The Treasury

Reserve Bank Act Review Phase 2 Second Consultation Information Release

July 2019

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REVIEW OF THE RESERVE BANK OF NEW ZEALAND ACT – PHASE 2

RESERVE BANK GOVERNANCE

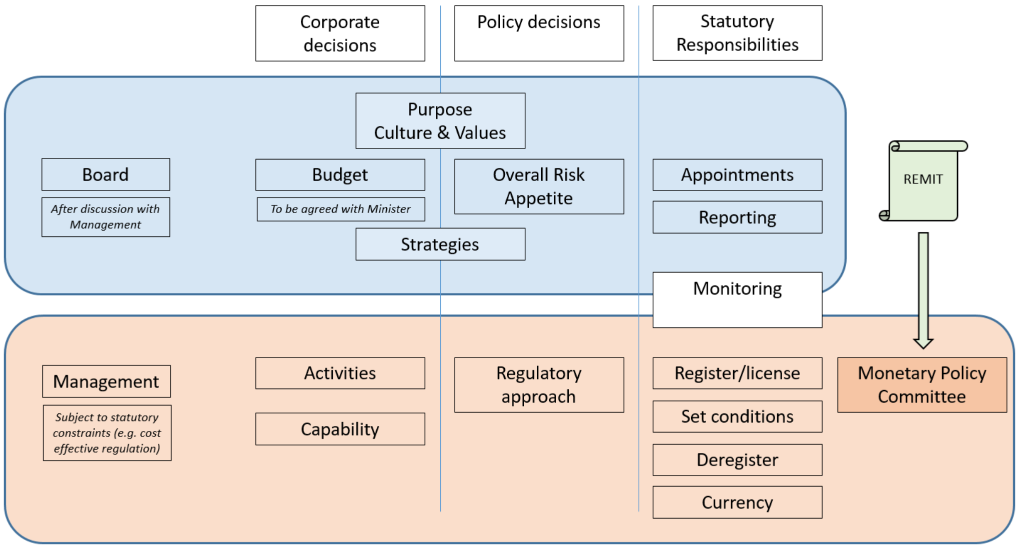
This paper outlines a preferred governance option for the Board of the Reserve Bank. This option has been endorsed by the Board.

The preferred model is based on a 'standard' corporate governance model, where the Board is formally responsible for all matters, except those explicitly assigned elsewhere through legislation (e.g., the statutory duties of the CEO/Governor, the pending Monetary Policy Committee or any potential statutory Financial Policy Committee). The Board would be able to delegate its remaining responsibilities as it sees fit to the CEO/Governor (as well as to individual Board members, committees and others as set out in the legislation). This would represent a significant increase in the responsibilities of the Board, and might affect the mix of skills and experience required of the Board going forward.

Some context issues for considering governance options are:

- The ability for relevant stakeholders to enunciate their expectations in a transparent manner consistent with the Bank's legislation;
- The Bank retaining appropriate operational independence – consistent with the legislation – given the challenges of time inconsistency of policy, principal-agent issues, conflicts of interest, and long horizon decision making; and
- The ability of the Board to adequately articulate the desired outcomes needed to best meet the Bank's purposes (e.g., a risk appetite statement and policies) and the policy decisions of the Minister, so as to hold management accountable for the most cost-effective, fit for purpose, implementation of activities to achieve the outcomes.

In the context above, the proposed model would divide responsibilities between the Board and management in broad accordance to the diagram below.



Overall approach

The Board would agree on the purpose of the Bank consistent with the objectives set out in legislation, the Minister of Finance's letter of expectations, and any other expectations set by the Minister (for example a Government Policy Statement). The Board would then set the broad framework within which the Bank operates and makes decisions, and monitor and advise management so as to best achieve the desired outcomes.

The Board would set the overall 'risk appetite statement' for the Bank, consistent with the statutory objectives for the Bank. The Board would also agree the culture and values needed to manage the organisation.

Management would be expected to provide advice on the purpose, risk appetite statement, culture and values, and broad organisation activities and needs (capacity and capability) to achieve the purpose.

Delegations from the Board

As per standard Crown Entity/corporate board models, the Board would be able to delegate responsibility for the management of the Bank to the CEO/Governor. Delegations could be made to the CEO/Governor in accordance with the legislative mandate and on principles that could include, for example:

- Ability to define strategies and expected broad outcomes, distinct from the specific management activities needed to achieve the outcomes;
- Domain/technical expertise required for the activities and decision-making;
- Timeliness and practicalities relevant to the decisions being made;
- Appropriate allocation of responsibilities (monitor performance versus undertaking activity), and confidentiality and conflicts of interest concerns; and
- Clarity of accountability for decision making responsibility.

The legislation for a Crown Entity may specify that certain functions or powers of the Board cannot be delegated.

The proposed model differs from the standard Crown Entity model in that there would be statutory carve-outs from the Board's formal responsibility in certain areas. It is important to note that the division of responsibilities between the Board and Management would be partly set by the legislation and partly through the control of the Board. For example, the Board's responsibility for monetary policy would be limited to reviewing the work of the MPC and its members, and prudential regulatory decisions would be reserved to the CEO/Governor.

Management of the Bank

The decision making structure and responsibilities within the Bank would be defined by statute and by the Board's delegations. Within the framework of delegations, management would be responsible for undertaking the activities agreed to be consistent with achieving the outcomes.

Once broad strategies and desired outcomes are established at the Board level, supervisory and policy activities would be the responsibility of the Governor/management, with the Governor retaining responsibility for firm-level statutory decisions (as under the current legislation) and the associated policy settings, and also having the ability to delegate those decisions to other employees. This would retain a clear accountability structure and the necessary degree of independence and operational timeliness of the regulator, in line with international best practice.

Management can draw on Board and external advice as necessary and appropriate, and establish internal decision making and committee structures to support a sound and consultative process within the Bank. Expected due process for decision making would be followed. The Board is then able to monitor the use of decision making frameworks and their effectiveness.

In practice – some examples

The above structure is best illustrated by use of some examples. As envisaged, the Board would approve a strategy and budget based on proposals provided by the Governor and Bank management. The strategy and budget would include setting the supervisory and policy focus for a given period (e.g., 3+ years ahead). This would include agreeing large scale capital expenditure programmes and significant special projects.

In practice, the Board would be asked to sign off on the Reserve Bank's high level financial policy and supervisory work programme – as outlined in the Statement of Intent. Some examples from the recent past would be the Board approving that the Reserve Bank focuses its effort:

- in **supervision** – on the accuracy of director attestations, banks' compliance with their IRB requirements, or management of cyber risk; and
- in **financial policy** – on a review of its capital settings, its outsourcing policy, its macro-prudential tool set and the implementation of a new regulatory framework for Financial Market Infrastructures.

After sign off by the Board, management would be responsible for the activities undertaken within that policy framework, with the Board monitoring and reviewing the performance of these tasks.

The Board would be in a position to question and advise management as part of its performance monitoring role. For example:

- are the chosen strategies the most effective ones (reviewed every 3-5 years)?
- are they being achieved as anticipated by Management's activities? and
- is the Bank complying with its statutory and other obligations – such as observing due process when reviewing a policy or undertaking supervisory actions – and are all relevant operational, legal, financial and reputational risks being identified and managed?

Under the proposed structure, and with the current legislation, the CEO/Governor would remain responsible and accountable for statutory decisions made under Parts 5-5C of the RBNZ Act, IPSA, the NBDT Act and the AMLCFT Act. This would include determining the associated policy settings, within the overall strategy set by the Board.

As such, decisions on the final outcome of a capital review, the setting of macroprudential restrictions, outsourcing requirements or any institution-specific supervisory matters would remain with the CEO/Governor.

This would ensure that the Bank continues to comply with international practice, suitable to the needs of the New Zealand financial system, and, more importantly, that issues of time-inconsistency and principal-agent issues, which might otherwise arise, are appropriately managed.

Equally important is the accountability structure and the requirement for clarity that will allow the Minister, Board, and Governors to understand where accountability lies in each case. It will also be important for stakeholders, including regulated institutions, to understand the distinction between the Board's responsibility and that of the CEO/Governor.

Internal accountability

The Board is responsible for making high level strategic decisions while the CEO/Governor is responsible for financial policy and supervisory decisions and will be held accountable for those decisions in a number of ways. This would be consistent with the proposed model, given the separation of 'strategies' and 'activities' discussed above.

The Board would monitor the CEO and the Bank more widely on how they are performing against a set of metrics agreed between Board and CEO, and accepted best practice. The latter refers to whether the Bank has followed best practice in its policy and other decision making processes. The Board might want to draw on Treasury regulatory impact assessment guidance or commission its own studies on the adequacy of the Bank's internal processes and decision-making structures.

All strategies should have measurable outcomes that can be reported against, including for example surveys of regulated industries, financial metrics, policy research, and general Enterprise Risk Management framework tools.

Management would report all of the above to the Board at an appropriate frequency and aggregation to allow the Board to judge how well the Bank was performing.

External accountability

Another layer of accountability for the CEO exists with respect to the public in New Zealand, the international financial community, and the Government as represented by the Minister of Finance. Accountability documents are very important in this regard. Current accountability tools and documents include:

- The **Statement of Intent** (outlining strategies/outcomes);
- The **Annual Report** outlining performance reporting consistent with the risk appetite statement and key priorities; and
- Reporting against any **other expectations**, such as Government Policy Statements, set by the Minister.

The Board would be responsible for approving these documents and reports.

Roles and responsibilities

The diagrams on page 7 set out how this might work in practice for four illustrative policy areas, showing the distinction between the areas of responsibility allocated to the Board and to the Governor.

The final table on page 8 sets out the current roles and responsibilities of the Minister, the Board and the Governor, and how these might be reallocated under this model.

Financial Policy Committee (FPC)

The issues and delegations related to prudential policy and supervision would need to be reconsidered if it was decided to establish a statutory FPC that included a legislated remit and charter, including external members.

Our view is that a legislated FPC would be unnecessary and inefficient compared to the model outlined above with appropriate expectations set at Board level.

The broad reasoning for this view is that under the preferred model:

- The Board would provide significant oversight of appropriate strategies and due process for the undertaking of Bank activities. The non-executive membership of the Board and its enhanced role would bring external expertise into the model to improve accountability, transparency, and the quality of decision-making – in line with the desired outcomes for governance identified by the review team;
- A separate FPC would not fit well with an enhanced role for the Board, since both bodies would be tasked with delivering high-level oversight of the Bank's micro-

prudential and macro-prudential policy settings. They will either cover the same ground or one may risk moving into more operational areas;

- Providing a FPC model alongside the MPC, Board and Governor would create a considerably more complex governance structure. The model in this paper can achieve the same outcomes in simpler form.
- Additional external expertise can be called on within the Bank as necessary and appropriate;
- Legal considerations are fluid and complex when dealing with individual entities (as opposed to products), and hence permanent external members of an FPC create significant operational and legal complexities compared to case by case external advice being sought; and
- Operational independence is paramount to overcome the principal-agent, time inconsistency, and longevity of Reserve Bank decision making. Having external members appointed by the Minister on a Board which sets the overall direction of the Bank will provide oversight and accountability without impeding day to day operational independence. By contrast, having external members, appointed by the Minister of Finance, on an internal committee will put operational independence at risk with no obvious value-add compared to the enhanced role of the Bank Board.

Reserve Bank of New Zealand

14 December 2018

Examples of how responsibility for decisions might be allocated between the Board and the Bank

Outsourcing

Board

- Approves overall policy position on purpose and objectives for outsourcing policy
- Monitors Bank's policy development process, including consultation, implementation plans and evaluation

Governor/Management

- Consults on details of the proposed policy
- Responds to input from stakeholders
- Determines the policy and reports back to the Board
- Issues conditions of registration to achieve the objectives of the policy
- Reports regularly on impact of the policy and evaluates effectiveness

Capital Adequacy Review

Board

- Approves overall purpose and objectives of review
- Approves target risk appetite for crises to frame the review
- Monitors Bank's consultation process, implementation plans and evaluation

Governor/Management

- Consults on details of proposed changes to regime
- Responds to input from stakeholders
- Determines calibration parameters and issues consistent with the risk appetite statement
- Reports regularly on impact of the policy instruments used and evaluates effectiveness of policy

Macro-prudential policy tools

Board

- Approves strategy and objectives for macro-prudential policy
- Approves overall policy position and approach, including tools to be used
- Monitors Bank's consultation process, implementation plans and evaluation

Governor/Management

- Consults on detail of specific tool to be used
- Responds to input from stakeholders
- Determines policy calibration and settings and issues conditions of registration to achieve the objectives of the policy
- Reports regularly on impact of the policy instruments used and evaluates effectiveness of policy

Open Bank Resolution

Board

- Approves strategy and policy objectives
- Monitors Bank's consultation process and implementation plans
- Keeps effectiveness of policy under review

Governor/Management

- Consults on proposed implementation
- Responds to input from stakeholders
- Issues detailed conditions of registration
- Monitors compliance by institutions
- Reports regularly on effectiveness of policy

Proposed allocation of statutory functions and best practice Board functions

Statutory Functions

	Minister	Board	Governor
Statutory Functions			
Appointments			
- Board members	Appoint		
- Board Chair & Deputy	Appoint		
- Governor	Appoint	Recommend	
- Deputy Governor	Appoint	Recommend	
- External MPC Members	Appoint	Recommend	
- Internal MPC Members	Appoint	Recommend	Be consulted
Dismissals			
- Board members	Recommend (to Gov Gen)		
- Governor	Recommend (to Gov Gen)	May recommend	
- Deputy Governor	Recommend (to Gov Gen)	May recommend	
- External MPC members	Recommend (to Gov Gen)	Recommend	
- Internal MPC members	Recommend (to Gov Gen)	Recommend	
Remit for MPC	Decide		Advise
Performance monitoring			
- Monetary Policy Committee		Responsible	
- Governor performance		Responsible	
- Deputy Governor performance		Responsible	
- Bank performance		Responsible	
Best Practice Board Functions			
Organisation Strategy		Approve	Recommend
Annual Plans/Budgets		Approve	Recommend
Accountability Documents			
- Statement of Intent		Approve	Recommend
- Annual Report		Approve	Recommend
Risk Management			
- Frameworks and appetite		Approve	Recommend
- Operations		Advise	Responsible
- Crisis management plans		Advise	Responsible
Audit and Assurance			
- External audit engagement		Approve	Recommend
- Internal audit plans		Advise	Responsible
Bank operations			
- High level policy & regulatory direction		Approve	Recommend
- Operational management		Advise	Responsible
- Financial management		Advise	Responsible
- Human resource management		Advise	Responsible