal supervision tools are highly effective as a timely and efficient way of achieving most prudential outcomes, while certain formal powers, such as court action, "can involve significant time, cost and supervisory resources. They also carry the risk the intended prudential outcome may not be achieved" (p. 7).

Nevertheless, the review argued that formal powers are an important part of the overall regulatory toolkit, as they lend credibility to non-formal supervisory actions through the threat of stronger action. The public nature of these actions can also underpin a broader deterrence effect to other industry participants.

The review concluded that APRA's current enforcement strategy is out of step with international peers, and its "low enforcement appetite has, in some instances, resulted in risks not being addressed in a timely manner. A lack of stronger action earlier has, at times, drawn supervisory resources into protracted engagement around remediation of issues in place of preventive supervision. General deterrence benefits have been limited given much of APRA's activity occurs in private. For regulated parties who do cooperate, a lack of consequences for those who flout the rules risks undermining the value and benefits of compliance" (p. 8).

APRA has committed to implementing all the recommendations in the report:

- Strengthening the coordination between APRA and the Australian Securities and Investments Commission (ASIC) on enforcement.
- Increasing APRA's enforcement appetite from a 'last resort' to a 'constructively tough' approach (and setting this out in a publicly available enforcement strategy).
- Assigning clear responsibility to supervisory divisions for applying the new enforcement appetite.
- Building a more forceful supervisory culture and approach, to better empower and support supervisors to hold entities and individuals to account, including through the use of enforcement action.
- Establishing a new internal committee to drive enforcement decision-making and strengthen oversight.
- Creating a combined team of investigation and legal experts, and ensuring adequate funding for enforcement activities.
- Bolstering various statutory powers, including revising and creating additional penalties.

Notwithstanding these changes, APRA expects to remain a supervision-led organisation, undertaking most of its work using non-formal approaches to facilitate corrective action.

Broadening the suite of enforcement tools

As a prudential authority, the Reserve Bank's regulatory tools will be primarily used to secure *ex ante* remedial actions by firms, in order to address emerging risks. This contrasts somewhat with the FMA and its role as New Zealand's financial market conduct regulator. The FMA has a broader population of regulated entities to supervise, many of which are not licensed, and its objectives focus on promoting confident and informed participation in financial markets. As a result, it will have a greater focus on *ex post* enforcement action, to denounce conduct or seek restitution for consumers and investors.

Given the Reserve Bank's focus on *ex ante* prevention, there is particular value in tools that can be used relatively efficiently and without recourse to lengthy court processes.

The Reserve Bank currently has a number of non-statutory tools that can be used to ensure that firms comply with their regulatory obligations. These include moral suasion, private warnings, and informal public notices. The Reserve Bank can also adjust the rules applying to certain firms, for example by imposing or changing a CoR. However, it is arguable that these tools do not empower the Reserve Bank with a sufficiently broad toolkit to act decisively in some circumstances. For example,

unlike a number of other regulators, the Reserve Bank does not have the following enforcement tools:

- **Statutory public notices** – these provide a statutory basis for issuing public warnings.
- **Enforceable undertakings** – these are commitments given to and accepted by a regulator. They are enforceable in court if parties fail to meet the commitments.
- **Infringement notices** – these are a subset of criminal offences that do not result in criminal convictions. In general they provide an effective remedy for minor compliance-type contraventions, such as a failure to lodge particular documents with the regulator. The entity can elect to either pay or contest the notice, in which case a District Court hearing is held.
- **Civil penalties** – these are non-criminal monetary penalties applied under the civil standard of proof.

In addition, some important powers (such as the ability to issue directions) require ministerial consent. This requirement means there is likely to be a very high threshold for the use of these tools.

Broadening and formalising the Reserve Bank toolkit has a number of potential benefits:

- It provides the Reserve Bank with more credible options to change the behaviour of firms that are not willing compliers. A wider toolbox may enable the Reserve Bank to approach non-compliance with more formality and sensitivity to the situation.
- *Ex post* public enforcement can serve a wider preventive purpose. For example, the use of more public enforcement tools can help the Reserve Bank to meet its objectives by sending clear signals to individual firms (and a regulated sector more widely) about the circumstances in which the Reserve Bank considers a firm's behaviour to be unacceptable, thereby helping to deter future non-compliance.
- Providing a stronger statutory basis for tools such as public warnings means they are less likely to be subject to challenge. It can also ensure that regulated entities receive appropriate access to process and natural justice (e.g. through a requirement to provide reasons, or a right to be heard).

Table 3C outlines the sanctioning powers currently in the Reserve Bank Act and compares them with other financial sector legislation in New Zealand.

Table 3C: Sanctioning powers

	Part 5 RBNZ Act 1989 (registered banks)	**Part 5D NBDT Act 2013** (licensed NBDTs)	**IPSA 2010** (licensed insurers)	**Part 4 RBNZ Act, IPSA** (restricted words)	**AML/CFT Act 2009** (money laundering)	**FMA Act 2011 / FMC Act 20113** (conduct regulation)	**Commerce Act 1986** (competition)	**Fair Trading Act 1986** (fair trading)	**CCCF Act 2003** (consumer credit)
Conditional waiver (informal)	✓	✓	✓	✓	✓	✓	✓	✓	✓
Private warning (informal)	✓	✓	✓	✓	✓	✓	✓	✓	✓
Public notice (informal)	✓	✓	✓	✓	✓	✓	✓	✓	✓
Statutory public notice	x	x	x	x	✓	✓	x	x	x
Enforceable undertaking	x	x	x	x	✓	✓	✓	✓	x
Infringement fee	x	x	x	x	x	✓	x	✓	✓
Impose or change conditions of licence	✓	✓	✓	x	x	✓	n/a	n/a	n/a
Remove directors and/or senior officers	✓	✓	✓	x	x	x	✓	✓	✓
Offence can be attributed to directors	x	✓	✓	x	x	✓	✓	x	✓
Ban directors/senior officers from industry	x	x	✓	x	x	✓	x	✓	✓
Issue directions	✓	✓	✓	x	x	✓	x	x	x
Revoke license/registration	✓	✓	x	x	x	✓	n/a	n/a	n/a
Statutory management	✓	x	✓	x	x	✓	x	x	x
Liquidate	x	x	✓	x	x	✓	x	x	x
Civil penalties	x	x	x	x	✓	✓	✓	✓	✓
Criminal prosecution	✓	✓	✓	✓	✓	✓	✓	✓	✓

Note: n/a = not applicable. The FMA have further enforcement powers in addition to those in the table under the FMC Act and the Companies Act.

The merits, or otherwise, of adding more formal tools to the enforcement arsenal are summarised in Table 3D.

Table 3D: Pros and cons of a broader suite of formal enforcement tools

Pros	Cons
▪ A fuller enforcement toolkit can reinforce a prudential authority's focus on *ex ante* preventive actions (through the credible threat of subsequent enforcement action). ▪ Provides a full range of tools that allows public enforcement action without resorting to criminal sanctions. ▪ In combination with supervisory actions, a full suite of corrective action powers allows a tailored and proportionate response to any non-compliance or emerging area of risk. ▪ Potential use of additional formal tools helps to reinforce current disciplines on directors. ▪ Public actions have an additional deterrence effect on other industry participants, over and above penalising the individual bank or its directors. Most supervisory actions are non-public. ▪ Current informal enforcement powers (e.g. non-statutory public warnings) may have limited public understanding – the formalisation in legislation of some of these informal tools could help promote greater awareness.	▪ Could create an unrealistic expectation amongst stakeholders that the default approach is the use of public enforcement actions – the Reserve Bank becomes an 'enforcement-led' supervisor. ▪ The potential for more public use of regulatory tools may decrease the willingness of regulated entities to discuss emerging issues with the Reserve Bank. ▪ There is some flexibility in the use of supervisory actions to promote a broader deterrence effect without additional formal tools (some actions can already be made public, like changes to CoRs).* ▪ Greater resourcing and capability requirements, including increased investigatory resources. The use of enforcement tools is typically costly and resource intensive to utilise, even those that do not involve court processes. ▪ Additional tools may come with greater prescription in how they are used, potentially reducing the ability to react adaptively and to individual circumstances.

* E.g. the capital overlay imposed on Westpac for breach of its CoR relating to its status as an internal models bank.

If the Reserve Bank's suite of enforcement tools were broadened, there would be a clear need for greater transparency on its proposed use of those tools and how the tools would interact with other supervisory responses.[64] This would help to mitigate the risk of banks perceiving the Reserve Bank as moving towards being an enforcement-driven regulator.

The specific merits of the individual additional tools are considered below.

- **Statutory public notices** – the Reserve Bank currently has the discretion to issue public notices about a supervised entity's behaviour where it considers that the entity has breached a

[64] See, for example, the FMA's Regulatory Response Guidelines or the UK PRA's Approach to Banking Supervision.

regulatory requirement but has decided not to prosecute. Formalising public notices in legislation may enhance a notice's effect on an entity's reputation, and help clarify the purpose behind and expected content of public notices. When used, it may also provide the Reserve Bank with additional protection, for example by reducing the scope for potential legal challenge.

- **Enforceable undertakings** – this tool would allow the Reserve Bank to agree certain outcomes with a regulated entity (such as remediation actions or even a penalty). As the enforceable undertaking is agreed with the entity, it can be tailored to outcomes that might otherwise be difficult to access without going through a court process (such as admitting liability or agreeing on statements of facts). If a regulated entity is proactively seeking to address a breach, an enforceable undertaking can allow for a more proportionate response than a direction or court action.
- **Infringement notices** – these can provide a relatively efficient way to incentivise compliance with requirements where breaches are minor and relatively unambiguous (for example, a requirement to disclose certain information by a certain date).[65] While an infringement notice can be challenged in court, it is not necessary to go to court to issue a fine under an infringement notice. Although the fees payable under an infringement notice are very low, their effectiveness is reflected primarily in the effects on an entity's reputation.
- **Civil penalties** – one of the Reserve Bank Act's current issues is that it provides for criminal liability in cases that may not involve knowledge or recklessness on the part of directors. Where breaches are neither reckless nor deliberate, it may be more proportionate to apply civil penalties. They require a different standard of proof and must be proved in court, so would likely only be used for significant breaches of regulatory requirements.

Note that applying many of the more graduated tools above will require meaningful resources. However, just having the ability and willingness to go up the enforcement pyramid (refer back to Figure 3A) is often enough to change bank behaviour well in advance of more serious non-compliance issues developing.

Options to enhance supervisory independence

Issuing directions

The requirement for ministerial consent to issue directions is out of step with international practice, and does not align with other Reserve Bank legislation such as IPSA and the NBDT Act. The IMF's FSAP also recommended that it be removed – stating that ministerial consent creates a very high hurdle for using directions, and may inhibit the development of a genuinely forward-looking and proactive approach to corrective action.

Deregistering a bank

Another area where the Reserve Bank's supervisory powers are somewhat circumscribed is in the power for the Minister to deregister a bank on the recommendation of the Reserve Bank (except in the case of voluntary deregistration).

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[65] The FMA can impose infringement fees under the FMC Act 2013. For example, a failure by an FMC Act reporting entity to lodge a financial statement by the required date can be subject to an infringement fee of up to $50,000.

Deregistration can be required for all sorts of reasons as defined in the Reserve Bank Act. The Reserve Bank may wish to deregister a bank if it finds out that the bank was initially registered using information that was false or misleading, or it believes that changes to the bank's business mean it cannot continue to meet the minimum registration requirements. In these circumstances it is not clear that the Minister needs an explicit role (and they do not have a delicensing role in the more modern IPSA and NBDT Act).

The architects of the 1989 Act were likely mindful of not giving the Reserve Bank unilateral power to issue directions or deregister a bank, reinforced by the sense that these actions would be rare but very significant for the banks subject to these actions.

Questions for consultation

3.E What are the appropriate enforcement tools for the Reserve Bank? Which tools in particular should be added to the toolkit?

3.F Is the Minister's role in issuing directions and deregistration appropriate?

Summary

This chapter has identified a number of gaps in the Reserve Bank's approach to supervision and enforcement relative to international standards, and presented a number of options for reform:

- A move away from a light-handed supervisory model to one that is inherently more sceptical and challenging, based on greater verification. This would require an increase in funding and the power to undertake on-site inspections.
- The development of a more formalised toolkit of sanctioning powers that can be used in a proportionate way to facilitate corrective action.
- Strengthening the Reserve Bank's operational independence by removing the Minister's role in issuing directions and bank deregistration.

Part B: The Reserve Bank's role in containing periods of financial stress

The Reserve Bank has a number of tools to help contain the consequences of periods of financial stress. This include tools that keep connections between banks running smoothly (liquidity facilities) and tools that keep bank failures orderly and contained (resolution tools). Both sets of tools are key parts of New Zealand's financial safety net, illustrated in the introduction to Part A.

Part B discusses the Reserve Bank's role in using its balance sheet to provide liquidity assistance and its resolution powers to deal with bank failures. Part B is structured around two chapters:

Chapter 4 asks how the Reserve Bank's balance sheet functions should be formulated.

In times of stress when banks are struggling to obtain funding from private creditors, the Reserve Bank can use its balance sheet to act as the lender of last resort (LoLR) – providing short-term loans to solvent banks to contain market panic. This function is a crucial part of New Zealand's financial safety net, but current legislation says little about when and how the Reserve Bank can undertake this LoLR role. Chapter 4 examines options to clarify both the purpose and boundaries of the LoLR function, which could include a mixture of changes to primary legislation and/or requirements to publish framework documents.

In addition to LoLR, the Reserve Bank can use its balance sheet for a number of other functions, including implementing monetary policy decisions and foreign exchange intervention. Chapter 4 considers how the legislation could be clarified to ensure the Reserve Bank has clarity over the purpose and governance arrangements of such decisions.

Chapter 5 asks what features New Zealand's bank resolution and crisis management regime should have.

Banks, like any type of business, can fail. But unlike other businesses, a bank's failure can have severe economic impacts on its depositors and can cause widespread contagion to other financial institutions, which can threaten financial stability and economic prosperity. It is for this reason that the prudential regulation of banks needs to be complemented by a 'resolution regime' that bestows sufficient powers on the Reserve Bank to deal with a bank failure in an orderly way.

Chapter 5 explores whether New Zealand's existing resolution regime is fit for purpose. It notes that, while the Reserve Bank Act contains many of the elements that are now recognised internationally as being important for the effective resolution of a failing bank, New Zealand's regime does falls short in some important areas. In particular, the resolution regime lacks a clear set of resolution objectives to guide the Reserve Bank's actions, it involves too much ministerial involvement in some decisions, it lacks some resolution tools, and it does not provide sufficient protections for property rights. Chapter 5 then presents options to address these issues and bring New Zealand's resolution regime into line with international best practice.

Chapter 4: How should the Reserve Bank's balance sheet functions be formulated?

Aim of this chapter

This chapter discusses how the Reserve Bank uses its balance sheet to support its objectives, and the governance arrangements for the key activities it undertakes in doing so.

Some of the most important issues relate to activities it might undertake during unusual market circumstances, such as a financial crisis. These activities have links to topics considered elsewhere in this Consultation Document (including coordination and crisis management). The chapter suggests possible ways to enhance and clarify the legislative basis for these activities.

Why the Reserve Bank's balance sheet matters

The Reserve Bank has the 'sole right' (see section 25 of the Reserve Bank Act) to create New Zealand dollars and supply them to the financial system.[66] This is arguably the key function of a central bank.

As well as generating income, the Reserve Bank's ability to create New Zealand dollars (which can be electronic as well as physical notes and coins) enables it to undertake a variety of other useful activities, including:

- **acting as the lender of last resort (LoLR)** (section 31) – providing financial institutions with New Zealand-dollar funding when market panic has made that funding hard to obtain elsewhere
- **implementing monetary policy** – this usually involves intervening in the financial market to keep short-term interest rates near the OCR. In very weak economic circumstances, when interest rates are around zero, it may also include purchasing additional assets for the Reserve Bank balance sheet (this is known as 'quantitative easing')
- **dealing in foreign exchange** (sections 16-24) – involves exchanging local currency for foreign exchange and vice versa
- **providing banking services and other activities** (section 39) – these include settlement account services for financial institutions and certain trading in financial markets.[67]

There are strong synergies between these activities and the Reserve Bank's role in managing the creation of New Zealand currency, so it seems appropriate to keep these functions within the Reserve Bank. However, it is worth considering issues related to their scope, objectives and governance. Chapter 7 discusses transparency and accountability arrangements in relation to the Reserve Bank's balance sheet (which are relevant to these activities).

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[66] References to sections in this chapter all refer to the Reserve Bank Act.

[67] Space constraints prevent a lengthy description of these activities in recent years, but interested readers can refer to Eckhold (2010) and Parekh (2016) for useful Reserve Bank background articles.

Objectives and governance of balance sheet functions in general

Most of the Reserve Bank's balance sheet functions are primarily directed at monetary policy or financial stability-related objectives. As a secondary consideration, it is appropriate for the Reserve Bank to seek to undertake these functions in a cost-effective and profitable way. The Governor currently has an implicit duty to ensure that the resources of the Reserve Bank are properly and effective managed.

As noted in Chapter 2 of Consultation Document 2A, it is important to scrutinise the way the Reserve Bank uses the above balance sheet functions to achieve the relevant objectives. In many cases the functions will have to balance conflicting objectives and priorities, and have constraints on their operation.

For example, funding extended under the LoLR function aims to promote financial stability by helping institutions to survive and mitigate market panics. If liquidity is too difficult to obtain, short-term problems could cause an unnecessary financial crisis. But if funding were available from the Reserve Bank too frequently and cheaply, banks might rely on it rather than working to develop diversified sources of market funding, which would make the financial system less resilient.

Finally, the amount of lending the Reserve Bank is prepared to undertake (without further government support) may be constrained by its capital levels and its assessment of the risks. Transparency could be increased by the Reserve Bank publishing policies that set out how it considers and balances these considerations. This would enable public scrutiny of the Reserve Bank's planned approach, as well as *ex post* assessments of whether the bank followed that approach.

The Reserve Bank's balance sheet-related decisions are generally undertaken independently, but the Minister of Finance has some decision rights. One important decision right (discussed in Chapter 7) is that the Minister has ultimate responsibility for setting the dividend the Reserve Bank pays to the Government each year. The dividend affects the Reserve Bank's capital base and therefore its capacity to take financial risks (such as quantitative easing or foreign exchange intervention). If the Reserve Bank ever considers activities that would increase financial risks to the Reserve Bank beyond what current capital could absorb, it would need to seek the Minister's consent to increase its capital.

The rest of this chapter briefly considers the current scope of the Reserve Bank's relevant powers, relevant objectives, and the balance of independence and Ministerial involvement. Options for change are identified in several areas.

Balance sheet function 1: lender of last resort

The Reserve Bank Act currently states (section 31) that:

> *"The Bank shall, if the Bank considers it necessary for the purpose of maintaining the soundness of the financial system, act as lender of last resort for the financial system".*

This is phrased as a duty, and is clearly linked to the Reserve Bank's 'soundness' objective. To match the proposed change to the Reserve Bank's high-level financial policy objectives (discussed in Chapter 2 of Consultation Document 2A), 'soundness' could be changed to 'financial stability'. The wording does not define LoLR, but seems to place some potential constraints on lending to individual firms if they are not important to the financial system's soundness. For example, a small institution that is close to failing may not meet the criteria implied by section 31 if its failure would not affect financial system soundness. However, as noted above, the Reserve Bank also has more general powers (section 39) to carry on the business of banking and issue financial products.

Tucker (2014) provides useful arguments on the appropriate structure and governance of the LoLR function:

- LoLR funding should only be provided to firms that the central bank considers solvent. Lending to insolvent firms would risk their problems worsening before they fail (exposing customers to more risk). While the Reserve Bank should protect itself by lending against collateral (see also Hauser 2017), this does not protect other customers of the bank. Also, if LoLR funding is only available to solvent firms, its provision should help boost confidence in the recipient. Conversely, if it is available more widely, even solvent firms may be unwilling to ask for LoLR funding, as that could be interpreted as a sign of serious problems.
- In order to assess an institution's solvency, decision-makers require access to private information on its balance sheet. This means the decision-makers are likely to want to consult prudential supervisors within the Reserve Bank. However, it is important that the decision-makers are not the prudential supervisors themselves, as they may have conflicts of interest (e.g. they may consider lending to a firm rather than letting it fail and having to explain why supervision did not pick up the issues earlier).
- LoLR funding should be provided with a clear purpose and credible exit strategy. For example, it may be intended to help institutions survive a market panic and calm markets. This will allow the loans to be repaid when conditions normalise.
- It is important to have a resolution regime that can be used (instead of LoLR) to manage institutions that do not appear likely to be solvent. If there are concerns that the resolution regime will not be able to restore a particular institution to viability, any support it is given should be clearly distinguished from normal LoLR funding (and should involve ministerial approval).

These arguments imply that:

- it is appropriate for the Reserve Bank to have an LoLR function, but there should be further principles. Some of these principles (and their definitions) could be detailed in primary legislation, with further details provided in a framework document published by the Reserve Bank and referred to in the SOI

- it should be clear that firms appearing likely to be insolvent should not receive LoLR. Emergency lending assistance could be provided to firms in resolution with uncertain prospects, but this should be distinguished from LoLR (and may require additional governance, such as ministerial approval – see the accompanying background paper on crisis management)
- the new proposed Reserve Bank board will have to manage the potential internal conflict that Tucker (2014) notes between supervisory responsibility and LoLR decisions.

Question for consultation

4.A Should more detailed principles for the Reserve Bank's LoLR function be set out in legislation? Do the principles and governance considerations in Chapter 4 seem appropriate? Would you add others?

Balance sheet function 2: monetary policy formulation and implementation

The Reserve Bank Act clearly links monetary policy formulation to specific economic objectives (price stability and supporting maximum sustainable employment). It also provides for the Reserve Bank's MPC to formulate monetary policy independently of the government.[68]

Monetary policy formulation currently focuses on setting the OCR. In severe downturns it could also involve decisions to undertake quantitative easing (expanding the Reserve Bank's balance sheet through purchase of government bonds) or even what Tucker (2018) calls credit easing (purchasing other assets to stimulate credit, and thus boost inflation, in a weak economy).

There are two related boundary issues to consider in monetary policy governance:

- **Issues between the MPC and the wider Reserve Bank** – quantitative easing creates risks to the Reserve Bank balance sheet. For example, if the Reserve Bank held a large portfolio of government bonds after quantitative easing and interest rates then began to rise, the Reserve Bank would suffer losses, reducing the Reserve Bank's capital. The MPC formulates monetary policy, but will need to take advice on these risks from the wider Reserve Bank (which implements monetary policy and has an implicit obligation to safeguard the Reserve Bank's capital).
- **Issues between the Government and the Reserve Bank** – credit easing has an important overlap with fiscal policy. For example, in an extreme crisis the Reserve Bank could consider purchasing corporate debt to support business investment. But much the same effect could be achieved if the Reserve Bank purchased (newly issued) government debt and the Government elected to use the funds obtained to purchase corporate debt. It is not clear that distributional decisions (e.g. what sort of private debt to buy) should be taken independently by the Reserve Bank (i.e. without the Treasury's involvement and/or additional accountability arrangements).

[68] The Minister has a reserve power to override Reserve Bank decisions on monetary policy (section 12 of the Reserve Bank Act), but this has never been used.

Both of these boundaries (and similar issues that arise with foreign exchange intervention) could potentially be clarified through future expansions to the remit provided to the MPC. This would appear more flexible than setting it out in revised primary legislation, but that would also be a possibility.

One potential addition (partly based on the UK Chancellor's remit to the UK MPC) would be:

> *"In formulating monetary policy that could create balance sheet risk (e.g. foreign exchange intervention under section 16 to support monetary policy objectives),* I [i.e. the Minister of Finance] *expect you* [the MPC] *to take advice from the Reserve Bank on the capacity of its balance sheet to absorb those risks, and to design those policies to remain within that capacity. If you consider that it may be appropriate to intervene in specific domestic credit markets, I will expect you to work with the Government and Reserve Bank to ensure the appropriate coordination and governance arrangements are in place".*[69]

Tucker (2018) argues that it is also important that Reserve Bank decisions to purchase government debt are taken independently of the Minister. If the Minister is involved in these decisions, there may be incentives to expand the purchase programme beyond what is appropriate for achieving the delegated monetary policy objectives, in order to increase the funding available to the Government.[70] As a result, Ministerial involvement could undermine the credibility of monetary policy.

In the ECB for example, these issues led to rules prohibiting it from offering overdraft facilities to member governments, or buying government debt at the time of issue (see Pisani-Ferry, 2012). While strict rules like this are unusual and may not be needed in New Zealand, it seems appropriate for the Reserve Bank to be independent in this area (with the Minister having reserve powers to use section 12 or amend the monetary policy remit).

Question for consultation

4.B If the Reserve Bank were to launch an asset purchase programme (quantitative easing), do you believe it should be able to make its own decisions to purchase government debt, but require ministerial consent to purchase other assets? Are there other implementation issues around asset purchase programmes that should be considered?

[69] There is no urgent need to add this to the MPC's remit – the issue is mitigated by the internal majority on the MPC, and 'credit easing' is not currently being seriously contemplated.

[70] The Treasury observer on the MPC could be seen as problematic in this context, but the issue is mitigated by their 'observer' status.

Balance sheet function 3: foreign exchange intervention

This function can be used in support of multiple Reserve Bank objectives (including monetary policy objectives and financial stability-related objectives), and there are major roles for both the Reserve Bank and the Minister. Specifically, the current Reserve Bank Act provides for the:

- Reserve Bank to deal in foreign exchange (for the purposes of performing its functions) (section 16)
- Minister to direct the Reserve Bank to deal in foreign exchange within guidelines the Minister sets (section 17). These guidelines can include specific exchange rates (section 18). If the Reserve Bank considers that these directions are inconsistent with monetary policy targets, there are further clauses (sections 19-20) to resolve the issue. Profits and losses from intervention under section 17 and 18 automatically flow to the Crown (section 21)
- Governor to direct all registered banks to cease dealing in foreign exchange markets (section 22)
- Minister to determine the appropriate level of foreign reserves for the Reserve Bank to hold in order to exercise these powers (section 24).

The Reserve Bank did not use the intervention powers provided in the Reserve Bank Act until after discussions in 2004 with the Minister of Finance and the Treasury. Those discussions led to an exchange of letters providing for the following:

- the Reserve Bank advised that its section 16 powers, as well as potentially being used in times of extreme market disorder, could be used to intervene when the exchange rate was "exceptionally and unjustifiably high or low" (RBNZ, 2004), to support monetary policy objectives
- the Minister provided extra capital to allow the Reserve Bank to absorb any resultant losses
- the Minister provided a standing section 17 direction to intervene to prevent or resolve market dysfunction where intervention is urgently needed and relevant Ministers are uncontactable.

To summarise, the Reserve Bank currently has powers to intervene in foreign exchange markets independently, in support of its objectives. These could include financial stability as well as monetary policy; for example, when the foreign exchange market appears dysfunctional the Reserve Bank can intervene on its own account. The Minister has scope to issue more extensive section 17/18 directions when circumstances justify it. Finally, the Minister's control of the Reserve Bank's capital and foreign reserve levels give them some control over the Reserve Bank's capacity to take intervention decisions on its own.

The MPC's charter specifically mentions that it may decide "the [Reserve] Bank should intervene in financial markets" – which appears to make it clear that decisions on section 16 intervention for monetary policy purposes are the MPC's domain. However, intervention affects the Reserve Bank's balance sheet, so the MPC should perhaps be constrained in intervention decision-making to keep the risk on the Reserve Bank's balance sheet at acceptable levels (the potential expansion to the remit discussed above would cover this). Once a monetary policy intervention mandate has been formulated by the MPC, its implementation (and any decisions to intervene for other purposes) should be the domain of the Reserve Bank itself, with overall responsibility given to the board. As

noted above, the Reserve Bank can always seek more capital from the Minister if an expansion in intervention capacity appears desirable.

Moser-Boehm (2005) surveys governance arrangements internationally, and concludes that most central banks are able to implement exchange rate policy (e.g. take intervention decisions) independently of the Minister. However, this is not universal and major economies like the UK and US (which were not represented in the Moser-Boehm survey) involve the Treasury in intervention decision making. The Reserve Bank Act Review (based on previous Reserve Bank analysis) has identified a number of areas where the powers and rules for foreign exchange intervention could be modernised and also potentially rebalanced to give more independence to the Reserve Bank:

- **Section 18** – it does not appear likely that a Minister would direct the Reserve Bank to fix the exchange rate. However, if they did, there would probably be a need to make major changes to the monetary policy remit or to impose capital controls (see below). The power to fix the exchange rate could be either removed, or retained as a reserve power if further analysis suggested it could be effective and consistent with the monetary policy framework.[71]
- **Section 17** – if the power to fix the exchange rate were removed, it would be possible to go further and eliminate the Ministerial role in intervention decisions by repealing section 17. The Reserve Bank would then decide independently on all intervention.
- **Section 24** – the Reserve Bank's capacity to intervene is effectively determined by the range in which the Minister directs its foreign reserves to be held. If this section were repealed, the Reserve Bank would have more autonomy to decide on the extent of intervention without creating excessive financial risks (it would still be limited by its capital).
- **Section 22** – it appears unlikely that the power to direct registered banks to cease dealing in foreign exchange markets will ever be useful or effective. When the Reserve Bank Act was drafted there may have been limited opportunities for New Zealanders to conduct foreign exchange transactions without involving New Zealand-registered banks, but today the bulk of New Zealand-dollar trading happens in international markets beyond the reach of New Zealand regulation. In the unlikely event that the Government wished to enact capital controls to limit New Zealanders' ability to trade in these global markets, new legislation would be required that went well beyond restrictions on banks registered in New Zealand.

Question for consultation

4.C How much power should the Minister have in determining the scope and objectives of the Reserve Bank's foreign exchange interventions? Should the current arrangements – which will give some decision-making power to the Minister, the MPC and the new Reserve Bank governance board – be broadly retained, or should the Reserve Bank's autonomy be increased?

[71] In principle, an exchange rate fixed at an appropriate level (to a country with a low and stable inflation rate) could be a monetary policy regime consistent with price stability in New Zealand, particularly after a period of instability (see, for example, Ghosh *et al*, 1996).

Balance sheet functions 4: other activities

Section 39 of the Reserve Bank Act gives it more general powers, including to "carry on the business of banking" and "carry on any business… conveniently carried on… in conjunction with its functions…". These functions are also empowered by section 5, which designates the Reserve Bank as a 'natural person'.

It is not always easy to separate general banking activities from the more specific functions discussed above. For example, in implementing monetary policy it is useful for the Reserve Bank to act as 'banker to the banks', allowing banks to hold accounts at the Reserve Bank and make payments to each other by transferring funds between these accounts. This system can be seen as using section 39 powers, but it also makes monetary policy implementation much easier (see Parekh, 2016). Certain other commercial activities of the Reserve Bank (such as the operation of NZClear) could be undertaken privately but have some synergies with other Reserve Bank activities, and their provision also has important financial stability benefits for New Zealand.

There may be other ways to use the Reserve Bank's balance sheet to support financial stability. For example, while the current Act specifically mentions LoLR, the Reserve Bank could also use its balance sheet to stabilise key markets. Internationally, this activity is sometimes referred to as the 'market maker of last resort'.

Overall, it seems useful to retain general powers for the Reserve Bank along the lines of section 39. These powers support other important Reserve Bank functions and allow it to undertake commercial activities for which it is uniquely placed, as described at the start of this chapter. Rather than specifically empowering individual balance sheet activities (e.g. foreign exchange interventions or LoLR), it may be enough to continue providing the Reserve Bank with general powers to transact, tied to more tightly specified objectives. Besides the monetary policy objectives for example, a specific financial stability objective could direct the Reserve Bank to "utilise the Reserve Bank's balance sheet, where necessary, to stabilise key financial markets or lend to market participants". As outlined above, framework documents would allow the Reserve Bank to explain how it plans to act in support of this objective (which would tend to be an emergency activity).

However, the risk of retaining broad powers like section 39 is that they could be used in unexpected ways. An alternative approach would be to constrain the Reserve Bank's powers to transact to specifically sanctioned activities. Some of the post-GFC reforms in the US, for example, tightened constraints on Federal Reserve transaction activity. However, some have argued (see for example Bernanke, 2015) that this is risky, since the central bank may need to respond quickly to unanticipated problems during a crisis.

The Reserve Bank holds substantial assets (currently over $30 billion) and must make investment decisions even when it is not transacting to support key objectives. Most of these funds are invested in safe assets like New Zealand government bonds and well-rated foreign government debt. This means the Reserve Bank makes fewer decisions about ethical investment allocation than an investment manager investing in a wider range of individual firms. Nevertheless, it may be worth

considering whether the Reserve Bank should be required to invest ethically or 'responsibly' (see also the discussion on green finance in Chapter 2 of Consultation Document 2A and the accompanying background paper). This requirement could be a legislated duty or a softer expectation (e.g. it may be considered consistent with the Reserve Bank Act's 'prosperity and well-being' objective). If it is adopted, the Reserve Bank could describe in an investment framework how it intends to consider those factors.

Question for consultation

4.D Do you have any other comments on the balance sheet functions described in Chapter 4?

Summary

The Reserve Bank has a flexible balance sheet with the ability to 'create' additional New Zealand dollars when circumstances require. This chapter has described Reserve Bank functions that are facilitated by this ability, and considered whether there is a case to alter the extent of the Reserve Bank's powers or independence in specific areas.

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

Aim of this chapter

This chapter summarises a review of New Zealand's bank crisis management framework. It considers developments in international best practice, the IMF's recommendations for reforms to New Zealand's framework, and how the objectives, governance, and tools for bank crisis management in New Zealand can be enhanced.[72]

The Reserve Bank Act already includes many of the elements that are now recognised internationally as being important for an effective resolution regime, but not all of them. This chapter:

- describes the existing bank crisis management regime and toolkit
- suggests clarifications to the framework where they would be helpful
- identifies tools and powers that could be added to the toolkit to give the Reserve Bank greater flexibility and options in dealing with failing banks
- considers the Minister's role and whether it could be made clearer and more meaningful.

The review of bank crisis management is organised around six questions relating to regime design:

- What should be the objectives of the resolution regime?
- Who is the resolution authority?
- What is the appropriate role of the Minister?
- What tools and powers are required to meet resolution objectives and responsibilities?
- What safeguards should there be for creditors?
- How should resolutions be financed?

The identification of possible improvements to the crisis management framework necessarily follows a staged approach. This consultation document focuses on key framework design questions at a relatively high level. The next consultation round will progress those design questions based on the feedback received and, where possible, provide additional detail. The next round of consultation will also set out the proposed accountability framework for crisis management and exercising resolution powers. It is likely that implementation of the reform work will take a similarly staged approach, with primary legislation setting out the enabling framework, leaving some aspects to be implemented through follow-up legislation or regulations as appropriate (and allowing for further consultation in the process).

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[72] This chapter refers to 'bank' as shorthand for deposit takers, which include NBDTs. The Minister of Finance has made an in-principle decision to bring together the regulation of the banking sector and the NBDT sector in a single 'licensed deposit taker' framework. See Chapter 4 of Consultation Document 2A. Under this decision, the crisis management of NBDTs would use the same regime as that for registered banks.

This chapter presents some of the discussion in summary form. You can find further detail in the accompanying background paper on bank crisis management.

What is bank crisis management and why is it important?

Bank crisis management refers to the use of powers and supporting arrangements to deal with events that seriously threaten a bank's viability. An effective bank crisis management regime encompasses elements that include:

- preparation and prevention
- the ability to intervene early and with a credible set of tools
- coordination between domestic authorities and, where relevant, national authorities in other countries.

'Special bank resolution' is a central element of crisis management; it covers the restructuring and/or orderly wind-down of all or part of a bank's business in a way that adequately safeguards the public interest. The 'public interest' in this context can include the continuity of the bank's critical functions (see Box 5A), containing distress at a failing bank and maintaining overall financial stability (see Box 5B), and minimising the reliance on taxpayers for meeting the costs of resolving a failed bank.

Box 5A: A bank's critical functions

Bank crisis management often focuses on maintaining the immediate continuity of a bank's critical functions and services during an orderly resolution. Banks perform functions that are critical for economic activity to take place. They provide services that are essential for day-to-day living, enabling participation in, and the smooth running of, the wider economy. Customers include individuals, businesses, other organisations, and local and central government – and all require an ability to make and receive payments and conduct other financial transactions. If a bank fails, the knock-on effects for the wider economy of abruptly discontinuing (or even disrupting) these financial services can be far greater than the losses incurred by the bank itself.

Box 5B: Contagion

Banks operate on the basis of public trust. If depositors and other creditors lose confidence in a bank, they may withdraw their funds quickly, which can lead to the bank's failure. The failure of a large bank may also undermine confidence in other banks, affect their finances, and create instability in the financial system as a whole. Through this contagion effect, difficulties facing one participant in the financial system can spread to other participants, rapidly eroding the value and viability of other banks and destabilising the entire financial system.

As covered in the introduction to Part A of this consultation document, bank crisis management is part of the wider regulatory framework known as the 'financial safety net', which comprises five elements that work together to support a strong, stable, and resilient financial system.

> *"The safety net mechanisms are operationally independent, but their objectives and uses are intertwined"* (Croitoru, Dobler and Molin, 2018, p. 5).

Business-as-usual prudential regulation and supervision functions are supported by the central bank's LoLR role, plus the two crisis management functions – depositor protection and special bank resolution. Crisis management, particularly special bank resolution, is sometimes referred to as the 'ambulance at the bottom of the cliff' when a bank fails.

The effectiveness of a bank crisis management framework depends in part on the effective operation of other parts of the financial safety net. For example:

- the likelihood of needing to use bank crisis management powers may be affected by prudential regulatory settings such as capital requirements – see Box 5C and Chapter 5 of Consultation Document 2A
- authorities' ability to move quickly and effectively in a crisis may depend on a good understanding and knowledge of the failing bank gained as a result of the supervisory practices that have been adopted by the relevant authority
- the system's exposure to contagion may depend on what depositor protection arrangements are in place – see Chapter 5 of Consultation Document 2A.

Nevertheless, the need to have bank crisis management powers available in legislation stands irrespective of the regulatory settings in other parts of the safety net:

> *"A well-established mechanism needs to exist in all key areas constituting the financial safety net. … if a country has established a well-developed mechanism in only some but not all of these areas, it is still likely to face difficulties in finding effective solutions for preventing or resolving serious problems in its banking system"* (Schich, 2008, p. 13).

Box 5C: Prudential capital requirements and bank crisis management

The Review of the Reserve Bank Act is being undertaken at the same time as the Reserve Bank is reviewing its capital adequacy framework for registered banks. The bank crisis management framework and capital adequacy framework for banks belong to different parts of the financial safety net. There is a relationship between the two, but they serve different purposes.

Capital is not money set aside for an emergency. Instead, it refers to how a bank finances its assets, much like how many people finance house purchases – partly with debt (mortgages) and the rest with their own equity. If a bank's assets lose value or the bank otherwise suffers a financial loss, it is the owners' equity (a type of capital) that must first absorb the loss. The more that a bank's assets are financed by capital, especially owner equity, the greater the bank's capacity to absorb losses without triggering failure – or 'insolvency'. A bank is insolvent if the value of its assets falls below the value of its debts.

However, high capital requirements do not make a bank immune from failure. A bank's regulatory capital ratio is a function of the value of its assets, adjusted for the riskiness of those assets. Bank assets can be hard to price, and those prices can be highly volatile in times of distress. When the financial system is under stress – as happened in the GFC – some of the more risky assets that banks hold might even need to be written off entirely, causing significant capital reductions for the banks. While a bank can try to raise more capital when this happens – for example, by restricting dividend payments to its shareholders, or issuing new shares – other parts of the financial safety net, particularly bank crisis management, need to be ready to step in before the bank burns through so much capital that it becomes insolvent.

Further, banks can fail for a variety of reasons, and not all of them due to insufficient capital. As the 2007 Northern Rock failure illustrated, capital ratios will not protect a bank facing a liquidity crisis, especially one that escalates into a retail run on deposits and precipitates the bank's downfall. Nor will they protect the wider financial system from the 'serious risk' of contagion that saw the UK government guarantee up to £51 billion of Northern Rock's liabilities and ultimately nationalise the bank to protect taxpayers' interests.

An effective bank crisis management regime is an essential part of the financial safety net, no matter how strong the prudential capital requirements may be.

The Reserve Bank Act's general framework for bank crisis management dates back to the 1986 Reserve Bank of New Zealand Amendment Act. Since then, much has changed in the threats posed by banking crises, and in the way that other jurisdictions have prepared themselves to respond to failing or failed banks – especially in the past decade.

New Zealand does not operate a zero-failure banking regime. This means that banks, like any other business, can fail. However, as the GFC showed, placing a failed bank into ordinary insolvency can have damaging consequences for its customers, the rest of the financial system, and the wider real economy. To prevent these wider spill-overs during the GFC, many governments bailed out institutions using public funds or supported them with temporary, ad hoc deposit guarantees. The GFC demonstrated a need for resolution regimes that enabled authorities to resolve failing banks quickly without destabilising the financial system or exposing taxpayers to loss. Publicly funded bailouts and financial sector guarantees came to be viewed as too expensive and too inequitable to society, and too harmful to market discipline. Special bank resolution tools were required.

The past decade has seen an international focus on deep and wide-ranging regulatory reforms to address the GFC's root causes and bolster the financial system's resilience to their recurrence. In the midst of, and soon after, the GFC, several jurisdictions undertook major legislative reforms to strengthen their resolution regimes, and many other jurisdictions have since followed suit. The G20 and international standard-setting bodies in particular have focused on ensuring that failing banks can be resolved in an orderly way without resorting to publicly funded bailouts or financial sector guarantees.

The FSB Key Attributes

In response to post-GFC international commitments that future financial crises should not impose the costs of bank failures on taxpayers, the Financial Stability Board (FSB)[73] adopted the Key Attributes of Effective Resolution Regimes for Financial Institutions (FSB, 2014). The G20 endorsed these Key Attributes as "a new international standard for resolution regimes" as part of agreeing on comprehensive measures to ensure that "no firm can be deemed 'too big to fail' and to protect taxpayers from bearing the costs of resolution" (G20, 2011, p. 3).

> *"The objective of an effective resolution regime is to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss, while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation"* (FSB, 2014, p. 3).

The Key Attributes reflect important lessons learned by the international community from the GFC; they are the internationally agreed standard for resolution regime design. The Key Attributes describe 12 features that the FSB members agree should be part of any effective resolution regime. This chapter refers to several of the Key Attributes (resolution authority designation, resolution powers, safeguards, resolution funding). Other Key Attributes will feature in subsequent stages of the Review. The accompanying background paper on crisis management summarises the full set.

New Zealand's bank crisis management framework and potential issues

This section surveys New Zealand's existing bank crisis management regime. With reference to the FSB Key Attributes and the IMF FSAP recommendations,[74] it identifies a number of issues with the existing legislative framework. The existing framework is structured around Reserve Bank powers, statutory manager powers, and the Minister of Finance's supporting consent role.

Reserve Bank Act powers in managing banking sector risks

The Reserve Bank Act provides the Reserve Bank with a set of graduated intervention measures to manage banking sector risks. At one end of the spectrum is business-as-usual prudential supervision; at the other sits statutory management.

Early indications of bank distress would normally be identified through business-as-usual supervision. If not addressed through early interventions, a deteriorating situation would trigger more intrusive

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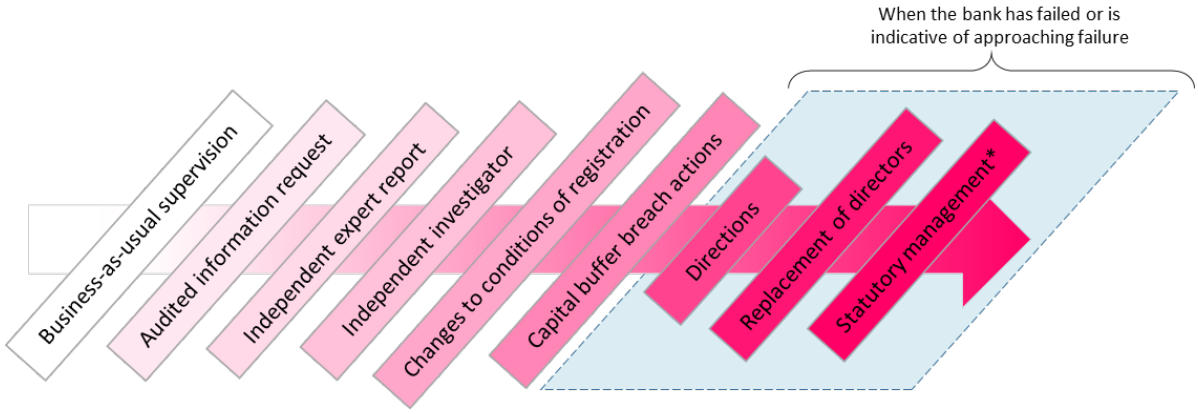
[73] The FSB is an international standard-setting and coordination body based in Basel, Switzerland. Its members comprise the G20 plus Hong Kong SAR, Singapore, Switzerland, Spain, The Netherlands, the Bank for International Settlements (BIS), the IMF, the OECD, the World Bank, and a number of international standard-setting bodies such as the Basel Committee on Banking Supervision, the International Accounting Standards Board, and the International Organization of Securities Commissions.

[74] The IMF FSAP included a separate 'Technical Note' on New Zealand's contingency planning and crisis management framework. The IMF's Technical note included several recommendations for making New Zealand's bank crisis management regime more effective and more in line with international best practice (IMF, 2017c). The full set of bank crisis management-related recommendations are listed in the accompanying background paper on crisis management, including commentary on how this Review has addressed those recommendations.

crisis management and, ultimately, the use of resolution powers. Figure 5A lists the existing tools in the graduated set of interventions – crisis management falls in the last three steps.

Figure 5A: Interventions available under the Reserve Bank Act



*Open Bank Resolution (OBR) is given effect through statutory management (see Box 5D)

The Reserve Bank Act essentially provides for three channels of crisis management intervention: Reserve Bank directions, director replacement, and statutory management.
The Act requires that the exercise of any of the Reserve Bank's crisis management powers must be for the purposes of:

- promoting the maintenance of a sound and efficient financial system, or
- avoiding significant damage to the financial system that could result from the failure of a registered bank.[75]

Reserve Bank directions – there are a number of grounds on which the Reserve Bank can direct a registered bank (or an 'associated person'[76]). The accompanying background paper on crisis management provides more detail on these grounds. The scope of the direction power is broad. The Act lists specific actions that can be required of the registered bank through a direction, as well as a more general requirement to "take the action that is specified in the direction to address any circumstances of financial difficulties" (section 113A(h)). The Reserve Bank must have ministerial consent to use the power of direction.

Director replacement – if the criteria for giving a direction are met, the Reserve Bank can also remove a director from, replace a director at, or appoint a director to, the bank concerned if it has reasonable grounds to believe it is necessary. As with the power of direction, the director replacement power requires ministerial consent.

Statutory management – If certain criteria for giving a direction are met, or if a bank has not complied with a direction, the Reserve Bank can recommend to the Minister that the bank be placed under statutory management.[77] A statutory manager takes over the running of the bank, assuming

[75] Section 68. This stipulation applies to all powers provided under Part 5 of the Act. Part 5 includes the crisis management powers.

[76] An 'associated person' is a person who directly or indirectly controls the management of a bank or has an interest in 20 percent or more of the voting or non-voting securities issued by the bank, or where the bank has the same level of control or interest over the person.

[77] See the accompanying background paper on crisis management for more detail on the triggers for statutory management.

the rights of the bank's board and shareholders and possibly ousting members of the bank's senior management, subject to advice from the Reserve Bank and also direction (where systemic[78] considerations arise).

Placing a bank into statutory management creates an automatic moratorium on creditor claims, including existing claims and legal action that may have already begun. However, the statutory manager can choose to waive that moratorium in whole or in part to any creditor or class of creditors.

Under the Reserve Bank Act, a statutory manager has powers to resolve a bank using a mix of measures, including:

- suspending deposit repayments, debt payments, or any other obligation
- cancelling obligations to provide funding to any person
- negotiating a compromise with any creditor of the bank or any creditor class
- setting up a new company to acquire the bank's business (including a foreign bank branch)
- selling or transferring viable parts of the business (whether or not subject to any existing charge or other security), or
- with the Reserve Bank's approval, applying to put the bank into liquidation (potentially imposing losses on any outstanding creditors).

A statutory manager does not have the power directly to write down a bank's liabilities (impose a 'haircut') or convert a bank's liabilities into equity. However, creditors can potentially bear losses to the extent that a statutory manager continues to suspend the repayment of deposits or the discharge of obligations during the whole of the course of the statutory management, with the insolvent rump bank[79] then being put into liquidation. This liquidation process can take years to run its course.

The main safeguard the Act provides for the statutory manager's powers is a requirement for Reserve Bank approval before selling or otherwise disposing of a substantial part of a bank's business. In turn, the Reserve Bank requires ministerial consent to grant that approval.

As noted, a statutory manager is subject to direction from the Reserve Bank. The Reserve Bank may also 'advise' the statutory manager. It would be through either of these mechanisms that the Reserve Bank would use its open bank resolution (OBR) policy option (see Box 5D).

[78] 'Systemic' in this context considers the impact that the failure of a bank can have on the wider financial system and, in turn, the real economy.

[79] The 'rump' would be what remains of the original failed bank after viable parts have been sold or transferred to another entity.

Box 5D: OBR

A bank can be resolved in an 'open' state (where the bank remains open) or a closed state. Any resolution that seeks to resolve a bank in an open state is called an 'open bank resolution'. The Reserve Bank has developed one particular form of open bank resolution, and called it OBR. The Reserve Bank's OBR option to stabilise a failed bank applies the Reserve Bank Act's statutory management provisions in conjunction with the Public Finance Act 1989's government guarantee provisions (section 65ZD). Banks that meet systemic thresholds (and smaller banks that opt in) 'pre-position' liabilities, including transactional, savings, and term deposits, for OBR.

If the Reserve Bank advised placing a failing bank into OBR and the Minister of Finance agreed, a statutory manager would be appointed. The statutory manager would then, under direction and/or advice from the Reserve Bank, close the bank temporarily. All creditor claims, including pre-positioned deposits, would be frozen through an automatic moratorium under statutory management. The bank would re-open the next business day, depositors would be given access to a portion of their pre-positioned deposits (net of the amount set aside to cover losses, which would continue to be frozen under the Reserve Bank's direction).

To restore confidence in the bank among financial markets and the wider public, all unfrozen deposits and all new liabilities (including new deposits) incurred by the bank from the date and time of the statutory manager's appointment would be underwritten by government guarantees.

As a stabilisation measure, OBR is intended to provide authorities with time to:

- learn more about the bank's financial condition (potentially allowing some funds still frozen to be released at a future point)
- determine the bank's ultimate resolution – such as selling the 'good part' of the business to a private-sector purchaser, then winding down and liquidating the remainder.

OBR is not a default solution and requires government approval to be used as the efficacy of the option is dependent on the Minister giving a government guarantee. While 10 banks are currently pre-positioned for OBR, no bank has failed since OBR was implemented, so it has not yet been used.

Other bank failure management options

New Zealand authorities currently have access to two other options for managing bank failures:

- **Bailout** – a bailout involves using public (taxpayer) funds to stop a bank failing or to restore a bank that has failed. A bailout typically involves a capital injection of public funds into the bank, but it can also be a government guarantee or indemnity.[80]

  In a bailout, taxpayers support the bank's continued operation, preventing losses developing that would otherwise fall to the bank's shareholders and creditors if it had been allowed to fail.

  Bailouts have been used to support failing New Zealand financial institutions in the past – such as in the case of the BNZ in 1990. Taxpayer funds have also been used to support New Zealand depositors affected by failing institutions – for example, through the Crown Retail Deposit Guarantee Scheme, which was put in place in 2008-10. The Scheme paid out approximately $2 billion in respect of nine failed institutions, and approximately $1.4 billion was received back in recoveries and fees. Bailouts were widely used internationally during the GFC.

- **Liquidation** – liquidation effectively shuts down a failed bank and begins a wind-up process, allocating the proceeds of realisable assets to creditors in accordance with the hierarchy of creditor claims and as between creditors of the same class on an equal proportionate basis. Shareholders are the last to be allocated any residual value.

  Liquidation is provided for under the Companies Act 1993. A number of parties can apply for it, including a statutory manager. The liquidation of a complex business such as a bank can take many years.[81]

Potential issues with the current framework

1. Lack of resolution objectives

In recent years the New Zealand public's expectations of regulators have changed significantly. One of the biggest changes has been recognition that visible and proactive regulators can be critical to the effective operation of a regulatory regime. A shift towards performance- or principles-based regulation has been matched by a shift towards the law being more specific about what is expected of both the regime and the regulator, typically in specifying objectives and functions.

The Reserve Bank Act's current resolution framework looks to constrain the purposes for which powers may be used while setting out a number of considerations that a statutory manager should 'have regard to' when exercising those powers. While these considerations provide guidance on the use of legal powers such as statutory management, the framework does not provide clear expectations for the resolution outcomes that the resolution authority should seek to achieve (other than the broad purpose of avoiding systemic risk from bank failure).

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[80] The FSB defines 'bailout' as any transfer of funds from public sources to a failed bank or a commitment by a public authority to provide funds with a view to sustaining a failed bank (for example, by way of guarantees), where the funds are not recouped from the bank or industry, or where the public authority is not fully compensated for the risks assumed.

[81] The liquidation of the failed global investment bank Lehman Brothers, for example, is still ongoing, more than ten years after it filed for bankruptcy in September 2008.

In addition, the considerations to which a statutory manager must have regard are only considerations, and they only apply to the statutory manager – not to the Reserve Bank. This lack of clarity hampers accountability, and provides limited guidance on where the Reserve Bank should focus its efforts in a resolution.

The IMF recommended the inclusion of statutory resolution objectives as well as requirements for accountability reporting against them.

2. Lack of clarity over the identity of the resolution authority

The Key Attributes state that there should be a designated authority responsible for, and accountable for, exercising resolution powers over the institutions within the regime's scope. Clarity in who exercises these resolution powers (and accountability for exercising those powers) is critical to the legitimacy of the resolution regime given its scope for affecting shareholder and creditor rights and the potential re-distributional decisions that may result.

The IMF noted that the Reserve Bank Act (which does not explicitly designate a resolution authority) is ambiguous on the exercise of resolution powers. The main source of ambiguity arises from the Act not requiring the Reserve Bank to direct the statutory manager on how its resolution powers are to be exercised, potentially leaving the statutory manager as the effective resolution authority.

A bank can also be put into resolution via statutory management by the Minister of Commerce and Consumer Affairs in accordance with a recommendation of the FMA under the Corporations (Investigation and Management) Act 1989 (CIMA). A statutory manager under CIMA has equivalent resolution powers to those available under the Reserve Bank Act but would not be subject to direction, other than through a court process (if the statutory manager applies to the court for directions).

This lack of clarity on who the resolution authority is can create uncertainty about who is responsible for leading bank crisis management decision-making and who is accountable for the outcomes. It can lead to poor pre-crisis preparedness and delay in responding to a crisis as officials scramble to agree on a strategy and how it should be executed.

The IMF recommended clarifying the Reserve Bank's role as the sole resolution authority for New Zealand's banks.

3. The Minister's unbalanced role

The Minister of Finance has a strong and legitimate interest in ensuring that bank resolution policies appropriately manage the broader fiscal and macroeconomic risks associated with banking failures. However, the Reserve Bank Act does not set out a coherent role for the Minister that reflects this interest.

There are a number of shortcomings:

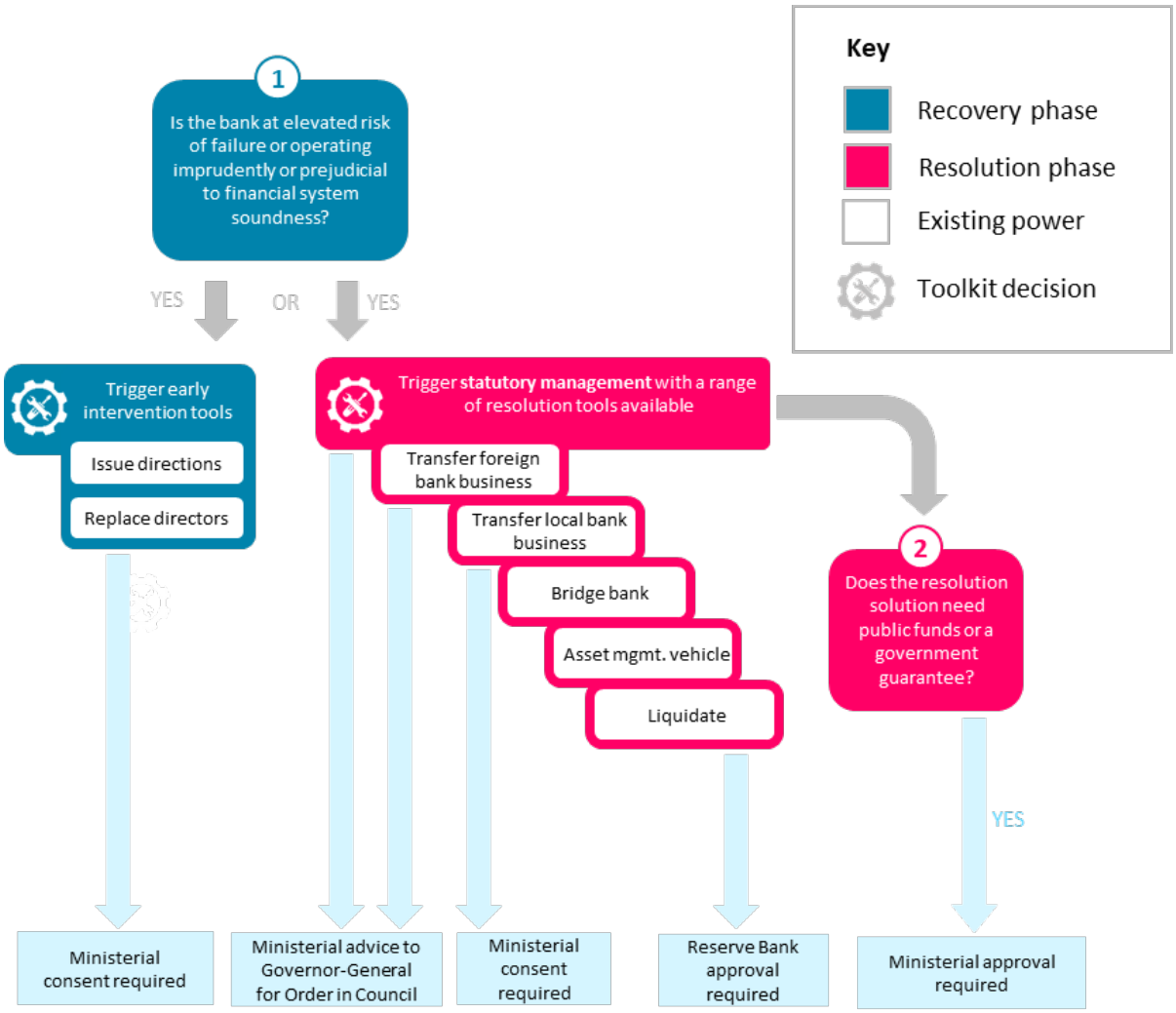
- While the Act requires the Minister's consent or approval in several areas (see Figure 5B), the Minister's role is entirely reactive. At all points the Reserve Bank has to make a recommendation to the Minister – with the implied expectation that the Minister would agree or not agree.
- There is no explicit provision for the Minister to direct the Reserve Bank, even if public funds were, or were likely to be, required.

- The Reserve Bank Act does not require early consultation with the Minister (or other agencies) on emerging financial crises.
- The Minister's consent is required for all types of direction – including, for example, something as simple as a direction requiring a bank to consult the Reserve Bank.

The IMF expressed concern that the requirement for ministerial consent for all directions was not in line with best-practice supervisory independence and would reduce the timeliness of supervisory enforcement actions. The IMF recommended that ministerial consent be required only for resolutions with fiscal or systemic implications.

The current arrangements threaten to slow down the Reserve Bank's ability to respond quickly when timeliness will likely be of the essence. They also do not provide the Minister with any formal tools to direct events when appropriate – for example, when public funds may be at risk or if wider economic issues (e.g. economic relations with Australia) need to be considered.[82]

Figure 5B: Existing bank crisis management tools



[82] Note, too, that the Minister is subject to the constraints that apply to the Reserve Bank – the Minister can exercise powers only to promote the maintenance of a sound and efficient financial system or to avoid significant damage to the financial system resulting from the failure of a registered bank. See section 68 of the Reserve Bank Act.

4. Limited crisis management powers and poor access to them

Figure 5B shows that the Reserve Bank Act's key powers of resolution are currently only available when a bank is under statutory management.

However, placing a bank into statutory management is a significant intervention. Ideally, it should be an action of last resort, when a failing bank's management is unwilling or unable to facilitate a recovery or resolution on a going-concern basis while the bank is under private control. According to the IMF, statutory management should be used very cautiously, as the appointment of a statutory manager could destabilise the bank by triggering or exacerbating funding runs (IMF, 2019a, p. 19).[83] Resolution tools should not depend on the failing bank first going into statutory management.

In addition, there are no enforceable tools available under the current Reserve Bank Act to directly allocate losses without completing a normal insolvency and liquidation process. Also, if transactions that departed from respecting the creditor hierarchy were deemed necessary in the course of the resolution, a subsequent liquidation of a rump institution poses significant risks of litigation if some creditors were afforded greater preference than they would have been in a full liquidation.[84]

Nor does the Act provide for any enforceable non-taxpayer-funded recapitalisation powers. The lack of direct loss-allocation and recapitalisation tools makes it difficult for authorities to secure a sustainable solution without having to rely on taxpayer support or otherwise putting public funds at risk. Finding new owners for a failing bank is far more difficult if the bank has not already been recapitalised.

The FSB Key Attributes imply that the Reserve Bank Act should provide a broader range of resolution powers – particularly the ability to override shareholders' rights (that is, without putting the bank into statutory management) to enable a resolution such as a merger, an acquisition, a sale of parts of the bank, recapitalisation, or a bail-in if recapitalisation is necessary to ensure the continuity of essential functions (see Box 5F for more discussion of bail-in).

The IMF, too, recommended that express bail-in powers be added to the Reserve Bank Act's suite of resolution options.

5. Inadequate director and creditor safeguards

Director safeguards

The Reserve Bank Act provides no explicit protection for bank directors during resolution. Directors may be directed to take certain actions, or may be required to suspend normal continuous-disclosure obligations during a resolution in the interests of financial stability. Bank director protections may be required to address conflicting requirements of prudential and financial market conduct regulation (including company law duties). Sometimes it is appropriate temporarily to require directors not to publicly disclose market-relevant information, so that resolution can be achieved in an orderly way

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[83] A bank may also struggle to recover once placed in statutory management given the lack of authorities' confidence in the board and management that statutory management signifies. Statutory management is also a common trigger for the acceleration and termination of swaps and derivatives contracts and other financial and commercial agreements that feature cross default provisions. A bank may struggle to regain the confidence of key financial markets if the widespread termination of its financial contracts is triggered.

[84] Section 292 of the Companies Act 1993 provides that a liquidator can void an insolvent transaction that enables a person to receive more towards satisfaction of a debt owed by the company than the person would receive, or would be likely to receive, in the company's liquidation.

without sparking a market panic. Legislation should be clear on the legal protections available to directors in this situation.

Creditor safeguards

Certain creditor safeguards in a resolution are now international best practice and a common expectation among creditors internationally. Respect for property rights is a fundamental principle of insolvency law that allows investors and creditors to identify the risks to which they are exposed, allowing them to be priced and managed prudently in normal business. The Reserve Bank Act envisages departures from respecting the creditor hierarchy during resolution under certain circumstances, but it does not require compensation to be made available to creditors whose property rights are displaced or modified. In this regard, New Zealand is an outlier internationally for its lack of safeguards for creditor property rights in a bank resolution.

Critically, this lack of creditor property right safeguards means that certain of the resolution tools the Act currently provides may not be implementable or sustainable in practice. The scope for creditor legal action to enforce their rights could pose fiscal risks to the government that make a taxpayer bailout option preferable. Also, a failure to respect property rights in an actual crisis risks serious damage to New Zealand's reputation as an investment destination – if not resulting in reduced bank funding options then at least in higher risk premiums demanded by wholesale bank funding suppliers.[85]

The IMF raised both director and creditor safeguards in its FSAP report.

6. Lack of resolution funding options and non-taxpayer-backed options puts public funds at risk

Reflecting the lessons learned from the GFC, the FSB Key Attributes state that authorities should not have to rely on bailout funds, blanket government guarantees, or public ownership to resolve firms. Instead, failed firms' owners and creditors should chiefly bear the costs of failure. The use of public funds should be:

- a last resort option
- temporary (i.e. recoverable from the failed bank or the industry)
- only for the purpose of maintaining financial stability and continuing critical banking operations.

In line with the Key Attributes, the IMF recommended that New Zealand's resolution authority have, and be tasked with pursuing, resolution options that do not require public funds and that maximise recoveries from failed institutions – with an exception possible only when necessary to protect financial system stability.

OBR as currently designed cannot work without some form of taxpayer support, and 'closed bank resolution' options may not be credible without either deposit insurance or taxpayer support.

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[85] APRA has already required Australian parent institutions to reduce their non-equity funding exposures in their New Zealand subsidiary banks to 5 percent (down from the normal cap of 50 percent) of the parent's level 1 Tier 1 capital by 2021. APRA has also required that contingent funding support by the parent to a New Zealand subsidiary bank during times of financial distress only be provided on terms that are acceptable to APRA. At present, only covered bonds meet APRA's criteria for contingent funding support to New Zealand subsidiary banks.

Deposit insurance, or some other form of pre-positioned system to levy the industry, is a key enabler of credible resolution options that do not rely on taxpayer support.

It is also important to note that a taxpayer-funded bailout is not currently a readily available option under all circumstances. The government does not have a permanent legislative authority to make capital injections in a financial emergency. Any such expenditure would either need to be small enough to be accommodated in any available 'Imprest Supply' contingency[86] or require its own parliamentary appropriation (which could be difficult to secure at short notice and only possible if Parliament is sitting).

Possible reform elements

Drawing on international best practice, the rest of this chapter discusses possible clarifications of and enhancements to New Zealand's crisis management framework. The general approach is to build on the existing framework, not replace it. This would be achieved by aligning the framework with international best practice where appropriate for New Zealand. The aim is to provide more options and flexibility for authorities, and provide them with greater accountability for exercising what are significant powers to intervene and resolve failing banks.

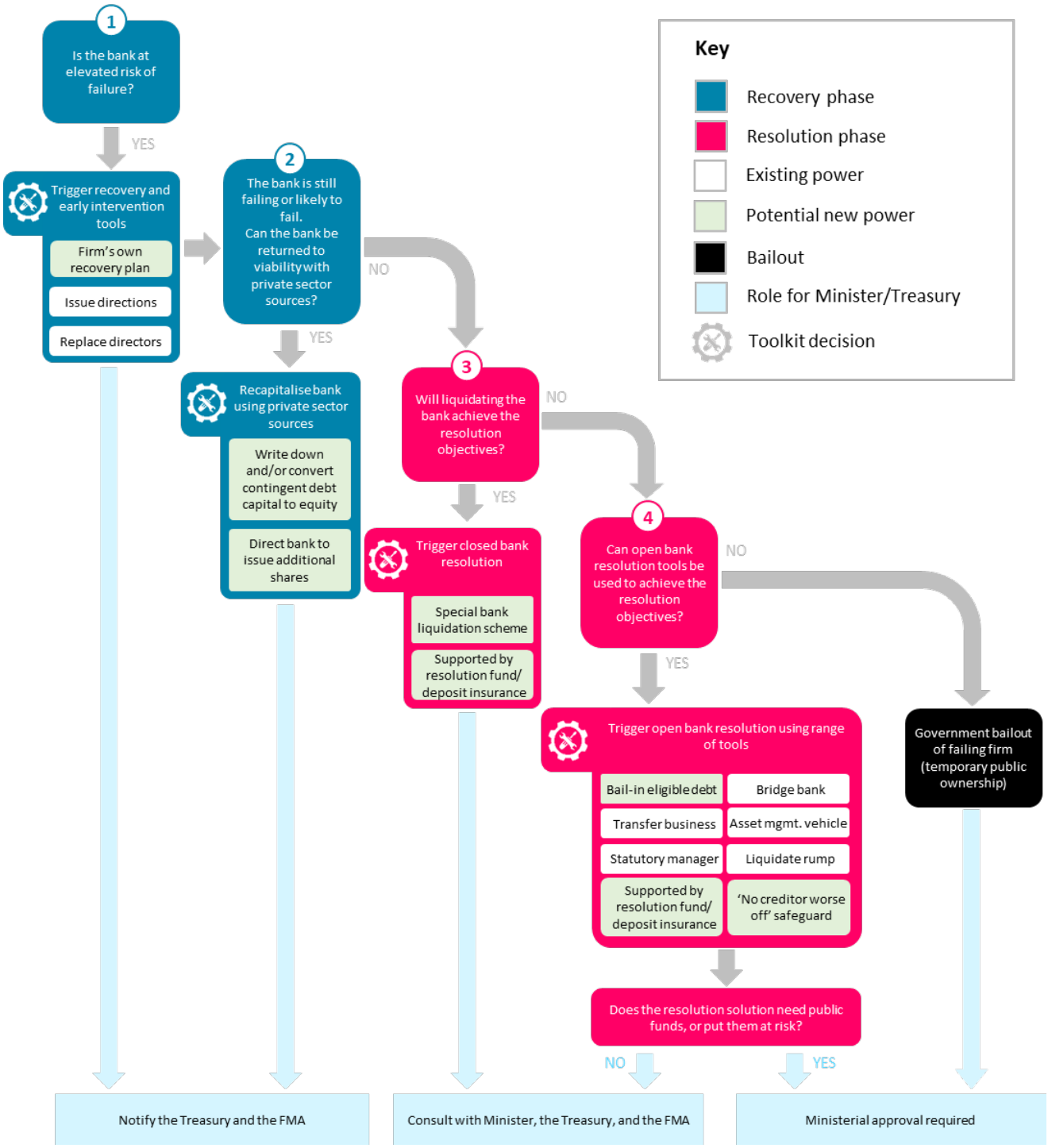
In particular, the framework could benefit from:

- clear resolution objectives
- clarifying the identity of the resolution authority
- a rebalancing of the Minister's role to one with less involvement during recovery and early intervention and a more purposeful involvement during resolution
- additional tools and powers for the Reserve Bank
- making resolution tools and powers directly available to the Reserve Bank rather than only via a statutory manager
- creditor safeguards
- making recourse to taxpayer bailouts a last-resort option.

These and other potential changes to the crisis management framework are outlined in Figure 5C.

[86] An Imprest Supply Bill is an interim parliamentary authority for public spending between the main Appropriation Bills.

Figure 5C: Suggested enhancements to bank crisis management powers



1. Specifying resolution objectives in legislation

Resolution authorities face difficult choices in deciding how to resolve a failing financial firm. These choices include how best to impose losses and how best to limit damage to the financial system. In order to make the choice that best reflects societal interests, and to legitimise the use of delegated powers, resolution authorities need a clear set of objectives to guide their actions. Good regulatory design demands that conferring extensive powers on an unelected body be accompanied by clear statutory objectives governing the use of those powers.

For New Zealand, the resolution objectives should identify the key outcomes expected of the regime and that the Reserve Bank, in implementing the regime, should seek to generate – provided that the objectives do not unhelpfully fetter the Reserve Bank's ability to deal effectively with a financial crisis. An overarching objective to 'protect and enhance the stability of New Zealand's financial system'[87] does not provide sufficient specificity for the bank resolution function. The intrusive nature of resolution powers and their potential distributional impacts demands greater clarity on the outcomes that the resolution authority should be aiming to achieve. Moreover, resolution powers may need to be exercised in relation to banks the failure of which would not have systemic implications, yet clarity on the expected outcomes would be no less important for the stakeholders concerned.

The FSB Key Attributes recommend that a resolution authority's statutory objectives include:

- pursuing financial stability and ensuring continuity of systemically important services
- protecting depositors that are covered by relevant insurance schemes
- where consistent with other statutory objectives:
  - avoiding unnecessary destruction of value
  - seeking to minimise the overall costs of resolution in home and host jurisdictions and losses to creditors.

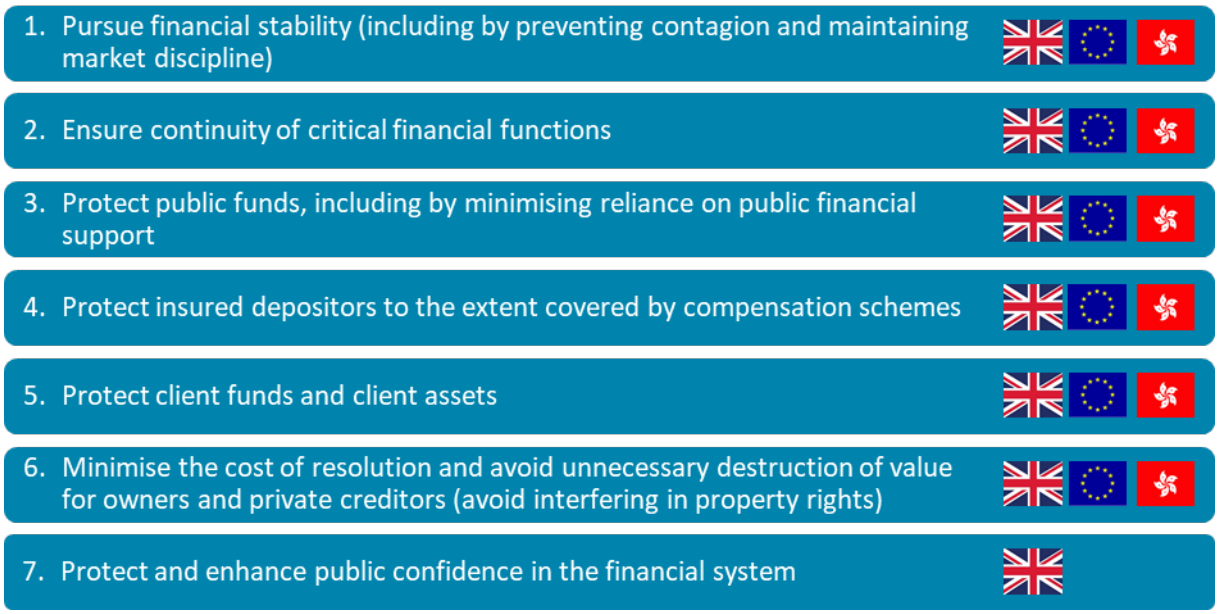
The accompanying background paper on crisis management describes how three other jurisdictions have applied the FSB Key Attributes when drafting their resolution regime objectives:

- The UK – one of the leaders in comprehensively reforming domestic crisis management arrangements in response to the GFC.
- The European Union – of interest because of the international consensus on resolution regimes that the EU's framework represents.
- Hong Kong – which has recently completed domestic resolution reforms that align well with the FSB Key Attributes.

Figure 5D summarises these three jurisdictions' resolution objectives.

[87] See the in-principle decision on overarching objectives set out in Consultation Document 2A.

Figure 5D: UK, EU, and Hong Kong bank resolution objectives



A number of options exist for how New Zealand can identify a set of resolution regime objectives that align with international best practice:

- **Number of objectives** – the above three jurisdictions have opted for a different number of objectives to cover broadly the same ground. The UK has seven objectives, while Hong Kong has only four (it has combined some elements that the UK has kept separate). Having more objectives allows for greater clarity and granularity in setting expectations for the resolution authority, but it can also make it more difficult for the resolution authority to determine how best to balance competing objectives. Having fewer objectives makes the tasks of balancing objectives easier, but means that less detailed guidance is given for exercising what are significant powers of intervention.
- **Weighting of objectives** – some jurisdictions have chosen to weight some objectives more prominently than others. In the UK, all seven objectives are equally weighted in statute – the resolution authority determines how best to apply them in each situation. The EU's objective to minimise the cost of resolution is secondary to others, while in Hong Kong 'minimising the cost of resolution' and 'protecting public funds' are both secondary. The FSB Key Attributes do not rank resolution objectives. Instead, the FSB notes that resolution authorities require flexibility to balance their objectives on a case-by-case basis, so that resolution plans can be tailored to individual circumstances.
- **Relevance** – some objectives are directly linked to features of a broader crisis management regime. For example, the objective to protect insured depositors is only relevant to New Zealand if the government confirms the in-principle decision to introduce a deposit insurance scheme. The specificity of objectives should also align with the level of autonomy envisaged for the resolution authority: greater autonomy in using powers implies greater specificity in the objectives.

Proposed resolution objectives

Table 5A outlines how New Zealand's resolution objectives could be specified in law. The annotations to the right show how these possible objectives could be varied based on the optionality discussed above.

Table 5A: Proposed bank resolution objectives

1. To 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.	Option to separate the sub-bullets into individual objectives
2. To protect insured depositors to the extent covered by an insurance scheme (and thereby minimise undue recourse to the scheme).	Option to exclude if additional depositor protection is not considered necessary
3. To protect client funds and client assets.	Option to exclude if client assets are not a significant concern
4. To protect public funds, including by minimising reliance on public financial support.	Option in positioning within an objective hierarchy
5. To the extent not inconsistent with the above objectives, minimise the cost of resolution and avoid unnecessary destruction of value for owners and private creditors.	Option in positioning within an objective hierarchy

Questions for consultation

5.A What are the most important objectives for New Zealand's resolution authority? Should they be ranked in order of importance? Would the objectives suggested above strike the right balance between providing guidance and accountability for the Reserve Bank and flexibility for the Reserve Bank to deal effectively with a crisis?

2. Clarifying the Reserve Bank as the resolution authority and its responsibilities

The resolution function

The crisis management function can be divided into three areas:

- Resolution planning before a crisis
- Working with the prudential supervisor on the design and implementation of recovery plans
- Exercising resolution tools and powers, in conjunction with other supporting functions such as depositor protection arrangements, in a crisis or in the lead-up to a crisis (see Box 5E).

Pre-crisis planning is essential in executing a resolution successfully. It should involve:

- resolution planning with financial institutions to make sure they are resolvable, including identifying preferred resolution strategies and impediments to resolution, and working with institutions to remove those impediments where possible
- coordination planning with other domestic authorities
- coordination planning with foreign authorities (for New Zealand's cross-border banks that either are foreign owned or have foreign operations).

Box 5E: Recovery versus resolution

Recovery plans and tools refer to measures that a bank in distress can take if necessary to reduce its risk profile and conserve capital. Recovery tools aim to avert a failure and the need for resolution tools. They include a distressed bank taking steps to recapitalise using private means, such as issuing new share capital instruments or triggering the contractual conversion of eligible debt instruments into equity. Recovery plans could also include more strategic options such as divestment of business lines and restructuring of liabilities.

Responsibility for developing and executing recovery plans sits with a bank's senior management. The Reserve Bank, however, could use early intervention powers to help secure a distressed bank's recovery, such as issuing directions to require the execution of a recovery plan, or directing the bank to take a specified action to address its financial difficulty, or appointing one or more directors to the bank's board (potentially replacing existing directors).

Resolution tools refer to steps that the resolution authority takes when it has been determined that a bank has failed or is likely to fail. The use of resolution tools means that recovery tools have failed to deal with the bank's problems.

Executing a resolution can be split further into an immediate 'stabilisation' phase (that is, immediately following a bank's entry into resolution) and a longer 'restructuring' phase, as the issues that caused the bank's failure are resolved. Applying resolution tools can involve exercising a variety of statutory intervention powers, which may involve overriding shareholder and creditor rights. Those powers would normally include the ability to:

- stabilise the failed institution
- take control of the failed institution
- allocate losses in the failed institution
- restructure, transfer, or sell part or the whole of the failed institution
- apply to have the failed institution liquidated.

These powers demand a high degree of clarity in the resolution authority's mandate, a good understanding of the bank in resolution, and strong accountability settings.

The resolution authority

International guidance and practice indicate that the resolution function should be handled by an authority that is operationally independent of political interference. However, bank resolution can have external costs and impacts that a regulator may not be able to internalise. In such situations there may be a legitimate role for elected officials (such as a Minister) in some parts of the resolution process. These situations may be best managed on an exceptions basis, leaving the default resolution function to an otherwise operationally independent authority.

Important synergies of knowledge and information-sharing exist between prudential supervision and resolution. Resolving a bank successfully requires the resolution authority to understand the bank's structure, its business operations, the critical services it provides, and the underlying cause of the failure. For this reason, other jurisdictions commonly co-locate the resolution authority and the prudential supervisor, although keeping them functionally separate.

In the absence of creating a new agency, the Reserve Bank is the only credible candidate to be the resolution authority. Little benefit would be gained in creating a new agency solely for the resolution function while prudential supervision remains with the Reserve Bank.

However, to avoid the risk of supervisory forbearance,[88] the resolution function should have a degree of structural separation from the supervision function when the two are located in the same organisation (while allowing for information-sharing). In jurisdictions such as the UK and Hong Kong, this separation is achieved by staffing the resolution function separately and having management reporting lines that ensure decisions on whether to recommend placing a bank into resolution are not made by the same people who perform the supervision function.

The Treasury's role

The Treasury plays an important role in:

- advising the Minister whether bank resolution policies appropriately manage the broader fiscal and macroeconomic risks associated with banking failures
- determining the risk of a bank failure to public funds and advising the Minister accordingly
- working with the resolution authority to manage any risk to public funds.

For the bank crisis management regime to be effective, the Treasury will also have a critical part to play alongside the Reserve Bank in resolution planning in pre-crisis times so that, when a distress event does arise, advice can be provided to the Minister with minimum delay and maximum utility.

Question for consultation

5.B Is the proposed resolution authority function for the Reserve Bank specified appropriately? Do you see any alternatives to the Reserve Bank as resolution authority?

[88] Forbearance in the context of bank supervision is a hesitation of prudential supervisors to trigger resolution actions – possibly in the hope that things might right themselves without intervention, or out of fear for the consequences of intervention. However, experience has shown that a failure to intervene early tends to increase the costs of a crisis (European Systemic Risk Board, 2012, p.1).

3. Rebalancing the role of the Minister of Finance

The requirement for ministerial consent to every direction the Reserve Bank gives to a bank is essentially a process check. There is little value in the Minister performing a process check for the use of bank crisis management powers when the Reserve Bank has already determined to exercise them in accordance with statutory processes. The Minister's value would be greater in decision-making involving political trade-offs or where a proposal would put public funds at risk.

With the addition of clear statutory resolution objectives and stronger accountability mechanisms to the bank crisis management process, there is a strong case to rebalance the Minister's role. Reduced ministerial involvement at stages where the Minister is less likely to be able to add value may also facilitate better resolution authority interventions and outcomes, especially when speed is of the essence.

One way to achieve this better balance would be to relax the requirement for ministerial consent to resolution authority decisions, and provide a clear 'exceptions' basis for ministerial directions. It would be important to define those exceptions to avoid undue political interference that could result in sub-optimal outcomes.

One possible exception is when **public funds are at risk**. This is a common exception in other jurisdictions (and recommended in the IMF's FSAP). Ministerial oversight of, and accountability to Parliament for, decisions involving the actual or contingent expenditure of public funds is embedded in New Zealand's public finance management framework and the democratic traditions underpinning that framework.

However, it is an open question whether a public funds test would be sufficient to cover all situations when a ministerial direction would be legitimate and appropriate given the Minister's ultimate responsibility for the performance of the resolution regime. For instance, should there be an exception which recognises that bank failures and bank resolutions can have wide-reaching economic impacts, and that resolution decision-making can involve trade-offs with economic externalities (e.g. economic or trade relationships with Australia) that the resolution authority finds difficult to internalise? Should there be an additional reserve ministerial power to direct the resolution authority where the Minister considers that wider economic impacts require a solution different from the one being proposed?

Answering this question involves balancing the desirability of protecting the resolution process from political interference with the argument that an elected government has a legitimate interest in steering resolutions that could have significant impacts across the wider economy. This consultation document seeks your views on where the appropriate balance lies, and whether a public funds test would be a sufficient democratic safeguard for the public interest.

Consultation requirements

Resolutions cannot be unwound after the event, so it is essential that the potential impacts of a resolution are understood, assessed, and considered early in the decision-making process. It would be vital to ensure that the Minister, the Treasury, and other relevant authorities are notified about it early, so that all involved can understand any potential impacts of the bank failure and the proposed resolution strategy – including the potential need for public funds. They will also need enough time to consider alternative policy options and to ensure adequate preparations are undertaken.

This early awareness could be supported by a statutory requirement for the Reserve Bank to:

- advise the Minister of Finance, the Treasury, and the FMA whenever the exercise of a recovery or early intervention power (e.g. the power to direct or to replace directors) is being contemplated
- consult the Minister of Finance, the Treasury, and the FMA on a resolution strategy as soon as it appears that a regulated institution is likely to fail and may need to be placed into resolution.

Question for consultation

5.C Should the current requirements for ministerial consent be replaced with an ability for the Minister to direct the Reserve Bank when public funds could be at risk? Are there additional circumstances in which the Minister should be able to direct the Reserve Bank on a resolution if public funds are not at risk?

4. Improving access to a wider range of bank crisis management tools and powers

As noted earlier in this chapter, key resolution powers are currently only available through statutory management, and the suite of powers does not contain all those recommended in the FSB's Key Attributes.

A range of resolution options is required to deal most effectively with different banks – which can have very different operating models, funding structures, and failure scenarios. For example:

- a small institution's failure may be most effectively dealt with through a special bank liquidation process, in conjunction with a mechanism to protect affected depositors from hardship (e.g. a deposit insurance scheme)
- small and medium-sized banks that are largely deposit-funded may be more suited to resolutions known as 'purchase and assumption', where a healthy bank or group of investors purchases some or all of the failed bank's assets and takes on some or all of its obligations. The Reserve Bank Act currently provides basic powers for purchase and assumption resolutions, but only if a statutory manager has been appointed first
- large, more complex banks may need to be kept open to maintain the continuity of essential financial services, and will require tools that return them to an appropriately capitalised and viable state. However, the Reserve Bank Act does not adequately provide for this type of resolution, necessitating taxpayers to be exposed to significant risk. Internationally, and in response to the GFC, a statutory bail-in is recommended (for more detail, see Box 5F and the accompanying background paper on bank crisis management).

  An alternative to bail-in that would also not require taxpayer support could be the use of a resolution fund paid for by industry-wide levies. However, a resolution fund could struggle to gain the size needed for a large bank failure, particularly if it were funded *ex post*. It would also see prudent and small banks paying for the failures of large and less-prudent banks. By socialising the costs of financial failure more widely, an industry-funded recapitalisation would also reduce the incentives for banks to manage their business prudently (moral hazard).

The following are changes that could address the Act's key shortcomings in bank crisis management powers:

- Make a clearer distinction between recovery and early intervention powers on one hand and resolution powers on the other, and give the resolution authority full operational autonomy to exercise recovery and early intervention powers.
- Supplement the existing intervention powers (to direct and to replace directors) with an ability to write down or convert contingent debt instruments to equity.
- Enable the Reserve Bank to direct a registered bank to issue additional shares or otherwise raise additional capital.
- Remove the requirement that a failing bank first be placed into statutory management before resolution tools can be exercised. In other words, confer resolution powers directly on the Reserve Bank as resolution authority (rather than solely on a statutory manager), while providing the Reserve Bank with the ability to appoint directly a statutory manager to replace or assist the management of a failing bank if that is necessary to implement a resolution.
- Add to the suite of resolution powers the ability to 'bail in' specified unsecured liabilities.
- Introduce a special bank insolvency/liquidation process that differs from normal insolvency processes by requiring the insolvency practitioner to prioritise the rapid return of insured deposits or to transfer insured deposits to an acquiring bank ahead of maximising value for shareholders and creditors.
- Add an explicit temporary public ownership vehicle for any situation where non-public ownership options are deemed not suitable for achieving resolution objectives.
- Require the Minister of Finance's approval for any resolution actions that could create a need for public funds or otherwise impact the Crown balance sheet.
- Clarify the ability to suspend temporarily a bank's continuous disclosure requirements in the lead-up to resolution, subject to conditions and safeguards.

Clarifying that a statutory manager would be appointed by, subject to the directions of, and responsible to, the resolution authority, or that the resolution authority itself could act as the statutory manager (as can be the case in Australia), would remove any doubt that responsibility and accountability for exercising resolution powers and for achieving resolution objectives remain with the resolution authority. A statutory manager appointed by the resolution authority would otherwise have the same ability to exercise all the powers and rights of a bank's board, management, and shareholders as would a statutory manager under the existing legislation.

In relation to director safeguards discussed earlier in this chapter, the FSB recommends that, to preserve market confidence, temporary exemptions from normal disclosure requirements or a postponement of disclosure requirements by a distressed bank be allowed where the disclosure could affect the successful implementation of resolution measures. Legislation could usefully clarify the resolution authority's ability to suspend disclosure requirements. Conditions and safeguards could include:

- it being reasonably likely that the distressed bank will be subject to resolution
- disclosure would mean that the bank would likely cease to be viable or would impede an orderly resolution
- a requirement to consult the FMA before suspending disclosure requirements.

Box 5F: The statutory bail-in tool

Statutory bail-in is a regulatory power to convert general unsecured liabilities (potentially with specific exemptions, such as insured deposits) into equity as part of a bank's orderly resolution. (**Contractual bail-in**, on the other hand, refers to the automatic conversion or write-down of debt instruments when a contractually specified trigger is met.)

Large and complex banks may need to be kept open to maintain the continuity of essential financial services and avoid damage to wider financial stability. These banks require special tools to return them to an appropriately capitalised state. Bail-in powers were developed in the aftermath of the GFC to enable authorities to recapitalise a failing bank quickly, helping to restore viability and capital ratios to above regulatory minimums. Bail-in helps to avoid insolvency and minimises the need for taxpayer bailouts or other taxpayer support.

The FSB Key Attributes state that bail-in should be applied in a manner that respects the normal hierarchy of creditor claims. That means that equity (the bank's owners' stake) and other instruments of ownership should fully absorb losses before eligible liabilities are bailed in.

Using bail-in is not without its complications. It must ensure that affected creditors are treated fairly – that the bail-in (for example, the value of any securities received) represents fair treatment of their property rights as creditors. Careful valuation work is essential to mitigate the risk of subsequent legal challenges for compensation.

Bail-in also requires sufficient unsecured liabilities or other instruments to be available to bail in. The incentives created by prudential requirements for banks to hold suitable quantities of bail-in-able liabilities can potentially determine whether bail-in is a credible option for a given bank. The availability of sufficient liabilities would therefore become part of a resolution authority's pre-crisis analysis of whether a bank is in fact resolvable. However, prudential requirements can change over time, so they should not in themselves determine whether bail-in powers should be made available in legislation.

Without explicit exclusions, deposits would be 'bail-in-able' liabilities alongside other unsecured liabilities like non-covered bonds. A deposit insurance scheme would therefore become an important element to protect depositors from what might otherwise be seen as an unfair imposition of losses on those who are least able to monitor and manage the risk of bank failure.

The FSB Key Attributes recommend that resolution authorities be vested with statutory bail-in powers. These powers have featured widely in resolution regimes introduced in other jurisdictions since the GFC as a way of minimising the use of taxpayer funds to recapitalise a distressed bank. Experience with using bail-in is still in its infancy and has both demonstrated benefits and revealed issues. The main benefit is the ability to recapitalise a bank while minimising the need for a taxpayer bailout. The Bank of England has noted other significant benefits, including avoiding operational challenges and legal consequences that can arise when transferring some of a failed bank's business to a purchaser.

Issues with bail-in include the need for robust valuations before and after the event, to support the determination of whether 'no creditor worse off than in liquidation' (NCWO) compensation is required and to mitigate the risk of creditor litigation. Bailing in foreign-held debt instruments also relies on either a contractual (and therefore enforceable) agreement to the resolution authority's power to bail in, or recognition of the bail-in power by authorities in the jurisdiction in which the debt instrument is held.

For New Zealand, one option for introducing statutory bail-in would be to provide for the general power in primary legislation, with eligible liabilities and exemptions set out in regulation, while options for the foreign enforcement of the power are developed further.

Questions for consultation

5.D Should the Reserve Bank, as the resolution authority, have resolution powers (instead of only statutory managers having these powers)?

5.E In principle, should the Reserve Bank have the power to 'bail in' specified categories of unsecured liabilities (with details of eligible liabilities to be determined and subject to creditor property rights safeguards – see below) in order to recapitalise a failing large bank after its owners have absorbed maximum losses, and to minimise the need for taxpayer support? Alternatively (or in addition), should the recapitalisation of a failing large bank be funded through industry-wide levies?

5.F Do you agree with the proposal to allow continuous disclosure-to-market requirements to be suspended temporarily, subject to conditions and safeguards? Are the suggested conditions and safeguards appropriate, or should there be others?

5. Protecting property rights through creditor safeguards

Haircutting creditors through statutory bail-in tools can displace their property rights. Institutional investors generally find it unacceptable to modify the rights and priorities underpinning normal insolvency law, unless the law provides for adequate compensatory mechanisms.

If property rights are unclear, investors can find it hard to identify and price accurately, then manage, the risks to which they are exposed. The FSB Key Attributes state that resolution powers should be exercised in a way that respects the hierarchy of claims in a liquidation. However, there is also recognition that sometimes creditors may need to take second place to wider or systemic stability interests. The FSB Key Attributes state that it is permissible to depart from the hierarchy, or otherwise interfere with established property rights, if it is necessary to contain the potential systemic impacts of a bank's failure or to maximise the value for the benefit of all creditors as a whole.

Even when it is necessary for a resolution to depart from respecting creditor property rights and priorities, the FSB Key Attributes state that creditors should nevertheless receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime. This principle is known as the 'no creditor worse off than in liquidation' (NCWO) safeguard.

Internationally, resolution authorities commonly have powers and discretion to act rapidly and flexibly in a crisis, with a provision for *ex post* compensation for any additional losses incurred as a result of a departure from normal creditor property rights and priorities in insolvency.

Continuing with the status quo of assuming flexibility to displace creditor property rights *without* compensation is, of course, an option – albeit an option that would likely undermine the credibility of the resolution regime. There are alternative options that could provide a safeguard for creditor property rights and priorities which would lend greater domestic and international credibility to the regime. They are either:

- the resolution authority is not given discretion to depart from respecting creditor rights (including respecting the creditor hierarchy in liquidation and maintaining the equal treatment of creditors within the same class) or otherwise to leave creditors worse off than they would be in a liquidation, or
- discretion in certain circumstances, as long as the resolution authority makes compensation available to creditors who are left worse off than they would have been in a liquidation.

Even if a resolution respects the creditor hierarchy, the process of special bank resolution is likely to depart from ordinary insolvency processes. But individual creditors should not be left worse off than they would have been in an ordinary liquidation. The provision of NCWO compensation in such situations is one of the reasons for resolution authorities requiring access to resolution funding arrangements.

An effective creditor safeguard provides reasonable certainty of outcomes in advance, to allow creditors to price and manage risks with sufficient accuracy, while not unduly constraining authorities' flexibility to act.

If a decision is agreed to establish a creditor safeguard, further work would be required to design the details of a safeguard that is practical for New Zealand. See the accompanying background paper on bank crisis management for further discussion on creditor safeguards.

Making an open bank resolution better for depositors, creditors, and taxpayers

The concept of restoring a failed bank's solvency through creditor recapitalisation – and thus enabling the bank to stay open – was the genesis behind the Reserve Bank's OBR option. Several of the enhancements to the framework suggested above would support and improve the workability of an open bank resolution by:

- enabling the resolution authority to exercise resolution powers without having to invoke statutory management
- enhancing the ability to stabilise and recapitalise a bank without taxpayer support
- providing creditors with greater certainty as to how they will be treated and comfort that their property rights will be protected.

The in-principle decision to introduce deposit insurance (see Consultation Document 2A) will further support an open bank resolution by protecting depositors from the prospect of bearing losses (up to the insured limit) in the recapitalisation process.

Question for consultation

5.G Should the resolution authority always be required to respect property rights (including the hierarchy of creditors in liquidation)? Or should it have discretion to override property rights as long as compensation is made available to creditors left worse off than they would have been in a liquidation? Or should no change be made to the protection of creditor property rights?

6. Making non-taxpayer-funded resolution funding available

Resolution funding is funding that can be used to support the use of resolution powers and achieve resolution objectives by:

- replacing illiquid, encumbered, written-down, or otherwise impaired assets[89]
- 'greasing the wheels' of resolution strategies, such as by paying a risk premium for a healthy bank to assume some or all of the failed bank's assets and liabilities
- compensating creditors under an NCWO safeguard.

International best practice is that the primary source of resolution funding – especially any that is required to recapitalise a failed bank – should come from 'internal' sources via bail-in. However, additional external funding may be required to buttress the internal resources of the failed bank.

The FSB recommends having supplementary resolution funding arrangements set up in advance, so that resolution authorities do not have to rely on public ownership, bailout funds, or government guarantees to resolve financial institutions. There are three broad types of arrangements available:

1. Industry-funded deposit insurance scheme funds.
2. Industry-funded resolution funds.
3. Temporary access to public funds within a mechanism that allows the government later to recover the costs incurred from the industry.

All three options share an ultimate recourse to industry funding, thus avoiding imposing the costs of bank failures on taxpayers.

Industry-funded deposit insurance funds

Industry-funded deposit insurance scheme funds can be used both to pay out depositors in a bank liquidation and to support bank resolutions that do not involve liquidation. For example, rather than winding up a bank and paying out insured deposits, an insurance fund could be used to support a 'purchase and assumption' solution, where an acquiring bank requires a premium to take over a failed bank's deposit accounts along with any 'good' assets.

[89] An illiquid asset is an asset that is difficult to convert to cash. An encumbered asset is an asset owned by one party (e.g. a bank) but subject to the legal claims of another party (e.g. a creditor of the bank). An impaired asset is a company's asset that has a market price less than the value of the asset on the company's balance sheet.

In these cases, the use of deposit insurance scheme funds would be subject to certain limitations – that is, up to the amount that would have been paid out to depositors in a liquidation less expected recoveries.

Deposit insurance scheme funds are usually industry-funded *ex ante* (through levies or premiums), but they may have a government backstop that could be repayable through *ex post* industry levies or premiums.

Industry-funded resolution funds

Similar to a deposit insurance scheme fund, a special industry-funded resolution fund can be used in a resolution and be either built up *ex ante* through industry levies or collected *ex post* through industry levies.

A resolution fund avoids some of the constraints in relying solely on a deposit insurance scheme, and works best when deposit insurance exists alongside it.[90]

Temporary access to public funds

As noted earlier in this chapter, New Zealand does not have a standing facility for accessing public funds in a financial emergency, other than through limited Imprest Supply contingencies or a guarantee under the Public Finance Act.

There may be a benefit in establishing a permanent legislative authority under the Public Finance Act, under which the Minister of Finance could make public funds available as a last resort in financial emergencies. It could include provisions and conditions to manage expectations of guarantees and taxpayer bailouts, and enable public funds to be recovered through *ex post* industry levies.

Chapter 4 noted the Reserve Bank's LoLR function and issues with providing liquidity support to a bank that is insolvent or approaching insolvency. The provision of emergency liquidity assistance to banks in resolution is considered possible under certain circumstances and is discussed further in the accompanying background paper on bank crisis management.

Question for consultation

5.H Should an industry-funded resolution fund be established (alongside any deposit insurance scheme fund)?

7. Implications for cross-border resolution

New Zealand's four largest banks account for 82 percent of New Zealand's banking system and are all wholly owned subsidiaries of Australian banks.[91] They represent the largest and most systemically critical overseas exposure of their Australian parent banks (IMF, 2019a, p. 29). Exercising resolution powers for these four banks may have particular challenges in the context of the wider trans-Tasman

[90] The main constraint in relying solely on a deposit insurance scheme is being limited to the amount that would have been paid out to depositors in a liquidation (less expected recoveries).

[91] Together with the Australian bank branches of ANZ, CBA, and Westpac, Australian banks account for 85 percent of New Zealand's banking system.

relationship. It is also conceivable that New Zealand will have other large, systemically important foreign-owned banks in the future.

The trans-Tasman relationship

The Reserve Bank and APRA each have statutory obligations to:

- support each other's financial system stability responsibilities
- avoid (if practicable) any action likely to have detrimental effects on each other's financial stability
- consult (if practicable) each other before taking such action.

These reciprocal provisions are appropriate and encouraging in their reciprocal nature, but they cannot ensure that a proposed resolution of an Australian-owned New Zealand bank will be mutually acceptable – and mutually acceptable resolutions cannot be legislated.

Legislation in both countries must necessarily provide sovereign powers to resolve banks in their respective jurisdictions, and enable each to resolve a bank independently of the other. However, the desire to reach mutual agreement on resolving a failed trans-Tasman bank remains compelling. Certain resolution options would effectively break a New Zealand subsidiary away from its Australian parent group, potentially destroying with it any value derived from retaining the group intact. Further, a resolution involving separation would inevitably have a significant impact on the Australian parent's balance sheet.

Dialogue on coordinating responses to a distressed trans-Tasman bank is taking place through the Trans-Tasman Council on Banking Supervision (TTBC).[92] The TTBC agencies have also agreed a Memorandum of Cooperation on trans-Tasman bank distress management. The Memorandum of Cooperation sets out principles to help ensure coordinated responses, but does not pre-commit to, or rule out, any particular resolution option. The TTBC also carries out crisis simulation exercises to test various aspects of the cross-border framework for coordination responses. Lessons from the exercises are used to develop further cross-border crisis management and resolution arrangements.

To a large extent, the options for an agreed approach to a trans-Tasman resolution will be limited by the options available in each jurisdiction's resolution regime. As noted in this chapter, New Zealand's options are currently limited compared with international best practice. The absence of a full suite of resolution options and the lack of a pre-arranged resolution funding mechanism necessarily limit the scope of meaningful resolution discussions with Australia.

If New Zealand's resolution regime were more in line with international practice, it would improve the range of options that can be explored and developed with Australia. Similarly, the provision of creditor safeguards that give Australian authorities greater assurance that the property rights of Australian parent institutions would be respected in a New Zealand resolution would support the ongoing dialogue.

For its part, Australia is moving in line with the international direction of travel, particularly in its recent strengthening of the legal basis for the contractual conversion and write-off of capital

[92] The TTBC comprises New Zealand agencies the FMA, Reserve Bank, and the New Zealand Treasury; and from Australia, ASIC, APRA, Reserve Bank of Australia (RBA), and the Australian Treasury.

instruments[93] and on resolution planning directly with institutions – both of which lend well to a coordinated approach to resolution with New Zealand, if New Zealand were similarly armed.

Other jurisdictions

In addition to the Australian-owned banks operating in New Zealand (either as locally incorporated banks or as branches of the overseas parents), there are 12 registered banks in New Zealand with home jurisdictions in seven other countries. These banks are small compared with the Australian big four. Irrespective of their systemic importance (which conceivably could change in the future), any failure would require orderly management and could require close coordination with the home jurisdiction. The prospects of reaching agreement on cross-border resolutions with those jurisdictions would similarly be improved if New Zealand's resolution framework were in greater alignment with international best practice.

Question for consultation

5.I Do any other aspects of cross-border resolution need to be considered in the design of New Zealand's crisis management framework?

Summary

This chapter identifies a number of issues with the existing crisis management framework. Focusing on key framework design questions at a relatively high level, the chapter proposes clarifications and enhancements to the framework aimed at providing the Reserve Bank with greater flexibility and options for dealing with a failed bank with less reliance on taxpayer funds, a clearer and more meaningful role for the Minister, and more closely aligning the framework with international best practice. The suggested changes, which should be seen as a package to support a coherent and effective regime, include:

- making resolution powers directly available to the Reserve Bank as resolution authority
- clarifying the objectives for which the Reserve Bank would be held accountable in exercising resolution powers
- less involvement of the Minister of Finance in routine matters and more involvement when public funds are at risk
- enhancing the ability to allocate losses from, and recapitalise, a failed bank without relying on taxpayer support
- providing creditors with greater certainty as to how they will be treated and comfort that their property rights will be protected.

[93] Australia has placed greater emphasis on contractual conversion of debt capital rather than statutory conversion of debt. The IMF has endorsed Australia's reforms but also recommended that Australia adopt statutory conversion powers to enhance further its resolution regime (IMF, 2019a, p. 24).

Part C: The Reserve Bank's role in the regulatory system and how it should be funded

In order for the Reserve Bank to deliver on all the policy areas highlighted in the previous chapters, it needs to work with other agencies and be sufficiently well resourced. Part C discusses whether the Reserve Bank should take a more active role in coordinating policy across the regulatory system and considers whether the mechanism through which it receives its funding is overly constraining its actions.

Part C is structured around two chapters:

Chapter 6 asks how the Reserve Bank should coordinate with other agencies.

The Reserve Bank is part of a broader eco-system of financial regulators and economic policymakers. Effective coordination with other agencies is important to improve the quality of policy, identify and address overlaps or underlaps in the regulatory framework and ensure an optimal mix of policies throughout the system. Coordination can also facilitate better planning for extraordinary events, which are likely to require more intensive cooperation between agencies.

Chapter 6 explores the existing mechanisms to facilitate policy coordination in New Zealand and asks whether they could be enhanced by formal statutory objectives that incentivise coordination, changes to governance arrangements, and increased resources.

Chapter 7 asks how the Reserve Bank should be funded and resourced.

Much of the discussion in the preceding chapters is consistent with a case for increased resourcing of the Reserve Bank (relative to the status quo) in order to ensure that key functions such as prudential supervision and enforcement and coordination are carried out at an appropriate degree of intensity. While determination of a particular level of funding and resources is beyond the scope of this review, a key issue for consideration is the mechanism under which the Bank's funding is determined.

Currently, the amount of revenue that the Reserve Bank is able to spend on operating expenses of certain functions is constrained by a funding agreement, which is negotiated between the Governor and the Minister of Finance. Funding agreements set out an agreement for each financial year, and cover a consecutive five-year period. The purpose of the funding agreement is to constrain the Reserve Bank's expenditure, while ensuring it has sufficient funds to carry out its responsibilities in a manner consistent with its operational independence.

Chapter 7 considers potential shortcomings of the current funding approach along with a range of possible options for change. It notes the need to ensure a good balance between budgetary independence and achieving value for money in whatever model is chosen. The chapter addresses the need for the Reserve Bank to explain how funding will be used, and what subsequently was delivered (and how), to enable stakeholders to assess whether it was spent in the most efficient and effective way.

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

Aim of this chapter

This chapter reviews whether the Reserve Bank's arrangements for coordinating across government remain appropriate, and highlights potential options for reform.

The Reserve Bank is one of a number of agencies responsible for overseeing New Zealand's financial sector and the broader macroeconomy. The Treasury, MBIE, the FMA, and the Commerce Commission all have distinct roles that intersect with those of the Reserve Bank.

This chapter:

- describes why coordination is important
- describes current coordination arrangements and identifies potential issues with the existing model
- presents stylised options to illustrate the possible spectrum for coordination reform.

Why coordination matters

More often than not, multiple agencies have interests in a regulatory system. As a result, the actions of individual agencies can affect others in that system. Coordination helps to deliver better policy outcomes by providing a forum for agencies to identify and exploit synergies, manage policy trade-offs, and mitigate regulatory overlaps and gaps.

Coordination also helps to ensure that:

- risks are identified and addressed promptly and appropriately, including macro-prudential risks
- information is shared and lessons are learned
- efficiency is increased by minimising the unnecessary regulatory burden on industry
- agencies develop the right capabilities given their respective roles
- agencies are responsive and have the ability to act optimally in crisis situations
- the whole regulatory environment is responsive to the changing shape of industries.

The importance of coordination in a twin peaks regime

New Zealand operates a twin peaks model for financial sector regulation. In a twin peaks model, separate regulators are dedicated to prudential and conduct regulation. The twin peaks model has the benefit of there being less danger that one aspect of regulation will dominate the regulatory

landscape, as was the case with market conduct regulation in the UK's mega-regulator (the FSA) prior to the GFC.

The twin peaks model also helps to manage operational conflicts of interest, given the overlaps between prudential and conduct decisions. These conflicts have been well recognised internationally.[94] Giving these respective responsibilities to different regulators preserves the independence of decision making.

However, there are also risks associated with the twin peaks model that need to be managed. In particular, agencies may not always recognise the interdependencies in their mandates. This concern is pertinent given the shift to more detailed regulation on both sides of the twin peaks since the GFC, both in New Zealand and globally. Regulators are still adapting to the increasing breadth of their mandates, making awareness of any interdependencies even more important.

As a result of increasingly detailed regulation on both sides of the twin peaks, many financial entities are subject to dual regulation, which can impose a considerable burden if regulatory initiatives are not coordinated. Examples of increased regulatory pressures on regulated entities in New Zealand in recent years include:

- the introduction of the FMC Act
- reforms to financial advice regulation
- the growing size of the prudential rulebook
- introduction of the AML/CFT Act
- the development of an enhanced oversight regime for FMIs
- changes to lending standards and other macro-prudential policy initiatives
- the recent focus on the conduct of banks and life insurers, and the potential for increased conduct obligations in this area.

In recent times, New Zealand government agencies have taken initiatives to manage this risk by progressively developing and enhancing coordination mechanisms. However, given the breadth of the financial industry, challenges remain in managing processes to:

- avoid overregulation, given the quantity of changes
- avoid the risks of taking insufficient account of broader economic and social concerns
- ensure that regulators coordinate consistently in all relevant areas in order to identify regulatory gaps or emerging risks.

[94] For example, the House of Commons Treasury Committee (2011) noted that in the event of a crisis "consumer protection can be well served by keeping a bank open, while stability is well served by closing it" (p.32). The Dutch National Bank has also noted that "promoting transparency and consumer interests may involve publicly challenging the behaviour of financial institutions in the market [sic] can conflict with the discretion and confidentiality that is needed in prudential supervision" (van Hengel *et al,* 2007, p. 3).

What does good coordination look like?

There are five criteria that can usefully be considered in designing effective mechanisms for coordination:

- **Appropriately scoped and targeted** – mechanisms allow for information exchange and coordination at a level that supports effective decision-making, but respects agencies' independence. Coordination is targeted to address agreed objectives.
- **Transparent and accountable** – clear objectives for coordination and the roles of different agencies are agreed.
- **Durable** – mechanisms are supported in a variety of circumstances. They are not dependent on personal relationships or goodwill alone.
- **Timely** – mechanisms support fast, high-quality decision-making in a variety of circumstances.
- **Flexible** – mechanisms are able to adapt and respond to changes in industries.

With strong agency leadership and relationships, it is possible for effective coordination to occur even if the coordination mechanisms do not meet some of the criteria outlined above. It is also possible that risks do not crystallise, even when there is a failure to coordinate. However, relying on these scenarios is not optimal. Financial services are critical to all aspects of the economy, and almost all New Zealanders make financial transactions every day. In order for regulators and policy agencies to manage the risks of issues arising, coordination arrangements should be enhanced so that they perform well against all of the criteria identified above.

What are the existing coordination arrangements for financial sector agencies?

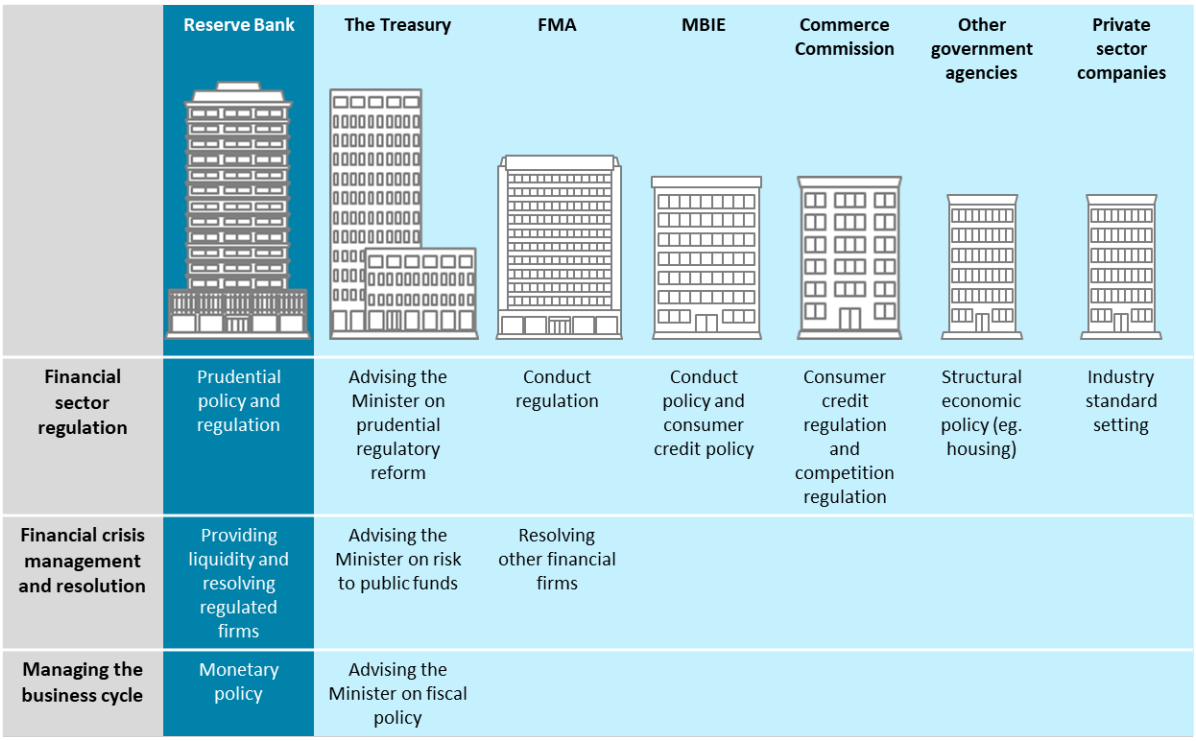
In financial policy, the Reserve Bank coordinates with other financial sector agencies in three main areas:

- financial sector regulation
- business cycle management
- banking crisis management and resolution.

From 2019 the Reserve Bank will also be looking to coordinate with non-financial sector agencies on climate change, as part of its Climate Change Strategy. Climate change poses risks to the financial system, so the Reserve Bank has an interest in keeping up to date with and influencing in the broader emerging climate change discussion. How the climate change discussion is relevant to the Reserve Bank's activities in prudential supervision is discussed in Box 3B of Chapter 3.

Figure 6A shows how the Reserve Bank's policy and regulatory responsibilities intersect with those of other financial sector agencies. The way that coordination arrangements are currently organised is then descried below.

Figure 6A: Who might the Reserve Bank need to coordinate with?



Coordination for financial sector regulation

As a starting point, State sector 'regulatory agencies' (a regulatory stewardship term that captures both regulators and policy agencies) are expected to engage with and work collaboratively with stakeholders.[95] These stakeholders include:

- other regulatory agencies
- regulated entities (for example banks, NBDTs or insurers for the Reserve Bank)
- other entities that have a role in the broader New Zealand financial system (for example, entities like NZX, credit ratings agencies, advisers like investment banks and auditors, and the NZFMA)[96]
- the broader public.

Bilateral coordination arrangements – in several areas, coordination on financial sector regulation is supported by bilateral MoUs. There are MoUs in place between the Reserve Bank (the prudential policy agency) and the Treasury (the government's lead economic and financial advisor), and the Reserve Bank and the FMA (the market conduct regulator). The MoUs are voluntary, non-binding arrangements that set out expectations about the relationships between the agencies. There is no MoU between the Reserve Bank and MBIE (the conduct policy agency), however the two agencies work together as required. There is also no MoU between the Treasury and the FMA, however the

[95] These expectations are contained in various locations such as the Government Expectations for Good Regulatory Practice 2017 (p.3) and the Crown Entities Act, section 50(c).

[96] The NZX operates New Zealand's primary market for licensed equity and debt instruments. The NZFMA promotes the efficient operation of the over-the-counter (OTC) derivatives markets, advocates for high professional standards, and sets benchmark interest rates.

FMA and the Treasury meet quarterly. The FMA has a more formal relationship with MBIE, given that MBIE acts as the administering department for FMA legislation.

Council of Financial Regulators (CoFR) – coordination also takes place through an inter-agency body known as CoFR. CoFR was set up in 2011 as an information-sharing hub, comprising the Reserve Bank, the FMA, the Treasury, and MBIE.[97] It meets quarterly. CoFR is the main mechanism for discussing the priorities of the member agencies and ensuring appropriate regulatory coordination. CoFR was set up by the agencies, and does not have legislative objectives or direct accountability to government.

In response to this Review, CoFR agencies commented on the value of having a forum that encourages member agencies to establish and maintain relationships and share information. CoFR agencies noted that CoFR enabled them to improve risk monitoring across the system by establishing a joint risk register. The risk register also helps CoFR and core agencies to prioritise and monitor action on prudential, conduct, and regulatory framework risks. The regulators (the FMA and the Reserve Bank) noted that it was helpful to have a forum to discuss the operational policy and regulatory issues they were facing with MBIE and the Treasury, who consider the broader economic and sectoral policy landscape.

Given its non-legislative nature, CoFR can tailor its approach to coordination based on the appetite of members. Since 2018, CoFR's role has at times expanded beyond information sharing. For example, to address the implications of the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (which led to New Zealand's Conduct and Culture reviews of banking and insurance), and to address EU benchmark requirements.[98]

In 2019, the member agencies agreed to develop a vision to map outputs to outcomes that will help them achieve this vision. One result of the vision development process was identifying the membership gap relating to the Commerce Commission. The Commerce Commission has now been invited to attend CoFR due to its responsibilities in enforcing consumer credit laws.

Coordination for managing the business cycle

Bilateral coordination arrangements – coordination for managing the business cycle amounts to information sharing on monetary and fiscal policy through working-level meetings between the Reserve Bank and the Treasury. These meetings occur to the extent and frequency that resources and priorities allow. The meetings centre on information sharing, rather than planning for how to stimulate the economy in a crisis. Likewise, the agencies do not prepare joint advice for ministers on the optimal mix of monetary and fiscal policy (although there is nothing preventing them from doing so if crisis conditions arose).

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[97] The Banking Forum is a sub-committee of CoFR that discusses ongoing and upcoming regulatory matters relating to registered banks. The Reserve Bank chairs the forum, which is attended by CoFR agencies, other government departments (such as Inland Revenue and the Ministry of Justice) and the New Zealand Bankers' Association.

[98] A benchmark is a price, estimate, rate, index, or value that is used as a financial reference to calculate the amount payable under various financial instruments. The main interest rate benchmark in New Zealand is the Bank Bill Benchmark Rate (BKBM). It is a benchmark that has an important impact on the real economy. For example, the interest rate paid on corporate loans and banks' own borrowing is directly linked to the BKBM, while the interest paid on most personal loans and mortgage loans in New Zealand is indirectly linked to the BKBM. In some jurisdictions, regulators set rules around the administration of financial benchmarks to ensure that they are robust and transparent. The EU is one jurisdiction that sets these types of requirements.

Treasury observer on the MPC – the Treasury observer on the MPC is also intended to support the flow of information on fiscal policy to the MPC. However strictly speaking, this allows for little in the way of coordination, as it is not a two-way flow of information. The Treasury observer is embargoed from sharing any information discussed at MPC meetings without agreement of the Governor, in order to protect the independence of monetary policy.

Crisis management and resolution of financial firms

New Zealand has not historically engaged in domestic crisis management planning for the failure of a financial firm. The 2016/17 IMF FSAP recommended that New Zealand commence domestic crisis management planning (IMF, 2017a, p. 36). As discussed in Chapter 5, in a bank failure or crisis event there would need to be coordination between the Reserve Bank and the Treasury, and potentially the Reserve Bank and the FMA.

While there is no *domestic* coordination on crisis management planning and resolution, the three agencies (the Reserve Bank, the Treasury, and the FMA) coordinate with their Australian counterparts through the TTBC. The TTBC conducts crisis planning exercises for the failure of a major trans-Tasman bank. New Zealand also has memoranda of understanding with a number of other jurisdictions on banking supervision.

Potential issues with existing coordination arrangements

Three potential issues have been identified with New Zealand's existing arrangements that could compromise effective coordination:

- **Lack of incentives or culture of coordination** – the allocation of roles and responsibilities in New Zealand's twin peaks model could lead to a lack of incentives for the Reserve Bank to coordinate with other agencies, and could also contribute to an overall lack of a culture to coordinate across agencies.
- **Lack of resources** – all agencies may be deprioritising coordination due to a lack of resources to coordinate.
- **Unclear roles and expectations regarding system stewardship and coordination responsibilities** – the New Zealand system of financial regulation is complex relative to comparable twin-peaks jurisdictions, and no agency holds clear system stewardship responsibility.

The reasons why these issues may be relevant and the resulting risks are discussed below.

Potential issue 1: Lack of incentives and culture of coordination

Why might incentives and culture be an issue?

Financial sector regulation – New Zealand began the shift towards a twin peaks model from the mid-2000s, as the Reserve Bank took on responsibility for the prudential regulation of NBDTs and insurers. Prior to the GFC, insurers and non-bank lenders were largely unregulated, or very lightly regulated. As a result there are notable differences between the designs of the prudential and conduct regulatory systems.

MBIE serves as the lead adviser on conduct regulation. In recent years, MBIE has led reform on the conduct peak, including the creation of the FMA and the development of the FMC Act. The Reserve Bank has served as the lead adviser on prudential regulation. [99] MBIE administers the FMA's and the Commerce Commission's primary legislation, while the Reserve Bank administers its own legislation.

The financial sector policy frameworks for the two peaks have developed relatively separately. System design has at times occurred without a clear focus on the interactions between the two peaks (for example in relation to consistency of legislative provisions, or the management of conflicts between prudential and conduct objectives).

The regulators (the Reserve Bank, the FMA, and the Commerce Commission) are also structured differently and operate differently. The Reserve Bank has historically operated under a single decision-maker governance model, and its place within the State sector is not clearly categorised. Conversely, the FMA and the Commerce Commission are independent Crown entities. The FMA has a non-executive board, and the Commerce Commission has an executive board.

The lack of integration between the twin peaks may have fostered a sense that a high degree of investment in coordination is not required, both in regulation and in policy development. This process was disjointed and took place on an incremental basis.

System design occurred without an explicit focus on regulatory stewardship across the two peaks. MBIE inherited its role as the lead policy advisor for conduct when it was created in the mergers of the Ministry of Economic Development, the Department of Building and Housing, the Department of Labour, and the Ministry of Science and Innovation. The Reserve Bank has always been the lead advisor for prudential policy.

Managing the business cycle – coordination between monetary and fiscal policies has become more relevant in the post-GFC low interest rate environment (where unconventional monetary policy may be needed following a negative shock to the economy), and it is not common in advanced economies. Therefore, there may not be a culture of coordination on this particular topic, and incentives to coordinate may be limited because crises are infrequent. Nevertheless, the Reserve Bank has committed to coordinating with the Treasury on emergency demand management planning in its SOI for 2018-2021.[100]

Why does the issue need to be considered?

If coordination is not valued, this can mean that advice provided to government doesn't sufficiently take into account a whole-of-system view. For example, a prudential regulator may identify risks that are best dealt with through conduct regulation, or regulation may not sufficiently take into account impacts on competition or the capital markets. This increases risk myopia and impacts agencies' ability to respond to cross-cutting issues. Alternatively, conduct issues can put the soundness of financial institutions at risk, or a group of non-systemic failures could have a systemic impact. Examples of these issues arising were seen in New Zealand with the finance company failures between 2007 and 2012. These failures may have contributed to a decline in public confidence in the

[99] The policy roles of the agencies involved in the prudential regulatory system (including administration of legislation) are currently under review as part of Phase 2.

[100] Emergency demand management planning refers to how the Reserve Bank and the Treasury may plan to coordinate to stimulate demand in the economy when there has been a crisis, and there is a highly constrained ability for monetary policy to be used to stimulate demand. In such a scenario, the Treasury may recommend that the government use fiscal policy to stimulate demand.

financial system at the time. They were a prudential problem that was caused by poor corporate governance and irresponsible lending. The failures partly contributed to the Government's decision to implement the Crown Deposit Guarantee Scheme in 2008. Prior to the GFC, non-bank deposit takers were not subject to prudential regulation. Greater coordination would support agencies to identify similar potentially systemic gaps in regulation in future.

While it will always be important for central banks to remain operationally independent in formulating monetary policy, lower interest rates and the prospective need for unconventional monetary policy could have implications for how the Reserve Bank should coordinate with the government.

Management of the business cycle has become more challenging. The decline in the neutral interest rate, both in New Zealand and globally, has meant that there is a 'new normal' for interest rates, which is significantly lower than it was in the past. This new normal leaves less scope to reduce interest rates to stimulate demand in the event of an economic downturn. As a result, it increases the likelihood that unconventional monetary policy measures (such as quantitative easing) and other demand management tools (such as fiscal policy) would be used.

Quantitative easing is an unconventional form of monetary policy in which the central bank increases the money supply through large scale asset purchases, often of government bonds. In New Zealand, coordination between monetary policy and fiscal policy will be particularly important because of the low level of government debt. With only 20 percent of GDP in government bonds available, there is not as much government debt that can be purchased to implement unconventional monetary policy in the form of quantitative easing. Moreover, New Zealand capital markets are thin, limiting private sector alternatives (such as corporate debt purchases).[101] As a result, the Reserve Bank may reach the limits of typical unconventional monetary policy more quickly than many advanced countries, increasing the likelihood that fiscal policy would be needed to stimulate demand when interest rates are zero. Any kind of fiscal stimulus would need to be set up jointly with the Treasury.

Potential issue 2: Lack of resources to coordinate

Why might resourcing become an issue?

The greater the expectation and need for inter-agency coordination across the financial system, the greater the need for dedicated resourcing.

A lack of resourcing for coordination initiatives across the financial sector could be an issue because:

- **Some agencies do not prioritise coordination** – this may be a symptom of a lack of perceived need to coordinate, or it may be a symptom of a lack of available resource relative to other obligations.
- **It is difficult to resource coordination in the current framework** – in a practical sense, it is difficult to ring-fence resourcing for coordination. In particular, the coordination that needs to occur between policy agencies and regulators that do not have an operational relationship.[102] There is no formal mechanism to secure funding for joint work across separate regulators and

[101] See Drought, Perry, and Richardson (2018) for more on unconventional monetary policy tools available in New Zealand.

[102] For example, the Reserve Bank and the Treasury, or the Reserve Bank and MBIE. This can be contrasted to the operational relationship between MBIE and the FMA.

ministries where the parties will be jointly accountable. Ring-fencing coordination resources would require establishing an appropriation, or relying on agencies to enforce a commitment in a MoU. Furthermore, as there are currently no explicit objectives or accountabilities for what financial system coordination should involve, it is more difficult for agencies to construct a business case for increased resources for coordination through any mechanism.

- **Agencies may be under-resourced overall** – the IMF identified in its 2016/17 FSAP that the Reserve Bank in particular is under-resourced across some functions and activities (the Reserve Bank's funding model is discussed in Chapter 7). Other stakeholders have also raised this issue during the course of this Review.

Why does the issue need to be considered?

Secure resourcing is critical to ensure that coordination occurs, and even to ensure that agencies are able to identify what kind of coordination needs to occur. A lack of resourcing for coordination may cause the regulatory framework to become out of sync with the needs of the system and regulated entities as industries change and develop.

There is a feedback loop between resourcing and incentives. When there are insufficient resources for coordination, coordination is de-prioritised, contributing to a culture where coordination is not considered important. There is no incentive to be the first agency in the system to raise or consider 'important-but-not-yet-urgent' issues that would affect all financial sector agencies. Examples of such potential issues could include prominent topics like FinTech, but they could also include less prominent issues or how New Zealand would respond to a large negative economic shock if it reached the limits of conventional monetary policy.

Furthermore, a lack of resourcing of domestic coordination would have the flow on effect of making it more difficult for New Zealand agencies to prepare for and engage in international coordination efforts. For example, in the TTBC.

Potential issue 3: System complexity, stewardship complexity, and unclear roles

Why might system complexity be an issue?

System complexity may be an issue in financial sector regulation in New Zealand because responsibilities are split across five agencies – including three policy agencies (the Reserve Bank, MBIE, and the Treasury).[103] The Reserve Bank and the Treasury report to the Minister of Finance, while MBIE, the FMA, and the Commerce Commission report to the Minister of Commerce and Consumer Affairs. Furthermore, conduct regulation is split across two agencies – the FMA is responsible for market conduct regulation, while the Commerce Commission is responsible for credit contracts and consumer finance. Many comparable jurisdictions – even those with more complex financial systems – distribute responsibilities across a smaller subset of agencies, particularly in relation to policy development.

While the Reserve Bank and MBIE are responsible for the stewardship of the prudential and conduct regulatory systems respectively, no agency or group has explicit responsibility for the stewardship of

[103] Financial regulation makes up only a small part of MBIE's mandate. The Treasury is listed as a policy agency because it is the Minister of Finance's lead economic and financial advisor.

financial system policy overall. The Treasury is the Minister of Finance's lead economic and financial adviser, but the Treasury has no system stewardship, policy, or regulatory role in financial sector regulation. To mitigate this issue, CoFR agencies have developed a Financial System Charter which outlines the principles for how CoFR agencies intend to work together on financial system issues. However, there are limitations to this approach as CoFR is primarily an information sharing body, and does not generally facilitate coordination on policy development.

Why does the issue need to be considered?

Financial sector agencies need to pay particular attention to issues arising from system complexity in order to avoid the manifestation of the following flow-on effects:

- **Insufficient system stewardship** – this would make it more difficult for the agencies to meet a regulatory efficiency objective, make good regulations, and avoid the risks of overlaps and underlaps between the twin peaks.
- **Insufficient capability** – fragmentation of roles and responsibilities across too many agencies could impact the level of capability and focus on financial system policy across government. This is a particular issue given the small size of the New Zealand market.
- **Legislative inconsistencies** – inconsistencies can emerge between two regulatory systems when system design does not occur in a coordinated manner. Some areas of meaningful inconsistency have emerged over time between conduct and prudential regulation, such as the design of liability frameworks or information sharing provisions. This may limit the ability of agencies to agree processes for sharing information and ensuring it remains confidential, even when mutual interest is agreed.

Pros and cons of coordination arrangement options

The options for change fall into two broad categories:

- Enhancements to the support status quo coordination arrangements.
- Changes to the role and structure of CoFR.

Options for enhancements to support current coordination arrangements

There are a number of options for change that could be implemented to support current coordination arrangements, and guard against the potential issues discussed above. These options for change focus on empowering regulators to take coordination initiatives, making minimal changes to formal requirements, but strengthening the model in some key areas. To some extent, this approach still relies on regulators and policy agencies having sufficient incentives to coordinate, and there being a culture that values and resources coordination. In this model, coordination is funded through individual agency funding arrangements.

Potential enhancements include the following:

1) **Introduce a high-level legislative coordination objective** – the Reserve Bank and the FMA are given a high-level coordination objective, which clearly sets expectations of a proactive approach to coordination across all of their respective functions. This provision would not specifically mention which agencies the Reserve Bank must coordinate with, what the scope of coordination should be, or any triggers for coordination and information sharing. This provision could therefore cover both the requirement to coordinate with agencies that have

responsibilities for the financial sector, as well as other agencies that are involved in dealing with issues that may affect the Reserve Bank (such as climate change).

In other parts of the legislation, requirements to work with other agencies could also be clarified. For example, whether the coordination requirements are to 'inform', 'consult', or 'coordinate on regulation design' with other regulators. Information sharing provisions would be modernised and streamlined across sectoral legislation. In addition, domestic crisis management planning and coordination with other agencies in resolution would be specified as functions of the Resolution Authority (see Chapter 5). Coordination requirements should be aligned between the Reserve Bank and the FMA, to support a comprehensive twin peaks approach.

2) **Legislate coordination requirements for business cycle management** – the Reserve Bank Act would require the Reserve Bank to have a plan for how it will coordinate with the Treasury if it is likely that unconventional monetary policy will be required (this is distinct from CoFR).

3) **Legislative harmonisation across the twin peaks** – legislative provisions are harmonised where possible to reflect a commitment to the twin peaks regulatory model (for example, proactive information-sharing expectations, search powers, regulatory tools, and enforcement). Other legislative provisions could be added to help frame the relationship between the Reserve Bank and the FMA. This could include requirements for each regulator to coordinate with the other in development of policy or regulatory strategy, and consult and proactively share information when taking actions that could impact on the other regulator. These requirements could be operationalised through a MoU.[104]

4) **Reallocation of policy development responsibilities** – Reserve Bank and FMA relationships with the government are aligned (for example in terms of institutional form, and having a department as the system lead on policy development). This would mitigate the likelihood of some of the potential coordination issues arising. Incentives would be supported because there would be a consistent approach to the roles of regulators and government agencies and it would simplify the regulatory system. While this change would not strictly change the level of resourcing that is available for coordination, a greater alignment of incentives and clarity of roles would make it easier for agencies to justify resourcing coordination activities appropriately.

Under these enhanced arrangements, agencies would still be able to establish or disestablish coordinating bodies as they consider appropriate. Some informal tools could also be used to signal expectations. For example, the Minister of Finance (for the Reserve Bank) and the Minister of Commerce and Consumer Affairs (for the FMA) could include expectations around coordination in any letters of expectation they issue.

[104] Some twin peaks jurisdictions, such as the UK or the Netherlands, formalise the requirement to have a MoU (including specifying its high-level content) in primary legislation. This reflects the particular importance of the twin peaks relationship.

Questions for consultation

6.A What do you see as the main pros and cons of the existing coordination arrangements, and why?

6.B What would you change about current arrangements, and why?

6.C Which, if any, of the options above for enhancing support for status quo coordination arrangements do you consider would be desirable, and why?

6.D Do you think that a high-level coordination objective, as described in item 1, would be an appropriate way to ensure that the Reserve Bank is effectively coordinating with non-financial sector agencies (for example on climate change)?

Options for changes to the role and structure of CoFR

In addition to the potential enhancements to status quo coordination arrangements, changes to CoFR could align incentives, promote a culture of coordination, ensure adequate resourcing, and provide for strong system stewardship. Three potential options for the role and structure of CoFR are presented below.

CoFR Option 1: Status quo enhancements

Possible features:

- CoFR is left to continue developing its vision, objectives, and membership independently.

In recent times, CoFR has increased its role in considering and addressing financial markets regulatory issues, risks, or gaps that arise. CoFR has moved to a more structured operating model, developing its vision and risk monitoring protocols.

Pros:

- **Flexibility** – keeping CoFR as a self-determining body will allow it to respond flexibly as issues and changes in the financial system arise.
- **Timeliness** – introducing a light-handed approach may support agencies to act quickly, as they would not be thwarted by excessive and potentially time-consuming processes. The light-handed model requires that agencies take initiatives to regularly review whether processes remain appropriate. If processes are lacking, this could also negatively impact on both the speed and quality of decision-making.

Cons:

- **Durability** – under current arrangements, the government already expects agencies to coordinate. However, these expectations are generic to all of government. Coordination mechanisms can be disestablished at any time, and the Minister of Finance can choose not to mention coordination in the letter of expectations.

- **Transparency** – with a relatively weak accountability framework, this option does not require the Reserve Bank or other financial sector agencies to disclose their coordination activities. Transparency initiatives may be perceived as 'unnecessary process' since they are not strictly required. This could ultimately impact on regulated entities' confidence in the regulatory system.
- **Resourcing risks** – without reasonably specific objectives and a comprehensive accountability framework, it may be difficult for agencies to identify the appropriate level for coordination and the resources that would be sufficient. It may also be more difficult to prioritise resources relative to other areas where there are statutory obligations.

CoFR Option 2: Increased structure and formality for coordination

Possible features:

- A coordination body such as CoFR is established in legislation, but does not exist as a separate legal entity. There is optionality regarding the extent to which this committee would be able to determine its own objectives, functions, and membership.
- The coordinating committee (which may be CoFR) could have a role in facilitating coordination on policy development across both the prudential and conduct regulatory systems (a system stewardship role).
- There is optionality around how the coordination committee is funded. CoFR may be funded by an appropriation paid to either the Reserve Bank, the FMA, or one of the monitoring agents (the Treasury or MBIE).[105]

This option focuses on introducing more structure around coordination arrangements for financial sector regulation, while balancing the need for flexibility. It strengthens the accountability framework by providing legislative objectives for coordination in financial sector regulation.

The option would be similar to the current requirements for a coordination committee under the AML/CFT Act.[106] The role of the committee is specified in primary legislation, and focuses on information-sharing, supervision, operational policy, and regulatory guidance. The committee is chaired by the Chief Executive of the Ministry of Justice.

In overseas jurisdictions, it is common for a financial sector coordination body to be legislated (Liang and Edge, 2017, p. 9). These bodies are typically focused on identifying risks to financial stability, rather than regulatory stewardship. Sometimes, these overseas coordination bodies also have powers to advise on the use of macro-prudential tools, although ultimate decision-making responsibility remains with the individual agencies. These advisory roles can take the form of powers that compel regulators to comply, or explain why they are not complying with a particular direction. Macro-prudential policy governance is discussed in Chapter 2.

However, there are also examples of unlegislated coordination committees. For example, Australia has made a deliberate decision not to legislate the Australian Council of Financial Regulators (CFR),

[105] Part of the role of a Crown entity-style monitor is to improve the coordination of the monitored entity's coordination with others within the ministerial portfolio, and to facilitate its collaboration with other entities in the public sector.

[106] The statutory requirements for the AML-CFT coordinating committee are contained in the AML/CFT Act, sections 149-152.

despite the IMF FSAP recommending that the formality and transparency of CFR should be increased (IMF, 2019, pp. 24-25).[107]

Within Option 2, there is further optionality to resource CoFR through an appropriation. While this could help to mitigate a potential issue of insufficient resourcing, that appropriation may not be large, and may be more efficiently funded out of individual agency funding arrangements, or an existing non-departmental appropriation. There is also optionality around membership and attendance.

Pros:

- **Balancing durability and flexibility** – this option balances durability and flexibility by legislating that a mechanism for multilateral coordination must exist and what it must achieve, but allowing the agencies flexibility in determining how they achieve this. Much of the detail could be contained in a legislated MoU, which is reviewed periodically.
- **Timeliness** – the speed of decision-making would be supported because agencies would be required to establish processes and plans for how they intend to meet their statutory objectives.
- **Accountability** – the increased structure of giving a coordinating body objectives, functions, and potentially reporting requirements would make the framework more accountable.
- **Transparency** – a statutory coordination committee arrangement is more prominent and transparent, and member agencies would be incentivised to make their activities more accessible to the public.

Cons:

- **Appropriate targeting** – care would need to be taken to determine the appropriate objectives for CoFR. A coordinating body that is tasked with system-wide policy coordination may not devote sufficient attention to equally important operational policy issues. While operational discussions will likely occur bilaterally between the regulators regardless, there can be benefits in having these operational policy discussions at CoFR, where MBIE and the Treasury can bring a useful perspective as policy agencies.
- **Resourcing risks** – the larger the scope of CoFR, the more resourcing will be required. While legislative objectives and functions will establish a statutory requirement for agencies to coordinate and support incentives, it would not directly address an overall lack of resources.

[107] The CFR is the coordinating body for Australia's main financial regulatory agencies. There are four members: APRA, ASIC, the Australian Treasury and the Reserve Bank of Australia, which chairs CFR. It is a non-statutory group, without regulatory or policy decision-making powers. Those powers reside with its members. CFR's objectives are to promote stability of the Australian financial system and contribute to the efficiency and effectiveness of financial regulation.

CoFR Option 3: Establishing a legislative body for financial sector coordination

Possible features:

- CoFR is established as a separate legal entity, and given a statutory purpose, objectives, and functions. There is an open question as to whether the CoFR's focus is on regulatory coordination and risk identification, or regulatory stewardship (policy).
- CoFR may have statutory powers. For example, relating to adjustments to the regulatory perimeter or macro-prudential policy governance.
- CoFR is funded through an appropriation.

This option establishes CoFR as a separate legal body, with a broader mandate to coordinate on policy and conduct system stewardship. However, in order to justify further formalisation (Option 3) over and above Option 2, there would need to be marginal benefits to the structure that could not be brought about by agencies individually, or the presence of very serious problems with current coordination arrangements that could not be solved in other ways. In such a model, the CoFR would either need to be bringing agencies together that would not otherwise coordinate, or it would need to be responsible for powers that were deemed unsuitable for delegation to an individual independent agency. This seems a difficult hurdle to meet in the context of financial system coordination as the potential member agencies already engage in coordination.

Pros:

- **Durability** – this option is the most durable, because it would require legislative specification of objectives, roles and responsibilities, and functions for the coordinating body. Durability is the main benefit of this option. However, permanence alone does not guarantee effectiveness, so the marginal benefits of this option over Option 2 should not be overstated. Furthermore, if the model is found to be unworkable due to the cons (mainly relating to complexity and inflexibility) this increases the chances that the CoFR is disestablished, decreasing the durability of this option in practice.
- **Potential system stewardship benefits** – under this option, system stewardship and policy coordination responsibilities may be clarified. This could help to manage some of the existing complexity in the New Zealand twin peaks model. However, if this is the driver for establishing CoFR as a separate legal entity, there may be superior and less complex solutions. For example, New Zealand could move to a more traditional model for coordinating the twin peaks by:
    - aligning the Reserve Bank's relationship with the government with the FMA's relationship with government (by shifting responsibility for primary legislation to a government department)
    - establishing coordination of policy across the twin peaks at the government level.
- **Resourcing benefits** – this option ensures that there is dedicated resourcing for coordinating the twin peaks regulatory system. This resourcing could be reviewed regularly as part of the budget process.
- **Transparency** – this option would formalise transparency and accountability requirements in legislation, which would increase the prominence of CoFR. However, the added complexity of existing agencies playing different roles in coordination arrangements (as distinct from their agency mandates) could decrease clarity for the public.

Cons:

- **Complexity** – while this option will likely clarify roles and responsibilities for system stewardship across the twin peaks, this type of CoFR would be very complex. It would create a sixth agency which would be accountable to two ministers. This could potentially increase, rather than decrease, complexity in the system.

  Furthermore, there are serious questions about the organisational design of CoFR under this option, and its relationship with the Government. This is an important consideration in order to ensure that CoFR's structure does not inappropriately impinge on the independence of the Reserve Bank and the FMA, or add complexity to ministerial control over policy development.
- **Flexibility** – legislating CoFR is the least flexible option. A lack of flexibility may pose risks because changing the objectives or functions of the coordination body would require legislative change. As a result, agencies may be less adaptable to changes in industry.
- **Appropriate targeting** – if CoFR is established with responsibility for system stewardship across the twin peaks, this may crowd out more operational policy discussions, to a greater extent than in Option 2. While these will likely occur bilaterally between the regulators, some stakeholders have noted that there is benefit in having operational policy discussions at CoFR, where MBIE and the Treasury can bring a useful perspective as policy agencies.
- **Timeliness** – the speed of decision-making may be hampered if processes are complex and poorly designed, or if there are too many stakeholders involved. Increased structure in legislation could significantly impede efficiency with little marginal benefit.

Summary of options for the role of CoFR

Table 6A summarises how the options above might compare with the criteria for good coordination outlined earlier in the chapter. The summary is for illustrative purposes, and specific circumstances may alter the assessment at the margins.

Table 6A: High-level comparison of the options against criteria for effective coordination

	Option 1: Status quo enhancements	Option 2: Increased structure and formality for coordination	Option 3: CoFR as an independent legislative body
Appropriately scoped and targeted	✓ ✓	✓ ✓	?*
Transparent and accountable	✓	✓ ✓	✓ ✓
Durable	✓	✓ ✓ ✓	✓ ✓
Timely	✓ ✓	✓ ✓ ✓	✓ ✓
Flexible	✓ ✓ ✓	✓ ✓	✓

*It depends – the role of CoFR, as distinct from the members, would need to be clearly defined, and it depends on the extent to which decreased flexibility is a material issue.

Questions for consultation

6.E Which is your preferred option for the structure of CoFR and why?

6.F Do you agree with the analysis of the pros and cons of the different options?

6.G Are there any other specific coordination mechanisms, bodies, or transparency requirements that the Review should consider?

Summary

This chapter discussed the importance of coordination between government agencies across the financial sector. It outlined a number of potential issues with current coordination arrangements including a lack of incentives to coordinate, a lack of resources for coordination, and the dynamic and complex nature of the financial system.

The chapter then presented a number of options for enhancing the legislative framework in order to support status quo coordination arrangements. These included legislating coordination objectives and requirements, formalising existing MoUs in legislation, harmonisation of legislative coordination provisions across the twin peaks, and streamlining of policy and regulatory responsibilities to support system stewardship.

In addition, the chapter explored possible changes to the coordinating body for financial sector regulation (currently CoFR). Two options were presented for the establishment of a formal body for the purposes of financial sector policy coordination – one formalising the existence of a coordinating committee, and the other establishing a separate legal body. This chapter sought your views on the optimal form for a coordinating body. Follow-up consultation will explore the specific objectives and responsibilities that a body could be given in order to achieve its purpose of supporting effective financial sector coordination.

Chapter 7: How should the Reserve Bank be funded and resourced?

Aim of this chapter

The way the Reserve Bank receives its funding – the funding model – has a direct bearing on its ability to achieve its statutory objectives. It captures:

- where the Reserve Bank gets its funding from
- who decides on the level of funding
- any conditions that apply when the Reserve Bank makes a spending decision.

The funding model needs to strike an appropriate balance between giving the Reserve Bank autonomy in its resourcing decisions (budgetary independence) and establishing safeguards (through appropriate accountability and transparency requirements) that ensure those resources are put to best use (value for money).

This chapter reviews the existing funding model and considers three areas that might benefit from change:

- Public reporting and accountability requirements.
- The Minister's role in the funding process.
- The sources of funding (including the potential use of industry levies).

It outlines a range of alternative funding mechanisms and seeks your feedback.

Why the funding model matters

An institution's budget sets its capacity to undertake its functions and meet its objectives. Given this critical role, it is international best practice for operationally independent institutions and central banks to have a high degree of budgetary independence.[108] The New Zealand Productivity Commission (2014) defines budgetary independence as "funding arrangements that protect the regulator from external pressure" (p. 223).[109]

In addition, budgetary independence helps to ensure that independent regulators have the:

- ability to obtain enough funding to achieve their statutory objectives efficiently and effectively
- flexibility to allocate funding to different functions and adapt promptly to changes in their operating environments
- confidence of the public and regulated entities that the cost of funding is borne equitably by those that benefit most from the regulator's actions.

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[108] See: BCBS (2012), New Zealand Productivity Commission (2014), OECD (2017), and Quintyn and Taylor (2004).

[109] Also see Hunt (2017b) for more discussion on the Reserve Bank's operational and budgetary independence.

The Reserve Bank is wholly owned by the Crown, and earns and spends Crown revenue. It is important that it spends responsibly and delivers value for money – that is, it provides a quality service that matches society's risk preferences in the most efficient way. In this case, the Reserve Bank's budgetary independence needs to be accompanied by safeguards that ensure it can be held to account.

Safeguards commonly include requirements to:

- develop in advance a plan that publicly explains how funding will be allocated to different functions and priorities in order to achieve the statutory objectives
- state, after the funding has been spent, what it delivered (and how) to enable stakeholders to assess whether it was spent in the most efficient and effective way.

Potential issues with the existing funding model

What are the current funding and resourcing arrangements?

Funding operational expenditure

The Reserve Bank earns money from its activities and uses a portion of this revenue to cover its operating expenses.[110] It generates revenue from:

- the Reserve Bank's monopoly power to create physical cash.[111] The production cost of printing notes and minting coins is much lower than their face values, but banks buy cash from the Reserve Bank at face value. The Reserve Bank invests the proceeds from selling cash in a portfolio of local and foreign currency assets that earns a return (this is known as 'seigniorage' income)
- charging fees for some regulatory services (such as registering banks)
- commissions for some commercial activities (such as for use of settlement systems like NZClear)[112]
- investment income generated from balance sheet activities.

The amount of funding that the Reserve Bank retains from its revenue is determined by a funding agreement between the Reserve Bank and the Minister of Finance (Figure 7A shows the agreement process).[113] The agreement aims to provide a constraint on the Reserve Bank's operating expenditure, so acts as an accountability mechanism.

The funding agreement provides some flexibility to include or exclude specific operational expenditure that may not be at the management's discretion. For example, actuarial gains/losses on

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[110] The Reserve Bank's total assets were $32 billion at 30 June 2018. They are recognised in the Crown's consolidated accounts.

[111] The Reserve Bank is not unique in being a publicly owned provider of a statutory monopoly. For example, Transpower New Zealand and Airways Corporation of New Zealand operate independent budgets and are regulated by the Commerce Commission.

[112] Fee revenue and building rental totalled $13 million in 2017/18 (approximately 2 percent of total expenditure). Fees are charged for applications to be registered as a 'bank', to obtain an NBDT or insurer licence, to have a settlement system declared a designated settlement system (or for a designation to be varied/revoked) or to register a covered bond programme, and some prudential services (internal ratings-based capital model approvals and capital instrument assessments).

[113] Reserve Bank Act, sections 159-161. Funding agreements are available on the Reserve Bank website

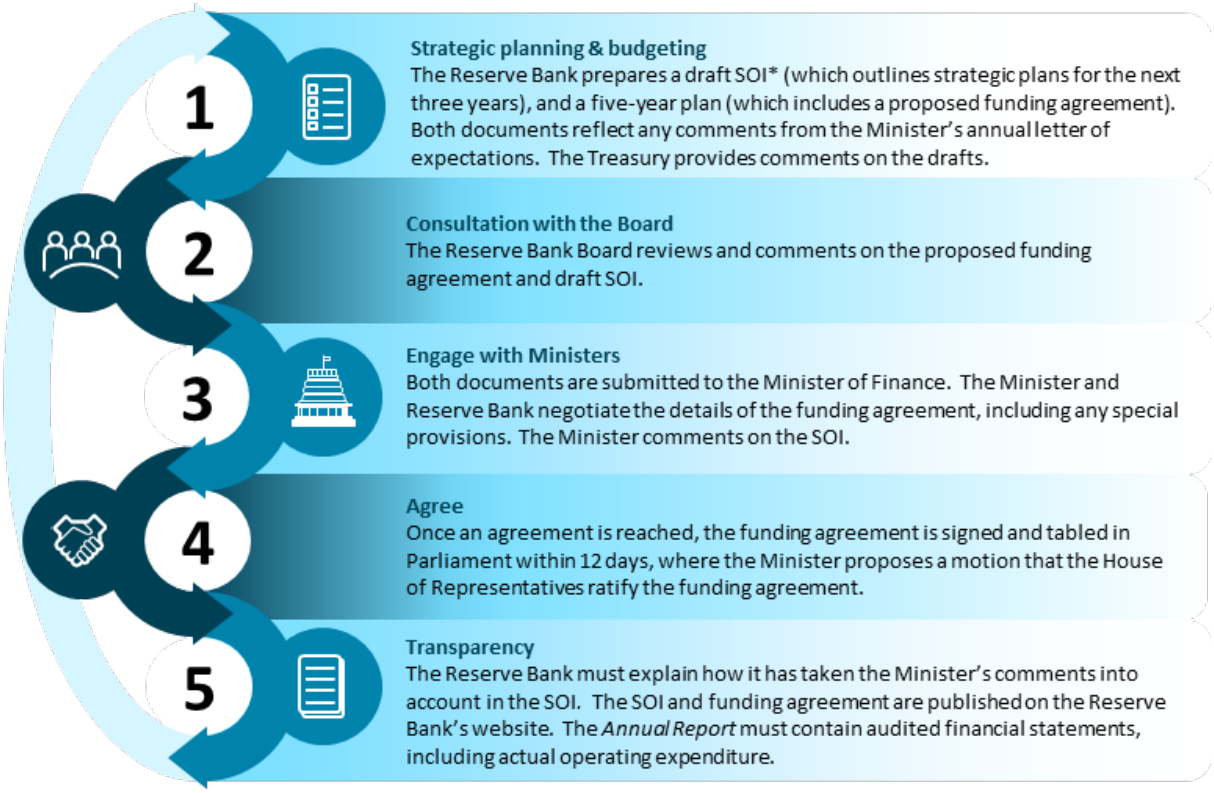
the Reserve Bank Staff Superannuation and Provident Fund are excluded as they reflect accounting adjustments beyond management's control.[114]

Each agreement covers a consecutive five-year period. Agreements can be renegotiated before the five-year term is up, as long as the renegotiated agreements are ratified by Parliament. Within the five-year funding terms, there have only been three amendments to funding agreements in the past 30 years.[115]

The five-year term has benefits in that it:

- reduces the scope for political interference in the Reserve Bank's operations (as the term is longer than a single parliamentary term)
- removes the need for the Reserve Bank to 'compete' directly with government agencies and priorities for funding in the annual budget process.

Figure 7A: The five-year funding agreement process



*The SOI is updated annually.

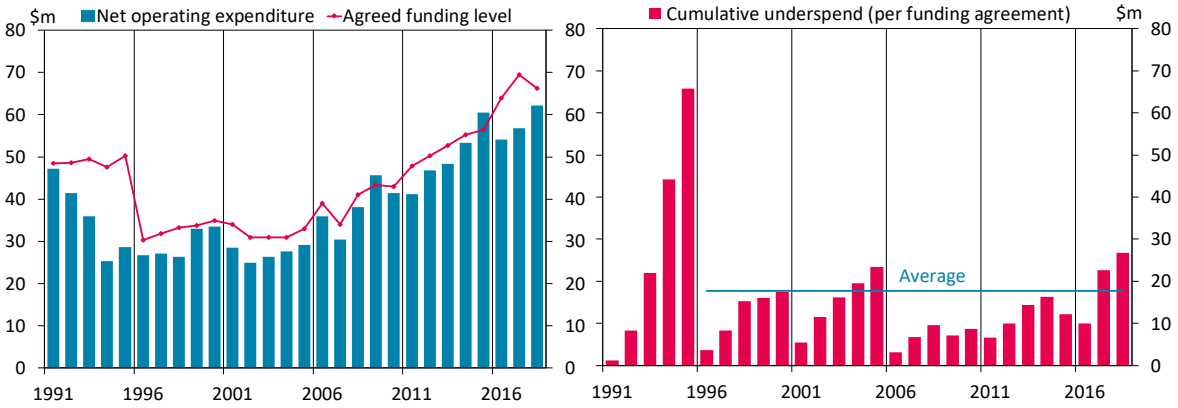
Historically, the Reserve Bank has tended to underspend on the funding agreements (Figure 7B). Since 1996 it has underspent by an average of $18 million per five-year agreement (a 10 percent underspend). The factors behind these underspends include forecast errors associated with the five-

[114] Actuarial valuations depend on assumptions which change over time, resulting in gains or losses. Key valuation assumptions include price inflation, employee earnings growth, employee retirement dates, and investment returns.

[115] The 2008 amendment provided additional resources for developing the regulatory regime for NBDTs and insurers; the 2004 amendment increased the Reserve Bank's capacity to intervene in foreign currency markets; and the 1997 amendment related to a change in the policy target for inflation.

year horizon, and the demand-driven nature of some operating costs (such as currency). Any surplus funding is paid to the Crown through a dividend payment, or is kept to build or restore capital on the Reserve Bank's balance sheet.

Figure 7B: Reserve Bank nominal net operating expenditure versus agreed funding levels (left chart), and cumulative underspending per funding agreement (right chart)



Source: Reserve Bank.

Note: Nominal annual totals, year-ended June. The agreed funding level is presented on a comparable basis (the funding agreement was changed to constrain *net* rather than *gross* operating expenditure from July 2000). Vertical lines distinguish each five-year funding agreement.

The Reserve Bank's balance sheet, capital, and dividend payments

The balance sheet is funded by deposits from banks and the Crown, and equity provided by the Crown from past capital investments and the retention of past surpluses. The balance sheet is used to support monetary and financial policy by enabling the Reserve Bank to transact in financial markets (as discussed in Chapter 4). To do this, the Reserve Bank needs to have enough capital to cover the financial risks of operating in financial markets.

The Minister sets the amount of capital through a separate process to the funding agreement. As soon as practicable after the end of each financial year, the Reserve Bank recommends to the Minister how much of its operating surplus should be retained as capital, and how much should be paid to the Crown as a dividend (section 162). The Reserve Bank calculates the dividend based on the Dividend Principles (published in the SOI), which take into account the capital required to cover the financial risks to the Reserve Bank's balance sheet.[116]

The Minister has the final decision on the dividend level, taking into account the recommendations of the Reserve Bank, the board, and the Treasury. The final dividend, along with the Reserve Bank's recommendation, is published in the Reserve Bank's Annual Report.

[116] For details on how the Reserve Bank calculates required capital for its balance sheet see Fraser (2013).

Allocating funding across functions

The Reserve Bank has discretion to allocate and use the funding it has agreed with the Minister. The existing Reserve Bank board, as the Minister's monitoring agent, is responsible for monitoring the use of the Reserve Bank's resources (section 53(1)(e)). The board provides the Minister with quarterly updates on the Reserve Bank's performance, and publishes a Board of Directors' Report in the Reserve Bank *Annual Report*.

Financial reporting requirements

The Reserve Bank is required to report on its funding use through a number of legislative and non-legislative requirements:

- **The *Annual Report*** – this is a key accountability tool, as it is where the Reserve Bank's spending is made transparent (section 162AA(b)(iii)). The *Annual Report* must include at least the Reserve Bank's audited financial statements, a comparison of realised operating expenditure for each year against the amount specified in the funding agreement, and the cumulative amount of net operating expenses for the funding agreement's five-year term.[117] The *Annual Report* also provides a breakdown of the Reserve Bank's revenue and expenditure by function
- **The Finance and Expenditure Committee's annual review** – this parliamentary hearing provides an additional check on the adequacy of the Reserve Bank's financial management and operations. Financial information to supplement the *Annual Report* is published
- **SOI** – the SOI presents the Reserve Bank's plan for spending its resources in the following financial year, broken down into its various functions. It also outlines the Reserve Bank's strategic priorities for the current year and the following two years. The SOI is revised four times during the five-year funding agreement
- **Funding agreement** – this is published on the Reserve Bank's website and covers the overall operating expenditure amounts agreed, along with any special provisions or exclusions.

Are current funding arrangements fit for purpose?

The five-year agreement model appears to have worked well for much of the period after the Act was established in 1989, during which the Reserve Bank operated in a relatively stable regulatory environment with a set mandate. However, its operating environment has evolved rapidly in recent years, particularly since the GFC, when priorities, approaches, and public expectations have changed dramatically.

Most stakeholders who provided feedback during the scoping process for Phase 2 of this Review thought the Reserve Bank is currently under-resourced to perform some statutory functions.[118] The 2016/17 IMF FSAP drew a similar conclusion, and recommended that the Reserve Bank's supervisory resources be increased as a priority (IMF, 2017a, p. 8). This indicates the design and/or use of the existing funding arrangements may not have given the Reserve Bank enough funding and resources to operate effectively and efficiently. There are a number of potential explanations for this outcome.

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[117] 2015-2020 Funding Agreement, paragraph 10.

[118] Refer to the Resourcing and Funding sections of Summary of Stakeholder Engagement on the scoping of Phase 2 of the Review of the Reserve Bank Act.

Potential issue 1: The agreement format

An agreement embeds an expectation of compromise between the Minister and the Reserve Bank. It has the potential to erode the Reserve Bank's operational independence, as funding negotiations can be used to influence or constrain the Reserve Bank's policy approaches and activities. Insufficient budgetary independence might also constrain the Reserve Bank's effectiveness by limiting long-term investment. This is a problem known as 'time inconsistency bias'.

The Reserve Bank has historically treated the expenditure level it agrees with the Minister as a binding ceiling on spending. It has also been aware of the need to show financial discipline and operate within agreed limits. This has driven a conservative approach to budgeting that has led to some underspending. While some conservatism is necessary to demonstrate prudence, too much self-discipline can also be damaging.

Potential issue 2: Flexible on paper, but not in practice

Under the Act the Minister and the Reserve Bank can jointly agree to amend the funding agreement (section 159(3)). However, amendments have generally been reserved for major changes in the Reserve Bank's responsibilities, so have not been made often. Funding reviews and amendments within five-year funding periods have only been used three times (as mentioned above), despite the Reserve Bank and the Treasury having concerns over some functions' resources. This may have restricted the Reserve Bank's ability to change its regulatory approach over time and to meet emerging international best practices. Alternatively, the focus on a low-intensity prudential approach may have driven the relatively low-cost model (see Chapter 3).

Unexpected or unanticipated developments in the scope of the Reserve Bank's existing functions have been funded from pre-agreed funding levels. Recent examples of such events include building-related costs and the legal costs of prudential enforcement actions.

While the funding agreement provides some contingency funding, historically these amounts have not been enough to address unexpected costs. As a result, hard decisions have been required to prioritise urgent matters over planned initiatives or scheduled regulatory reviews. Recent examples of this are the reviews of IPSA and the bank liquidity policy, which were both deferred in June 2018. The Reserve Bank has not formally requested additional funding to carry out these reviews. New Zealand's financial system – and the Reserve Bank's advancement of its statutory objectives – could be at risk as a result of delays like these. While projects will always need prioritising, funding constraints should not compromise the Reserve Bank's ability to meet its statutory objectives.

There is also a mismatch between the five-year funding agreement and the strategic planning process in the SOI (which happens annually and covers the following three years). Strategic priorities are planned at the same time as the funding agreement is negotiated. However, the Reserve Bank has a limited ability to fund any newly identified strategic priorities that emerge in the later years of the funding agreement.

From a practical perspective and given the dynamic nature of the financial services industry, it is challenging to forecast new strategic priorities and capital expenditure requirements five years in advance. This can result in less-than-ideal investment timing, with projects being selected based on residual funding availability rather than emerging strategic priorities.

Potential issue 3: A lack of transparency

The Reserve Bank publishes a range of information on how it is meeting its funding agreement commitments. However, some stakeholders have criticised the disclosure process for not providing enough detail to hold the Reserve Bank fully to account, or assess whether it is achieving its objectives efficiently and effectively. Key criticisms have included the following:

- The funding agreement only outlines the *total* net operating expenditure permitted for each year of the five-year period, along with any special provisions agreed between the Minister and the Reserve Bank. The supporting funding agreement proposal and five-year plan are not published. This makes it difficult for stakeholders to assess the Reserve Bank's capability to deliver on its medium-term commitments, beyond the next year (which is presented in the SOI).
- Disclosure is limited on how funding is allocated to the Reserve Bank's functions. Although information is published on each function's share of net and total operating expenditure (in terms of revenue and expenses), information is limited on how funds are spent in providing each function or delivering the strategic priorities. For example, expenditure on prudential supervision is not split into policy and supervision. This has led some stakeholders to speculate that resources have been misallocated, with funding favouring particular functions or activities.
- There is no evidence of a cost-benefit or risk analysis of the different funding levels, at least not in the public domain. The risks of taking a non-intrusive approach to supervision within a full-service but low-cost central bank are not weighed against other approaches that may imply different funding levels. This could make it difficult for the Minister to make informed decisions on funding levels that are in society's best interest.

Potential issue 4: Accountability arrangements have not delivered the desired outcomes

The existing Reserve Bank board has a duty to "keep under constant review" the Reserve Bank's use of resources. The board reviews annual budgets, comments on resource allocations to functions, and reports to the Minister.

These arrangements were designed to provide a strong degree of oversight of the Reserve Bank's budget and spending, at arm's length from the government. However, stakeholders have questioned whether they have delivered the desired monitoring intensity. This may partly relate to some confusion over the board's role and the extent to which it has been able to assess whether particular policy and regulatory functions are being adequately resourced and delivered. The only public comment from the board is the Board of Directors' Report in the *Annual Report*.

In giving the Minister a role in determining the Reserve Bank's capacity to meet its statutory obligations, the funding agreement blurs the lines of accountability between the Reserve Bank, the board, and the Minister. Internationally agreed best practice is that incentives are best aligned when roles, responsibilities, and accountabilities are clear and not shared.

Potential issue 5: The funding source is simple, but may not align with where benefits fall

Another potential criticism of the funding model is that the costs of funding the Reserve Bank's regulatory regime do not fall on those who most benefit from the regime, namely, the financial sector itself.

Financial firms profit from being part of a stable and sound financial system, but can also generate negative impacts on society that they may not appropriately take into account. Prudential regulation

aims to correct this market failure, but financial firms do not currently directly bear the cost of prudential regulation. Instead, the costs of funding the Reserve Bank fall disproportionately on taxpayers.

Question for consultation

7.A Do you agree with the potential issues identified in the current funding model? Are there any additional issues with the current funding model?

Pros and cons of different funding mechanisms

The funding mechanism options should be assessed in the context of the in-principle decisions that the Minister has already made following Consultation 1.[119] These include:

- introducing a formal governance board, appointed by the Minister, to oversee the Reserve Bank. The governance board will replace the Governor as the Reserve Bank decision-maker and have full responsibility for managing the Reserve Bank's finances and budget. As a result, all resourcing and funding decisions will be made through a group decision-making process
- introducing a Crown entity-style monitoring framework. This will likely see the Treasury appointed as the Minister's monitoring agent under the current allocation of ministerial portfolios.

Overall, these changes will strengthen the Reserve Bank's accountability arrangements, resulting in a greater scrutiny of the Reserve Bank's actions.

In addition, the Review is considering the merits of a Financial Policy Remit. This would allow the Minister to explicitly convey society's risk preferences to the Reserve Bank, and potentially influence the intensity of the Reserve Bank's regulatory regime (see Consultation Document 2A, Chapter 2). Such a remit would support the Minister's existing means (monetary policy remit, comments on the SOI, and letters of expectations) to influence the Reserve Bank's goals and objectives in the public interest.

In this context, three key areas are presented for discussion:

- How should the Reserve Bank report on, and be held to account for, its use of funding and resources?
- How much independence should the Reserve Bank have in funding and resourcing decisions, and what role should the Minister have?
- Where should the Reserve Bank get its funding from?

[119] These in-principle decisions are discussed in more detail in Consultation Document 2A.

How should the Reserve Bank report on, and be held to account for, its use of funding and resources?

The Reserve Bank is currently required to publish information on how it uses its funding, and the Reserve Bank Act sets out the minimum information that must be disclosed.

These statutory disclosures are intended to help the Minister, Parliament, and the wider public to hold the Reserve Bank to account for its spending decisions and assess whether it is delivering value for money. However, stakeholders have criticised the existing requirements for not delivering enough transparency. Stricter reporting requirements may be needed to address these concerns and improve the Reserve Bank's legitimacy, regardless of the chosen funding model.

The monitoring agent (the Treasury), Finance and Expenditure Committee hearings, and external auditors all provide formal opportunities to check that the Reserve Bank is using its resources effectively and appropriately. In addition:

- the Minister's annual letter of expectations and comments on the SOI can be used to indicate the government's satisfaction with the Reserve Bank's approach to financial management
- the Reserve Bank can use financial reporting documents to express current and future funding needs. The *Annual Report* and SOI provide formal opportunities for the Reserve Bank to comment on the efficacy of its funding and resourcing levels.

However, stakeholders' concerns indicate these mechanisms may not be operating as desired and that they could be strengthened. Three possible channels to do this in relation to the Reserve Bank's funding and spending are:

- imposing additional legislative reporting requirements. These might include requirements for the Reserve Bank to publish supporting evidence for the funding process (such as cost-benefit analyses), provide more detail on spending on each function, and where possible benchmark its spending with comparable institutions or functions (such as comparing the cost of the Reserve Bank's corporate functions with those of other public institutions)
- enabling the Controller and Auditor-General to conduct performance audits and inquire into the Reserve Bank's use of its resources.[120] This could replace the existing arrangement under which the Minister of Finance can commission a performance audit of the Reserve Bank (section 167)
- clarifying the monitoring agent's role and expectations. In line with guidance from the State Services Commission, the monitoring agent should be responsible for providing advice to the Minister on the Reserve Bank's strategic direction, planning processes and performance, institutional capability, financial and other risks, and any requests for additional funding.[121] The Minister could also set expectations for monitoring through a periodic letter to the monitoring agent.

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[120] 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" (section 18). The Controller and Auditor-General is also not able to examine under a Performance audit "the extent to which [the Reserve Bank] is carrying out its activities effectively and efficiently" (section 16). The Controller and Auditor-General supported the removal of the provisions in the Public Audit Act 2001 that exclude the Reserve Bank from their mandate to inquire or carry out performance audits in their submission to Consultation Document 1.

[121] The State Services Commission issue guidance on the roles and responsibilities of monitoring departments.

Overall, any changes to the transparency and accountability framework should ensure that:

- the funding process is made more transparent
- the information published by the Reserve Bank enables stakeholders to assess accurately whether the Reserve Bank is managing its financial resources responsibly and delivering value for money.

See Chapter 3 of Consultation Document 2A for more discussion on the Reserve Bank's transparency requirements.

Question for consultation

7.B How should the Reserve Bank report its funding and spending? Do you have any comments on the transparency of, or accountability for, the Reserve Bank's funding and spending, including the possible channels to strengthen arrangements?

How much independence should the Reserve Bank have in funding and resourcing decisions, and what role should the Minister have?

The Reserve Bank has been established by statute as New Zealand's central bank and prudential regulator. It is wholly owned by the Crown, and generates Crown revenue by virtue of the unique functions assigned to it by Parliament. That said, the Reserve Bank is a separate legal entity from the Crown, and as such would normally have power to spend revenues generated without requiring explicit approval from the Minister.

The current funding agreement constrains this power, and in doing so it provides the Minister with influence and control over the Reserve Bank's budget, and makes the Reserve Bank directly accountable for how it uses its budget. However, the question arises as to whether this influence and control may potentially limit (or be seen to limit) the Reserve Bank's operational independence.

The Minister's role in the Reserve Bank funding process should appropriately balance influence and accountability, with operational independence to ensure the Reserve Bank's incentives are aligned with the public interest and that the level of funding achieves both value-for-money and what is best for New Zealand.[122]

[122] Regardless of the Minister's role in the funding process, the Reserve Bank will always be accountable to the Minister and Parliament for its actions and spending.

There are three broad options for involving the Minister in the funding process.

Consult – the Reserve Bank would have overall control to set its funding and budget, but be *required to consult* the Minister. The Minister would convey society's risk preferences by setting expectations and objectives. The Reserve Bank would have sole accountability for its capability and outcomes.

Agree (the status quo) – the Minister and the Reserve Bank would jointly *agree* on the funding and budget, and each would have a veto right (with enhancements to address some of the potential issues identified). The Minister and the Reserve Bank would share accountability for capability and outcomes.

Approve – the Minister would have a veto right over the Reserve Bank's funding and *sign off* the budget. The Minister and the Treasury (as the Minister's monitoring agent) would take significant accountability for the Reserve Bank's capability and outcomes, and set performance expectations and objectives.

While these options describe how funding decisions would be governed in law, the way the funding process is used in practice is equally important. For example, the 'Agree' model was designed to be flexible and balance ministerial influence and Reserve Bank independence. However, in practice (and as discussed in potential issue 1), it has failed to deliver enough funding and has not been flexible enough to adapt to the Reserve Bank's operating environment. Enhancements could improve agency incentives and result in the intended use of the 'Agree' model. Examples of such enhancements are discussed in the potential options section below.

Internationally, most central banks have more autonomy over their funding and budgets than the Reserve Bank. For example, there is no formal role for a minister in the budget process at the Reserve Bank of Australia, the BoE, the Bank of Canada, or the US Federal Reserve. Instead, they use a mix of consultation and monitoring by treasury departments, transparency requirements, and central bank self-discipline to support spending decisions that are delivering value for money. In a sample of 17 central banks, three-quarters (13) set their budgets independently of government.[123]

Where the government does have a role, this is generally an approval right. However, these parliamentary powers are not typically exercised to override budgets proposed by central banks – they are there to provide cross-checks. In practice, the governments in these jurisdictions invariably approve the central bank budgets without amendment.

In jurisdictions with independent prudential regulators (such as Australia), the funding mechanisms tend to differ from those of central banks. In a sample of 141 prudential supervisors, one-third set their budgets independently of government (World Bank, 2011). Funding is often sourced from industry levies, which are set through regulations or delegated instruments. It is relatively common

[123] The sample included Australia, Canada, Chile, China, Czech Republic, the ECB, Germany, Ireland, Japan, Korea, Mexico, the Netherlands, South Africa, Sweden, Switzerland, the UK, and the US. Source: Bank for International Settlements (BIS), individual country legislation. BIS (2009) also finds that a similar proportion of budgets are set independently of an external body such as a parliament or a ministry of finance.

for the levy to require ministerial approval, although with a high degree of independence for the regulator to decide how to use the money that it collects through levies.

Question for consultation

7.C Given the in-principle decisions to change the Reserve Bank's governance framework as outlined in Consultation Document 2A, what role should the Minister have in the Reserve Bank's funding model? Should it be different for prudential and non-prudential functions?

Where should the Reserve Bank get its funding from?

The Reserve Bank is different from other independent regulatory agencies in New Zealand.

Instead of receiving its operational funding from the government, it makes money from its operations and retains a share of this to cover its costs. Currently it is funded by a combination of revenue (the seigniorage income and investment returns as previously discussed) and fees. However, it could have up to four sources of funding:

Revenue	Fees	Prudential levies	Crown funding via appropriations

Revenue and Crown funding are the only sources that can fund all the Reserve Bank's functions, but each could be combined with a mixture of fees and industry levies for particular prudential functions. A fee is a charge imposed on a specified party in return for the provision of a good or service, which directly benefits that party (e.g. a bank registration fee). A levy is a charge imposed on a particular party or group, as a proxy for those that benefit from a specific good, service, or regulation. Box 7A describes the rationale and practice for financial sector levies in New Zealand, while Table 7A summarises the broad pros and cons of each funding source. Fees and levies would be set in accordance with best practice cost recovery guidelines.[124]

Where do other central banks and regulators get their funding from?

Core central bank functions include monetary policy, currency issuance, and balance sheet management. Internationally, these functions are almost always funded from central bank revenue, most often seigniorage income. In a sample of 17 central banks, all used self-generated revenue such as seigniorage, and around half recovered some costs from industry via levies or fees.[133] Central banks like the Reserve Bank in New Zealand, that are also responsible for prudential regulation, commonly use revenue to cover some of the costs of this function.

When compared with central banks, prudential authorities are more commonly funded – at least in part – by industry levies. In a sample of 37 separate prudential authorities, 60 percent were funded by charges or levies on regulated entities (Masciandaro *et al*, 2007, p. 15). The Central Bank of Ireland, the UK's Prudential Regulation Authority, the ECB, the US Federal Reserve, and Australia's APRA and ASIC all require regulated entities to pay levies and/or fees for prudential regulation and supervision. In a sample of 141 prudential supervisors (that were separate or co-located with central

[124] For cost recovery guidance, see Treasury (2017), Controller and Auditor-General (2008), and LDAC (2018).

banks), almost half sourced some of their funding from industry (World Bank, 2011). One-fifth of the 141 prudential supervisors sourced some of their funding from government.

Domestically, the majority of the FMA's funding (paid through a Crown appropriation) is recovered for the Crown through a levy. The levy is charged to financial market participants annually and on the occurrence of certain events. The levy is generally collected through the registers maintained by the Companies Office. A small portion of the FMA's funding comes from taxpayers and there are also fees that cover the costs of specific services (such as licensing and exemptions). The levies that are charged to each participant are designed to be proportional to the benefits that each participant receives from operating in a well-regulated financial market. A combination of levies, fees, and Crown funding are also used to fund the Commerce Commission.

Box 7A: Financial sector levies in New Zealand – rationale and practice

The rationale – two prevailing economic theories justify cost recovery via industry levies:

- The beneficiary theory is based on the principle that those who benefit from a good or service should bear the cost of providing it.
- The externality theory states that the entities that produce negative externalities (for example, systemic risk for financial institutions) should bear the costs of mitigating them.

It is appropriate to fund most core central bank functions with public funds as these functions provide public goods from which everyone benefits. However, the case is not so obvious for prudential supervision. On one hand, prudential supervision is a public good as its core aim is a public benefit (financial stability). On the other hand, many of the benefits of supervision accrue to the customers and investors of particular financial firms, which themselves produce a negative externality (systemic risk) and should bear the cost of mitigating the impacts of this externality on the public.

The practice – in the early 1990s the Reserve Bank recovered a portion of its operating costs via levies.[125] These were abolished in 1996 due to a sweeping change in the supervisory approach, which increased an emphasis on self- and market discipline and reduced the role of regulatory discipline. However, since the GFC many countries have revisited their prudential supervision models. The same exercise is now underway in New Zealand (see Chapter 3). Only Parliament can levy money for the Crown. If a levy model is chosen, an empowering provision must be added to the Reserve Bank's primary legislation to allow for this, and the detail of the levies (e.g. the amounts and the entities charged) must be prescribed through regulations. Levies could recover a portion or all of the costs of particular functions. A levy to fund prudential supervision could only recover up to the total cost of the function ($15 million in 2018, around 20 percent of total operating expenses). Some aspects of macro-financial stability policy may also qualify for cost recovery ($9 million in 2018, around 12 percent of total operating expenses). Levy revenue could be collected by the Reserve Bank or the Crown (then redistributed to the Reserve Bank through an appropriation, similar to the FMA).

[125] Reserve Bank Act, section 79 [repealed]. Regulated entities were charged an annual fee equivalent to 75 percent of the costs of prudential supervision.

Table 7A: Potential pros and cons of funding sources

	Potential pros	Potential cons
Revenue: Returns generated from seigniorage, investments, and commercial activities.	▪ Simplest form of funding with low administrative costs. ▪ Not dependent on ministerial consent, so consistent with Reserve Bank independence. ▪ Large enough to fund all Reserve Bank functions. ▪ Consistent with the way most central banks are funded for non-prudential functions.	▪ Cost of funding falls broadly on all New Zealanders rather than on regulated-financial firms that benefit most from regulation.
Fees: Charges for specific regulatory services provided to a regulated entity (e.g. a bank registration fee).	▪ Targeted source of funding as individual firms have to pay for specific services they use. ▪ Not dependent on ministerial consent, so consistent with Reserve Bank independence.	▪ Insufficiently broad to cover all central bank functions (fee income currently accounts for just 2 percent of Reserve Bank operating expenses). ▪ Additional administrative costs of collecting fees.
Prudential levies: An industry-wide charge to cover the cost of providing prudential regulation (discussed in more detail in Box 7A).	▪ Targeted source of funding that allows the cost of prudential regulation to fall on the industry that benefits from it. ▪ Provides an opportunity for regulated-industry to have a voice in the funding process. ▪ Consistent with the way the FMA is funded.[126]	▪ Risks eroding supervisory independence by transforming the Reserve Bank's relationship with regulated firms into a customer-service dynamic. ▪ Ministers typically play a role in setting levies in New Zealand, potentially compromising budgetary independence. ▪ More complex funding source with higher administrative costs. ▪ Insufficiently broad to cover all Reserve Bank functions (only around 20-30 percent of current total operating expenses would qualify for levy cost recovery – see Box 7A).
Appropriations: Public funds (from general taxation) provided by the government on an annual or multi-year basis.	▪ Common funding mechanism of Crown entities. ▪ Increases democratic accountability by providing a significant role for the Minister in funding decisions.	▪ Cost of funding falls broadly on all New Zealanders rather than on regulated-firms. ▪ Significant role for the Minister risks introducing political biases, potentially compromising the Reserve Bank's independence. ▪ Inefficient process: as revenue would have to be returned to the Crown and appropriations would come from the Crown.

[126] The IMF's 2016/17 FSAP also noted some concerns about the FMA's resourcing of its financial market infrastructure responsibilities (IMF, 2017e, pp. 17-18). A levy and appropriation model does not guarantee the best possible resourcing levels and/or allocations.

Question for consultation

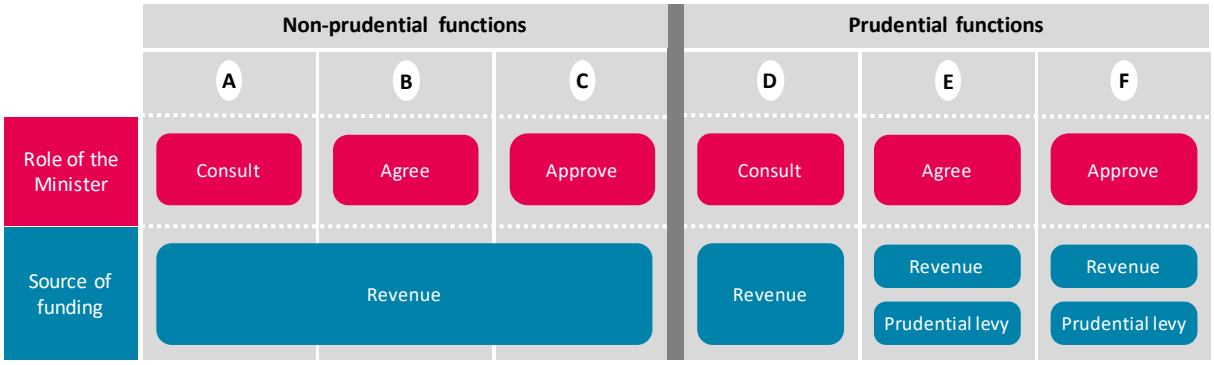
7.D Should the Reserve Bank continue to be fully funded from revenue (seigniorage and investment income) and fees, or should other funding sources be considered? In particular, should the Reserve Bank have the option to introduce an industry levy to fund the Reserve Bank's prudential supervisory function?

Potential options for the funding model

Figure 7C shows the key choices for specifying the Reserve Bank's funding model, drawing on the key design features discussed above. These options should be considered in the context of the Minister's in-principle decisions to change the Reserve Bank's governance and monitoring framework. The options are not exhaustive, but try to convey some of the interdependencies between different combinations. For example, prudential levies will always result in a significant role for the Minister.

Fees for specific goods or services (such as those already charged) would likely continue to exist in all options. Appropriations are not explicitly displayed in Figure 7C, as they depend on both the role of the Minister and the source of funds. For example, prudential levies could be collected by the Crown, with an associated appropriation paid to the Reserve Bank (similar to the FMA).

Figure 7C: Illustrative options for the Reserve Bank's funding arrangements



Important features of the 'Agree' and 'Approve' models include:

- **the annual dividend** – how the dividend is determined, and the purpose for which any operating surplus can be retained, could be reassessed. A change to the dividend arrangement and treatment could provide more structural flexibility to address emerging funding pressures
- **the funding term length** – the term of an agreement or appropriation (both can be multi-year) is important for budgetary independence (OECD, 2017, p. 15). The strategic planning term could be aligned with the funding term to reduce the probability of underfunding
- **contingency funding or buffers** – the contingency funding allowed under any constraint provides for flexibility, while retaining a ceiling on spending. Buffers are particularly important for *ex ante* levy funding models as levy revenue is uncertain.

Important features of prudential levies include:

- ***ex ante* or *ex post* levy collection** – if prudential levies were used, these could be raised based on *ex ante* budgets or collected in arrears after the budgets have been spent. There is a trade-off between providing certainty for industry participants (so they understand what they will have to pay) and the potential to over-/under-collect if levies are based on budgets and forecasts. *Ex post* levies can recover the exact costs incurred, but are more uncertain (they are state-contingent). These issues and options will be explored in more detail if a levy model is chosen
- **memorandum accounts** – can be used to ensure that under-/over-recovery of costs is managed. These can smooth changes in levies to provide more certainty for industry.

In the interests of simplicity, a number of important design features are not displayed. The objective of these features is to ensure that various agents' incentives are aligned and that the chosen mechanism is used as intended. Some preliminary ideas are raised below and Table 7B presents how these features could be used.

Table 7B: Illustrative packages of funding mechanisms (see Figure 7C for 'A' to 'F' categories)

	Autonomy (A and D)	Enhanced status quo + levy (B and E)	Hybrid (A and F)
Description	▪ The Reserve Bank has the autonomy to determine its budget for all functions, and consults the Minister. ▪ Funding is sourced from revenue and fees.	▪ The Minister and the Reserve Bank agree on net operating expenditure. ▪ Funding is sourced from revenue and fees for non-prudential functions, with a prudential levy used to recover some or all of the cost of prudential supervision.	▪ The Reserve Bank has the autonomy to determine its budget for non-prudential functions, and the Minister approves funding for prudential supervision. ▪ A prudential levy funds some or all of the cost of prudential supervision.
Pros	▪ This provides budgetary independence, in line with international practice. ▪ There are clear lines of accountability. ▪ The funding source is simple, efficient, and flexible. ▪ The Minister's focus is on objectives, society's preferences, and outcomes.	▪ The costs of prudential supervision are borne directly by the industry. ▪ There is democratic accountability due to an explicit ministerial role.	▪ This reflects potential differences in operational independence between prudential and non-prudential functions. ▪ There is a greater degree of democratic accountability for prudential supervision due to an explicit ministerial role.
Cons	▪ The funding source is not targeted. ▪ There is an assumption that operational independence is equal across all functions.	▪ There is reduced budgetary independence for prudential supervision. ▪ Accountability is shared by the Reserve Bank and the Minister. ▪ It introduces more complexity (see below). ▪ Levies introduce perceptions of conflicts of interest/customer service relationship.	▪ There is reduced budgetary independence for prudential supervision. ▪ It introduces more complexity. ▪ Levies introduce perceptions of conflicts of interest/customer service relationship.
Additional considerations	▪ Term length is not applicable. ▪ Any net operating surplus would be paid to the Crown, after capital calibration.	▪ The annual dividend could be treated differently. ▪ Larger funding buffers could mitigate the chance of underfunding. ▪ The term length should balance independence and flexibility.	▪ The prudential levy design would be critical to ensuring flexibility and adaptability.

Question for consultation

7.E Do you have any comments on the illustrative options in Figure 7C and Table 7B? Are there other options, combinations, or additional design features that should be considered?

Summary

This chapter outlined a number of potential issues with the Reserve Bank's funding arrangements. Any funding model needs to strike an appropriate balance between giving the Reserve Bank autonomy in its resourcing decisions (budgetary independence) and establishing safeguards (through appropriate accountability and transparency requirements) that ensure those resources are put to best use (value for money).

Keeping in mind the Minister's in-principle decisions to establish a governance board and introduce a Crown entity-style monitoring framework, the chapter focuses on three key aspects of the funding model:

- **Reporting and accountability requirements** – the funding process should be transparent and enable stakeholders to assess accurately whether the Reserve Bank is managing its financial resources responsibly and delivering value for money. Transparency requirements could be strengthened through additional legislative reporting requirements. Accountability requirements could be strengthened by enabling the Controller and Auditor-General to conduct performance audits and inquiries, and clarifying the role of the monitor
- **The role of the Minister** – the Minister's role should appropriately balance influence and accountability, with operational independence to ensure the Reserve Bank's incentives are aligned with the public interest and that the level of funding achieves both value-for-money and what is best for New Zealand. The Minister could be consulted on funding levels, agree funding levels with the Reserve Bank, or approve the funding level
- **The source of the Reserve Bank's funding** – the Reserve Bank could be funded from four potential sources of funding: revenue, fees, levies, and appropriations.

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