The Treasury

Reserve Bank Act Review Phase 2 Second Consultation Information Release

July 2019

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THE TREASURY
Kaitohutohu Kaupapa Rawa

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

C1 Recommendations

Safeguarding the future of our financial system

Phase 2 of the Reserve Bank Act Review

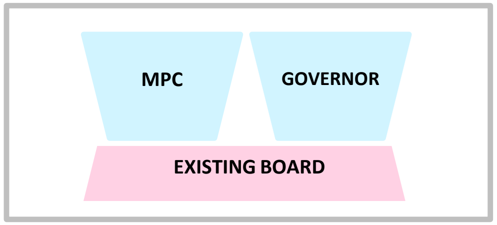
Plan

- Governance (10:30 – 12:15)
- Objectives (12:15 – 13:15)
- Depositor Protection (14:00 – 15:00)
- Regulatory Perimeter (15:00 – 15:30)
- Separation (15:45 – 16:15)
- Confirming panel views (16:15 – 17:00)

GOVERNANCE

Setting the scene

- **Objective -** ensuring we have an optimal governance framework that empowers the Reserve Bank to carry out its responsibilities for financial policy in the most effective and efficient way.



- **Problems with the status quo** – the single decision maker model is not seen as reflecting best practice or providing robust accountability. Stakeholders expressed concerns regarding the single decision maker model including concentration of power, lack of accountability and overall effectiveness. The existing board is not seen as being able to provide an effective check or challenge on financial policy because it has no policy responsibilities.

- **Strong support for group decision making** – nearly all stakeholders supported moving to a group decision making model. Well designed group decision making structures with high quality individuals are seen as having the potential to produce higher quality decisions over time. Groups bring a diversity of perspectives, information and experience to decisions that can lead to better decisions and enhance the credibility of the decision making process

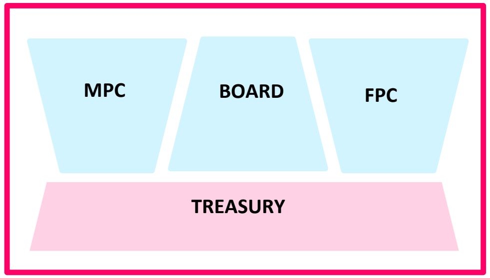
Establishing a governance board

- **Rationale for establishing a governance board** – a board structure would embed group decision making at the Reserve Bank within a robust accountability framework.

- **Strong support for establishing a governance board** – a board is seen as a well understood governance structure commonly used in the public and private sector. A board provides for robust accountability through the division of governance and management responsibilities. Efficiency costs and risks associated with groups (such as social loafing) are seen as manageable within a well designed board structure.

- **Financial policy responsibilities** – the governance board would have responsibility for the strategic direction of the Reserve Bank, corporate decisions and oversight of management. There are choices around where responsibility for financial policy decisions sits. Financial policy decisions includes setting the prudential regulatory framework (capital and liquidity), taking macro-prudential policy decisions, and overseeing supervision and enforcement. The two options considered are:
  - A Policy Board model – under this model, the board would have responsibility for financial policy decisions in addition to strategy, operational and corporate decisions.
  - An FPC model – under this model, a separate financial policy committee would be established with responsibility for financial policy decisions. A board would be responsible for all other matters outside of financial and monetary policy.

Merits of an FPC model



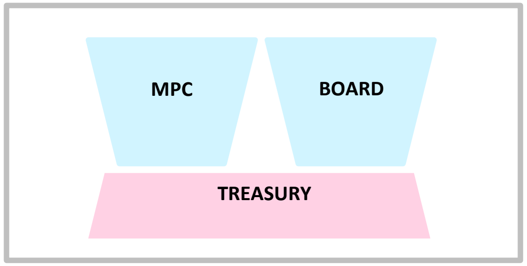
- **An FPC model – provides focus, prominence and specialisation** - an FPC provides the benefits of group decision making while also better providing for focus, prominence and specialisation to financial policy and better embeds external input.

- **Advantages of an FPC include:**
  - Specialisation – a financial policy mandate would better attract specialist expertise
  - Focus and prominence – to the Reserve Bank's financial policy functions
  - Better embeds externals – a role targeted at financial policy only is likely to be more attractive to externals and better facilitates independent perspectives

- **Disadvantages of an FPC include:**
  - Unnecessary complexity and cost
  - Lack of role clarity – the split of responsibilities between the board and FPC may be difficult
  - Difficulties in securing suitable appointments

- **Bottom line** - financial policy decisions are multi-faceted and involve complex analysis. In these circumstances, the Review Team considers the advantages of specialisation and focus to financial policy decisions outweigh any additional complexity. Some of the complexity will be transitional as individuals adapt to the new framework

Merits of a Policy Board model



- **A Policy Board provides simplicity and accountability** - a Policy Board represents a more simple and conventional governance structure used widely in the public and private sector

- **Advantages of a Policy Board include:**
  - Robust accountability within a well understood governance model
  - Simplicity – no need to split responsibility between separate statutory bodies
  - Flexibility – the use of delegations, divisions and internal committees allows efficient resource allocation and specialisation

- **Disadvantages of a Policy Board include:**
  - Broadness of mandate and lack of focus
  - Dilution of expertise impacting on the quality of decisions
  - Higher demands on external board members

- **Bottom line** - while a Policy Board represents a significant advance on the status quo, the Review Team considers the FPC model offers a superior decision making model. Financial policy is complex and the breadth of responsibilities risks overburdening a Policy Board. An FPC better facilitates specialisation, focus and external input for financial policy decisions.

The delegations framework

- **Delegations critical to effectiveness** – the board/FPC would need to delegate responsibility for many of its operational functions, powers and duties (including for nearly all firm level decisions) in order to operate effectively. The board/FPC should be operating mainly at a strategic level. It may not always be best placed to take urgent decisions, and is likely to be overburdened if it gets intensively involved in operational matters.

- **The board/FPC should have statutory responsibility for all delegated functions** – the board/FPC will ultimately be responsible for the exercise of functions and powers it has delegated. In order to provide accountability and effective oversight, the board/FPC should have statutory responsibility for all financial policy decisions. While it would be unusual, the governing body should ultimately have the ability to disagree with management and recommend alternative action.

- **Financial policy includes firm level decisions** - the board/FPC should have good oversight of supervisory matters and the institutions they are regulating. Delegations for monitoring, supervision and enforcement should flow from the governing body setting the prudential framework. Some of these decisions may be high profile or involve reputational consequences and the governing body will be required to give an account for decisions made.

- **The FMA's delegations framework** – the FMA is a good working example of a delegations framework.

Monitoring arrangements

- **Objective** – an effective monitoring framework results in a productive three-way relationship between the Minister, the Reserve Bank and the monitor, including effective assessment of both the performance of the regulator and the regulatory system

- **Problems with the status quo** – the Reserve Bank Board is responsible for both strategic and operational monitoring. This role is challenging to execute effectively.
  - It is hard to provide operational monitoring without decision-rights.
  - The Reserve Bank Board is not sufficiently resourced, or sufficiently engaged with the Minister, to act as an effective strategic monitor.
  - In practice the Reserve Bank Board has to balance two masters: Reserve Bank and the Minister.

- **The Review Team recommends shifting to a Crown-Entity style monitoring framework** – operational monitoring shifts to the internal governance layer. [2]

  The monitor would be Treasury, based on current distribution of portfolio responsibilities. This model was strongly supported by stakeholders.
  - *Advantages:* established model, clear lines of accountability, synergies between performance monitoring [2]
  - *Disadvantages:* performance of the monitor is dependent on sufficient investment in capability and level of Ministerial engagement, level of independence from Government.

[2]

OBJECTIVES

Problem definition

Potential issues with the existing high-level financial policy objectives:

Promote the maintenance of a <u>sound</u> and <u>efficient</u> financial system.

- **Relevance** – The existing' objectives are 30 years old. But the nature and tools of financial policy have changed significantly. Are they still the most appropriate terms?
- **Clarity –** Neither soundness nor efficiency is defined in legislation. The meaning of 'efficiency' is particularly ambiguous. A lack of objective clarity makes it harder to hold the Reserve Bank to account for its policy actions.
- **Weighting** – Soundness and efficiency can conflict with one another, but no weighting is prescribed. In practice, prudential regulation has been focused on soundness, with efficiency as a moderator. Is this appropriate? Should a hierarchy be made explicit?
- **Coverage** – Some stakeholders argue there are gaps in NZ's regulatory architecture e.g. a lack of competition, consumer protection or public confidence in the financial system. Should the Reserve Bank be given additional objectives to plug those gaps?

Recommendation 1

Replace the existing high-level financial policy objectives, with a single objective to:

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

Complement this with a fuller set of objectives that incorporates soundness & efficiency.

Rationale:

- **Relevance –** Financial stability is directly tied to the purpose of prudential regulation – which is to ensure financial firms conduct their business prudently.
- **Clarity –** Financial stability is the internationally accepted term, provides a clearer mandate for macro-prudential policy and is already the de facto way the Reserve Bank pursues its objectives.
- **Weighting** - Having a single high-level objective provides role clarity to the Reserve Bank and avoids the need to prescribe a weighting between dual objectives.
- **Coverage –** Financial stability is broad enough to span all of the Reserve Bank's financial policy areas (resolution/micro-pru/macro pru) - a requirement for a high-level objective.

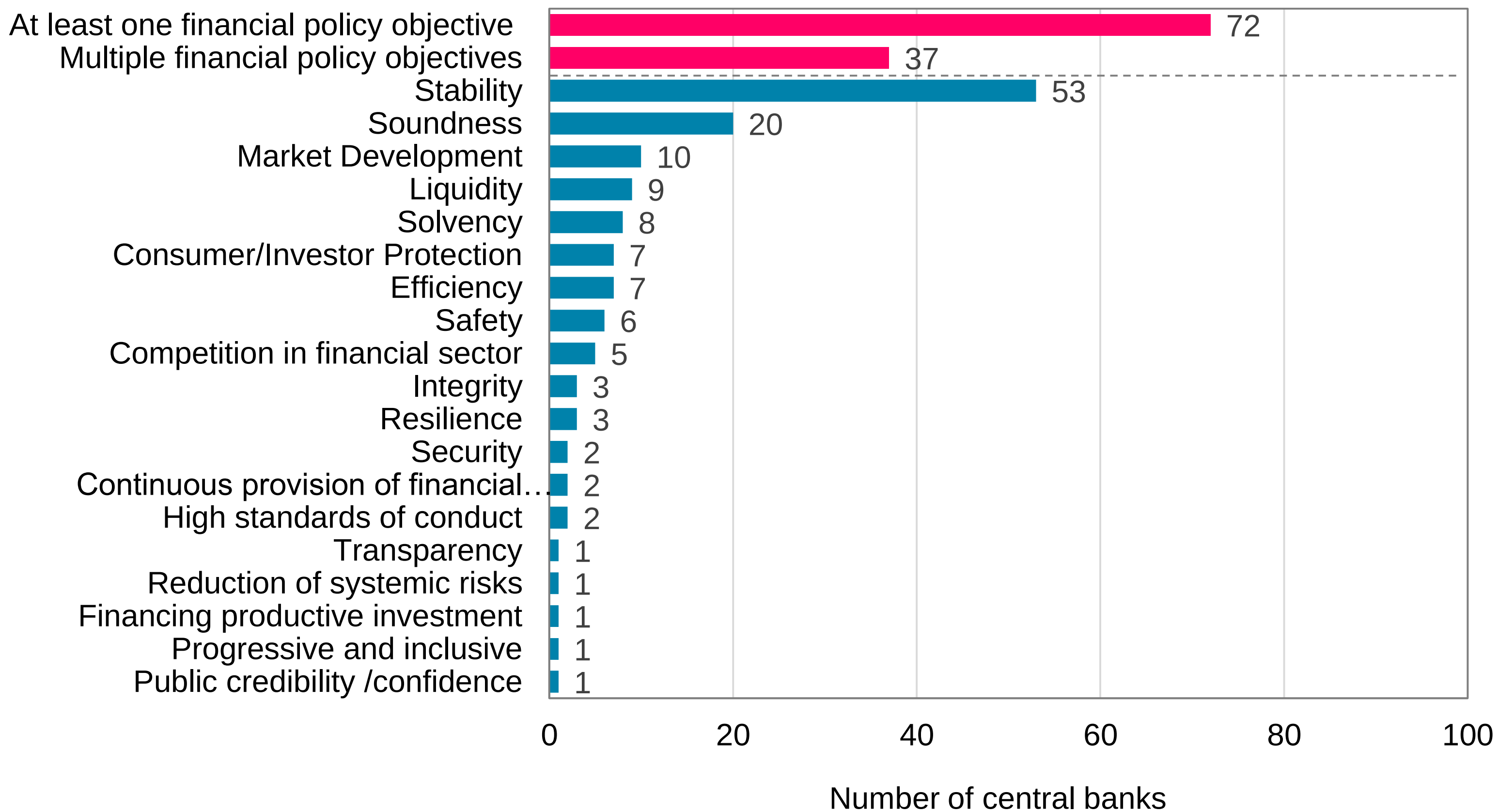
Summary of Submissions

Around 75% of submissions had some feedback on objectives (25,000+ words).

1. How many high-level objectives should the Reserve Bank have?	1 objective 44%	2 objectives 49%	2+ objectives 7%	
2. Should 'soundness' or 'financial stability' be a high-level objective?	Soundness 33%	Stability 66%		
3. Should 'efficiency' remain a high-level objective?	High-level 50%	Lower-tier 38%	Excluded 12%	
4. What role should the Bank play in supporting efficiency?	Regulatory 80%	Competitive 38%	Dynamic 30%	Allocative 16%
5. Should 'competition' be a high-level objective?	High-level 10%	Lower-tier 45%	Excluded 45%	
6. Should 'public confidence' be a high-level objective?	High-level 19%	Lower-tier 33%	Excluded 48%	
7. Should 'consumer protection' be a high-level objective?	High-level 10%	Lower-tier 30%	Excluded 60%	

International Context:

Survey of 100 central banks' financial policy objectives



- Stability is by far the most common financial policy objective. Only 7 central banks have a system-wide efficiency objective. Only six central banks have both soundness and efficiency objectives: New Zealand, Uruguay, Tonga, Iceland, Hungary, and Canada.

Soundness

Key arguments for replacing soundness with stability;

- **Clarity –** Soundness is seen as a vaguer concept than stability by some stakeholders, given that financial stability is the internationally recognised term and is already regularly used by the Reserve Bank.

- **Breadth** – Soundness is a static concept focused narrowly on the structural resilience of firms to cope with shocks. Financial stability is broader, capturing the need to adjust regulatory settings through the financial cycle and consider how the financial sector can affect the real economy. Financial stability therefore provides a clearer mandate for macro-prudential policy and its breadth makes it a more challenging objective than soundness alone.

Efficiency

Key arguments for clarifying the efficiency objective at a lower level:

- Efficiency provides two elements to the existing objective set:
  - As a way to motivate dynamic financial policy changes through the financial cycle
  - As a counter-weight to stability

  The first element is captured by a broader financial stability mandate.
  The second remains an important consideration, but it is arguably not sufficient on its own to retain efficiency as a high-level objective.

Narrow definition: If the main focus of efficiency is on ‘regulatory efficiency’ ensuring prudential regulation does not place undue burden on regulated entities, this is a constraint on the way prudential regulation in enacted rather than an objective in its own right.

Broad definition: If efficiency includes others elements such as boosting competition and deepening capital markets, the Reserve Bank can only play a limited role in delivering efficiency through its current statutory powers. Either the Reserve Bank would have to be given more powers to justify a high-level efficiency objective (which risks concentrating too much power in one institution) or the Reserve Bank can at best play a supporting role – implying it should be at a lower tier.

DEPOSITOR PROTECTION

Recommendation

- **New Zealand should develop a deposit protection regime** that insures depositors against the risk of loss on their deposit balances up to a pre-announced limit.
  - A formal insurance system to be the regime's primary tool

- The principle objectives of the regime should be:
  - to **protect depositors from loss** up to a known limit…
  - …and in so doing **contribute to the confidence of depositors and the financial stability of New Zealand.**

- This approach would:
  - Support consistent, predictable, and fair outcomes for New Zealand depositors
  - Mitigate vulnerabilities to bank runs and contagion for the New Zealand financial system
  - Reflect the results of Review Team's public engagement programme
    - two thirds of New Zealanders support enhanced depositor protections
    - only one in 10 New Zealanders prefer the status quo
  - Align New Zealand with international best practice
    - Deposit insurance is part of the FSB's Key Standards for Sound Financial Systems

Other options considered, not recommended

• **Status quo**	— Does not treat depositors consistently
• **Enhanced status quo**	— Exposes taxpayers to risk that cannot be planned for — Non-credibility of the protection element of OBR — Not compatible with a credible resolution regime that requires a number of resolution options, including those that don’t require taxpayer support
• **Standalone preference**	— Lacks sufficient certainty to meet either policy objective
• **Insurance with a low limit**	— De-stabilising in a crisis/Does not meet financial stability objective (cf pre-GFC schemes)

Next steps

- Subject to Ministers' agreement, a **work programme** would be established to develop a deposit protection regime for New Zealand that reflects:
  - the agreed public policy objectives of deposit protection
  - modern international best practice
  - lessons learned from the GFC
  - New Zealand specific considerations
  - design features to mitigate moral hazard risks

- Work programme would be shaped by a framework Terms of Reference and supported by ongoing public engagement programme

- Work could be further assisted by:
  - International outreach and development programmes
  - Engagement with deposit insurance organisations
  - Possibly outsourcing technical design tasks to external consultants
  - Access to institutional-level data

REGULATORY PERIMETER

A single deposit taking framework?

- **Objective:** design of the perimeter aligns with the principles of best practice regulation

- **Problem definition:** the current 'deposit taking' framework is not growth compatible
  - Lack of regulatory neutrality
  - Duplicative supervisory and regulatory framework
  - Complexity makes it harder to adapt to change in the financial sector

- **Recommendation:** the Review Team recommends the Minister bring the bank and non-bank deposit taking (NBDT) regimes together, into a single 'licensed deposit taker' framework. A revised framework would be based around:
  - An activities-based definition
  - Flexible licensing and regulatory framework
  - Single supervisor – the Reserve Bank

- **Next steps:** further work is required, primarily around definitions (definition of deposit, wholesale), design features and transitional arrangements: potential opportunity to progress in cooperation with the four CoFR agencies.

Summary of submission feedback

- **Single licensed deposit taker framework:** strong feedback in favour of an single licensed deposit taker framework
  - Submitters have emphasised the need for any framework to allow for differences in both regulation and intensity of supervision between firms
  - A number of submitters expressed concern around the potential treatment of the NDLI sector – this will be explored in the next phase

- **Perimeter flexibility:** the majority of submitters favoured introducing tools that would provide a more flexible perimeter, with ability to regulate new sectors to address risks to financial stability. Tools seen as required to address systemic risk and allow for innovation – FMC Act a precedent
  - While acknowledging the merits of perimeter flexibility in the abstract, a minority of submitters noted a preference for any change to occur through the legislative process. Perimeter tools require clear governance arrangements, activation thresholds and accountability processes – these submitters had concerns about ability to appropriately specific a framework that would align with the principles of best practice regulation
  - Further consultation on more detail options is required before any decisions can be sought. This includes drawing out links to other aspects of the Review (governance, regulatory instruments macro-prudential policy)

SEPARATION

Should the prudential regulation remain within the Reserve Bank?

Problem definition

- Stakeholders identified a number of issues with current prudential framework – some thought 'separation' necessary. Consulted on 3 options:
    1. 'Enhanced' status quo
    2. New Zealand Prudential Regulation Authority (NZPRA)
    3. New Zealand Financial Services Authority (NZFSA)

Recommendation for MoF

- Status quo with 'enhancements' – option 1
    - Reframing of objectives (in-principle decision #1)
    - Shift to some form of collective decision-making body (in-principle decisions #2-3)
    - Greater resourcing (addressed in C2 consultation)

Summary of submission feedback on separation

Overview

- 39/65 submissions commented specifically on separation
- 30*/39 supported the (enhanced) status quo; 4 supported separation (NZPRA) including Westpac and Tower; 5 on the fence
- *Several thought insurance responsibilities should be separated out, but other prudential functions retained within RBNZ

Status quo

- Scale/cost argument followed by coordination/synergies from co-location
- Enhancements: greater resourcing, clearer objectives, changes to governance

Separation

- NZPRA: greater focus on prudential, with appropriate staffing, capability & organisational culture
- Enable shift to international orthodoxy (more intensive supervisor)
- Simplifies governance question associated with status quo