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NEW ZEALAND BANKERS ASSOCIATION

Submission

to the

Treasury and Reserve Bank of New Zealand

on the

Consultation Document 2a and follow-up questions and Consultation Document 2b: RBNZ’s role in financial policy – tools, powers and approach

30 August 2019

About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes that contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following seventeen registered banks in New Zealand are members of NZBA:

   - ANZ Bank New Zealand Limited
   - ASB Bank Limited
   - Bank of China (NZ) Limited
   - Bank of New Zealand
   - China Construction Bank
   - Citibank, N.A.
   - The Co-operative Bank Limited
   - Heartland Bank Limited
   - The Hongkong and Shanghai Banking Corporation Limited
   - Industrial and Commercial Bank of China (New Zealand) Limited
   - JPMorgan Chase Bank, N.A.
   - Kiwibank Limited
   - MUFG Bank, Ltd
   - Rabobank New Zealand Limited
   - SBS Bank
   - TSB Bank Limited
   - Westpac New Zealand Limited

Background

3. NZBA welcomes the opportunity to provide feedback to the Treasury and Reserve Bank of New Zealand (**RBNZ**, together **Review Team**) on C*onsultation Document 2A: In-principle decisions and follow-up questions on the role of RBNZ and how it should be governed*, and *Consultation Document 2B: RBNZ's role in financial policy – tools, powers and approach*. NZBA commends the work that has gone into developing those Consultation Documents.

4. If you would like to discuss any aspect of the submission further, please contact:

Antony Buick-Constable Deputy Chief Executive & General Counsel [1]	Olivia Bouchier Policy Director and Legal Counsel [1]

Key themes underlying our submissions

5. Prudential regulations and financial policy are critical to economic and social outcomes. This is recognised in the expanded statutory objectives set out in s 1A of the Reserve Bank of New Zealand Act 1989 (**RBNZ Act**) following Phase 1, in the Reserve Bank's prudential and other functions, to "*promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy*".

6. The existing provisions of the RBNZ Act were designed at a time when prudential regimes received limited attention compared with monetary policy and were comparatively under-developed. This balance has switched around in the intervening 30 years, the pace of change internationally has accelerated since the GFC, and best practice is still emerging.

7. The economic significance of prudential regulation has grown and broadened, alongside a corresponding expansion of the range of prudential tools and approaches internationally. Governance and accountability arrangements, resourcing, and tools have not always kept pace with this increasing importance and complexity.

8. As such, it is important that:

   (a) The Reserve Bank, and any other agency which acts as monitor on behalf of the responsible Minister, each has resources commensurate with that significance and to discharge their responsibilities now and as contemplated in future (for example, more intensive supervision, an expanded range of enforcement tools, and more rigorous oversight and accountability arrangements).

   (b) Governance and accountability arrangements of the Reserve Bank and any other such agencies are fit for purpose and help ensure that prudential policy delivers stability and efficiency to enable the financial system to perform the key functions that underpin economic development, productivity and well-being. In the event the Reserve Bank is allocated greater resources, as recommended, it will be all the more important that robust governance and accountability arrangements ensure that resources are efficiently applied, and that powers are exercised appropriately.

   (c) The statutory objectives align with the overall s 1A objectives and give due recognition to the critical functions the banking system performs in the economy – in particular providing clarity to how concepts of efficiency will interact with, or form part of, the financial stability criterion.

9. In relation to the last point, we submit that the in-principle decision to adopt financial stability as the primary objective of prudential supervision needs to be balanced with a continuing commitment to systemic efficiency. If efficiency is relegated to a second level consideration, there is a strong risk of decisions striking an "inefficient" balance for the economy.

10. An important note in this regard is that, despite its ubiquity, the meaning of financial stability is not settled and potentially encompasses a wide range of goals. In particular, international literature emphasises the significance of overall financial system performance and efficiency as being inherent in the concept of "financial stability". The centrality of this concept in the regime requires that proper focus continues to be given to these elements.

11. The prudential framework also needs to be coordinated in a way that reflects the inter-connected and evolving nature of the financial system, including a more coordinated approach to:

(a) home-host arrangements, as recommended in the IMF FSAP – it is important that there is specific consultation on this topic to ensure outcomes which take account of the reality of New Zealand's internationally connected financial institutions; and

(b) overall customer and market outcomes, through regulatory coherence with companion market and micro-prudential regulation and enhanced inter-agency coordination, in particular with regard to any executive accountability regime.

12. Crisis management fundamentally underpins financial stability and has a significant influence on a range of prudential policies and potential capital and funding instruments. Statutory management is a blunt tool and has not been meaningfully reviewed since it was implemented in the late 1980s, despite Law Commission and Reserve Bank work acknowledging its flaws. In the intervening time, bank resolution and recovery regimes have been fundamentally overhauled internationally, most notably through the Bank Recovery and Resolution Directive in the European Union and the FDIC receivership process and Orderly Liquidation Authority in the United States.

13. The crisis management regime, and prudential policies more generally, also need to be reviewed if the in-principle decision to adopt a deposit protection regime is finally adopted. The design of that regime needs to be considered alongside, and as part of, the broader review of recovery and resolution arrangements. These should also be informed by international best practice guidance, including from the Financial Stability Board and the International Association of Deposit Insurers. There is a need for a strong framework with the flexibility to evolve to meet new challenges and emerging best practice, including by providing for periodic reviews.

14. It has been acknowledged by the Review Team that, given the very ambitious timetable for the Phase 2 reforms, any movement on the crisis management regime will be at a framework level, to be followed by significant further work and consultation. This is also true of other key components of the regime – by nature, prudential regimes are very complex and interconnected. With this in mind, as well as the more specific policy considerations addressed in Question 1.A of Paper 2b, there will need to be careful thought given at the point of legislative design as to the balance between primary legislation and matters that are best addressed in regulations or other secondary instruments. More generally, although it is a truism, it is important to take the time necessary to get this right.

15. These are significant and complex reforms with wide-ranging impacts. We welcome the review and look forward to engaging with the Phase 2 team in developing the new policy framework.

Brief summary of our responses, by Chapter

16. The matters involved in the new consultations being undertaken under Paper 2b, and the feedback and further policy development under Paper 2a, are very complex and also involve some significant changes to longstanding prudential policy settings. We set out below a brief overview of the key submissions we have made on the topics set out in those papers.

Consultation Paper 2a

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

17. No feedback sought.

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

18. The prudential policy objectives must support the over-arching aim of the Act to promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy.

19. We support the move to financial stability as the core prudential objective, but there are significant issues with how this is proposed in the Paper to be carried out. First, despite efficiency being integral to how financial stability is understood internationally, it has been backed out of the framework as a general concept and replaced by a series of narrowly formulated components of the term. Second, and partly as a result of the first, a complex array of secondary objectives has been put forward for consideration. Third, the purposes are directive and comparatively prescriptive in nature, focusing on how the Reserve Bank must carry out its prudential mandate. Complexity is the result.

20. This is unnecessary because the aim of purpose provisions is to provide the "why" of an Act, not the "how". It is also common to use terms that, while they may not be capable of precise definition, are well understood.

21. We doubt that it is the intent of the proposed changes to remove the current focus on efficiency as generally understood, but we think that is their effect. A continued focus on efficiency is the cornerstone of good policy-making and is of paramount importance in ensuring that the financial system in achieving the over-arching aim of the Act. Finally, it is important that the objectives are concise and readily understandable to the public. We suggest on pg 45 some options for better achieving these aims.

Chapter 3: How should the Reserve Bank be governed?

22. It is important to have a board with independence and reflecting the right mix of skills, and a focus on the process of appointment is important in achieving this. The board should be responsible for overseeing the broad direction of the prudential framework, including material policy decisions in respect of its design. The Treasury, the Minister's principal policy adviser, should assume the role of administering the RBNZ Act.

Chapter 4: How should the regulatory perimeter be set?

23. The regulatory perimeter should be set on a principles- and activities-basis, should be adaptable to emerging systemic risks (at a minimum, the supervisor needs to have access to data from outside the regulatory perimeter to assess those risks on an ongoing basis), and it needs to minimise the scope and incentives for regulatory arbitrage. In relation to the latter, in particular it is important to ensure that application of macro-prudential tools (such as high LVR restrictions) is competition-neutral, applying to all entities in the business of lending regardless of whether their funding model brings them within the perimeter.

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

24. In light of the in-principle decision to adopt a depositor protection scheme, the key issues addressed are of design. It is important that this is closely aligned with the broader crisis management framework and is driven by the financial stability objective. We are sceptical about the additional benefit of adding depositor preference to the framework, which adds significant complexity in the context of wider insolvency laws and is only relevant in a gone concern context.

Consultation Paper 2b

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

25. The redesigned Act will need to provide an appropriate statutory underpinning for the prudential rules currently applying on an unreviewable basis under the Banking Supervision Handbook, by way of banks' conditions of registration, and should contain a clear framework for determining which secondary instruments are the right ones to give effect to the various elements of prudential regulation. As a general matter, more checks and balances are required, and there should be a greater consistency of treatment in this regard across the monetary, macro-prudential and prudential functions.

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

26. Macro-prudential policy is emerging as a key part of the prudential toolkit. Although it is relatively new, evidence is emerging that it can add value. The key to its successful deployment is sound and transparent policy development, adaptability, and review, each informed by high quality data.

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

27. Effective prudential policy-making and supervision would benefit from more adequate resourcing and from greater coordination, both with other domestic agencies and with supervisors under home-host arrangements. The question of whether more intensive supervision is required should be informed by a realistic assessment of the contribution that would make to financial stability.

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

28. We agree with the core analysis and directions set out in Chapter 5. Since a crisis management regime is a cornerstone of financial stability, it will be important to devote the considerable resources required to ensure the regime reflects international best practice.

29. Two significant challenges in this regard will be assimilating the in-principle decision to create a depositor protection scheme, which is a significant change in policy direction, and to retain the benefits of the investments made in ensuring continuity of core banking functions in a crisis scenario.

30. A key opportunity in the new regime is to provide a robust statutory basis for alternative loss-absorbing instruments. This will help to develop the capital markets while enhancing financial stability.

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

31. Enhanced coordination arrangements are critical given the broad scope of regulation applying to banks and the costs that arise from having distinct regimes

that are not aligned to achieve the best results for customers and other stakeholders.

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

32. The Reserve Bank's resourcing has not kept pace with its increased responsibilities. Nor is it proportionate to the size of the financial system or its importance in underpinning the economic development, prosperity and well-being that are the key over-arching aims of the Reserve Bank. This has broad implications across the consultation topics and ought to be addressed as a matter of priority.

Submissions on Consultation Paper 2b

33. **It is important that our specific submissions are read in conjunction with the key themes set out at the start of this submission, as the key themes outline important inter-relationships between various specific submissions.**

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

34. The structures around the prudential powers in the RBNZ Act have not kept pace with their increasing importance and complexity, reflecting that prudential regulatory frameworks were in their infancy 30 years ago when the current Act was passed.

35. Prudential policy-making and supervision receive very little specific treatment in the RBNZ Act, being built primarily on the delegated power in section 74 to register banks and to impose conditions of registration on them. The current supervision structure is built on this foundation, primarily through the Banking Supervision Handbook.

36. Accountability and oversight arrangements in Part 6 of the RBNZ Act extend to prudential policy-making, but their effectiveness is hampered by:

    (a) lack of clarity about the relationship between operational independence and accountability; and

    (b) oversight and control tools that were not designed for modern prudential policy-making.

37. Further, the points made in our key themes section relating to resources, and objectives, also impact the effectiveness of prudential policy-making.

38. In response to the GFC, prudential supervisors have been given a broader range of tools to contribute to financial stability. We support the reform of the RBNZ Act to ensure that the Reserve Bank has access to an efficient prudential toolkit while further underpinning appropriate accountability under the self-discipline pillar.

39. As indicated by the IMF in its most recent FSAP assessment, these arrangements need to be clarified so as to coordinate with the Basel Core Principles for Effective Banking Supervision (**BCPs**). BCP Principle 2 requires that:

    > *The supervisor possesses operational independence, transparent processes, sound governance and adequate resources, and is accountable for the discharge of its duties.*

40. Underlining this, prudential literature underlines that appropriate accountability arrangements are "*the indispensable complement to independence*".[1]

41. The IMF also recommended clarification of how Reserve Bank oversight should be undertaken and greater coordination with other prudential authorities, including APRA and other peer supervisors. We agree, and submit that more resources need to be devoted by the Reserve Bank (and any monitoring agency) to enhanced coordination, both in a policy-making and crisis management planning context. It is critical to outcomes in particular that home-host arrangements are actively maintained and strengthened.

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[1] Donato Masciandaro, Rosaria Vega Pansini and Marc Quintyn "The Economic Crisis: Did Financial Supervision Matter?" (IMF Working Paper WP/11/261, November 2011), pg 21.

42. We submit that these matters should be addressed in the design of the new framework. It is important that this is done in a way that preserves the adaptability and operational independence necessary for the effective conduct of prudential policy, while providing for tools that are fit for purpose and for more effective integration and oversight of prudential policy-making. In short, it is time to update the historical approach to one more in line with modern supervisory regimes.

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

43. We submit that the new RBNZ Act model should encompass a balance between primary legislation, secondary legislation (regulations and orders in council), and reviewable delegated powers that is more in line with other legislative frameworks applying to the financial system.

44. There is an array of instruments available, which carry differing levels of formality and oversight and are intended to fulfil different purposes. These include primary legislation subject to formal Parliamentary processes, secondary legislation (Regulations and Orders-in-Council), reviewable Standards or Codes, directions and orders that may be issued as part of a more comprehensive regulatory toolkit, and Guidance Notes. An example of a more tailored approach to using the range of instruments is the Financial Markets Conduct Act 2013 (**FMCA**), under which:

   (a) The primary legislation sets out the most important principles, starting with clear and concise objectives, and a framework for supplementary provisions by way of both formal Regulations and more informal orders and directions that may be made by the FMA (which are reviewable).

   (b) The Financial Markets Conduct Regulations 2014, which were prepared under their own rigorous consultation process, contain much of the detail required to flesh out and give effect to the statutory framework.

   (c) Each is further supplemented by Standards (such as the general conditions applying to market service licences) and by Guidance Notes issued by the regulator.

45. In the context of prudential regulation, significant care will be required to ensure that the instrument chosen is fit for purpose. In particular, it is important to achieve the right balance between:

   (a) the adaptability and operational independence required for the effective conduct of prudential policy-making and supervision (including, for example, for instances in which the supervisor needs to act quickly and decisively); and

   (b) the rigour required for more significant policy choices.

46. Much can be learned by looking at how other developed nations with a similar legal (common law) and cultural heritage have struck this balance, e.g. Australia, Canada, Ireland, Hong Kong, Singapore and the United Kingdom. In each case, they have found that a more formal framework, like that under the FMCA, is beneficial and leads to better quality rule making.

47. The new Act should provide a clear and transparent framework for making choices about the appropriate instrument, and about the principles and objectives that should guide their drafting interpretation and use. This is one of the reasons that it is crucial to invest in achieving a clear and coherent set of statutory objectives (please refer to our submissions under Chapter 2 of Consultation Paper 2a).

Achieving the legislative timetable

48. Pragmatically, greater use of secondary legislative instruments may also be required to meet the ambitious timetable set for decision-making on the Phase 2 Review, and for legislation to give effect to it. For example, secondary legislative instruments are likely to be required to underpin:

    (a) new crisis management tools and powers in relation to recovery and resolution, since the legislation is expected to be framework in nature and in any event the regime will need to be adaptable to new developments, domestically and internationally, and to emerging financial stability risks;

    (b) the depositor protection framework;

    (c) any industry levies or charges to be implemented as part of revised funding arrangements; and

    (d) transitional elements.

49. One of the most significant choices in the context of prudential regulation is the instrument that is best adapted for the detailed prudential rules, which are currently contained in the Banking Supervision Handbook. As an administrative instrument, they are not subject to Parliamentary or other scrutiny conventionally applying to instruments of their significance. We submit that they should be.

50. It may be that the best answer lies in a clear framework for the most significant policies, e.g. subject to Reserve Bank board approval with a lower tier of instrument applying to the more operational requirements giving effect to those policies.

51. Given the evolving nature of and emerging financial stability risks, instruments should be subject to formal periodic review (for example every three to five years, depending on context). There may also be merit in engaging independent experts in reviews in areas of significance, as has been done in relation to the Capital Review.

Policy basis

52. We agree with the Review Team that:

    (a) the RBNZ Act has not kept pace with the increasing importance, complexity and impact of prudential regulation; and

    (b) there is a strong case for a clearer attachment of functions, duties and powers to conventional oversight and accountability arrangements, underpinned by concise and clear statutory objectives to guide the exercise of the prudential mandate.

53. One of the most significant gaps in that regard is that matters as diverse as the Handbook and macro-prudential tools are channelled through the conditions of registration in section 74 of the RBNZ Act. The result is that there is:

    (a) limited oversight;

    (b) use of formalised procedures normally required for directives of this importance are absent; and

    (c) little guidance with respect to the scope and use of the powers.

Inconsistent treatment in the current legislative framework

54. The position of prudential regulation is also anomalous within the existing framework by comparison with both:

    (a) **monetary policy**, which is governed by detailed requirements in sections 8 to 15 of the RBNZ Act (which were augmented in Phase 1 by the creation of a Monetary Policy Committee), including detailed consultation, step-in and transparency procedures and obligations, formalised under the MPC remit (previously, the Policy Targets Agreement); and

(b) **macroprudential policy**, which is the subject of an MOU providing for coordination with, and consultation with, the Minister of Finance and Treasury.

55. The considerations underlying these accountability and oversight arrangements apply equally to prudential policy in general, and should be applied consistently across the full range of the Reserve Bank's functions, adapted to the specific circumstances. The recently announced macro-prudential framework is an example of the potential benefits of this approach.[2]

56. In addition, the accountability mechanisms which are included in the 'natural justice' provisions of sections 74(3) and 77(3) of the RBNZ Act are based on the impact on particular institutions, and are not well designed for rules applying generally (by way of the Banking Supervision Handbook) to banks or classes of banks.

57. For those reasons, there is a strong case for:

(a) prudential policy-making to be subject to oversight arrangements applying to significant delegated powers, consistent with the arrangements already applying to monetary and macro-economic policy, including by a more active governance role for the Reserve Bank board in approving material policies and appropriate delegations to the Governor; and

(b) checks and balances that are fit for purpose for rules applying to a broad range of financial institutions or the banking system generally, rather than on an individual basis to specific banks.

58. In designing and giving effect to such arrangements, it is important that the Reserve Bank maintains the operational independence, flexibility and scope for expert judgement necessary for the effective conduct of prudential supervision. In particular, the organisational architecture must be very clear and transparent about the scope and purpose of the roles for other agencies.

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

59. There is no blanket answer to this because the correct approach in each situation depends on striking the right balance identified above between the needs:

(a) for operational independence, adaptability and specialist judgement that are necessary for effective prudential supervision; and

(b) the need to ensure that important decisions are subject to rigorous processes and that the system overall contains appropriate checks and balances.

60. Although at first sight these are conflicting considerations, sound regulatory design would create a framework in which optimal choices can be made in relevant circumstances according to coherent and transparent principles. Further the points made at the start of this submission, in relation to the key themes, are highly relevant to take into account. Specifically, the relationship between

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2 Piers Ovenden "Macroprudential Policy Framework – Mitigating the likelihood and severity of boom-best cycles" (Reserve Bank, 22 May 2019).

resourcing, governance and accountability, and objectives, need to be recognised in constructing that framework.

61. As noted in relation to Question 1.A, the current prudential framework has two key limitations:

(a) inconsistency in oversight and accountability arrangements between the various Reserve Bank policy-making functions (monetary, macro-prudential policy, and broader prudential policy); and

(b) safeguards that are not commensurate with the importance and breadth of application of resulting rules.

62. Because the framework needs to have flexibility to adapt to meet new challenges and emerging best practice, the safeguards should also include provision for periodic review of policies and rules.

63. These would be building on the present accountability arrangements in sections 162AA to 167 of the RBNZ Act, introduced in 2004 at the same time as the Crown Entities Act.

64. Part 6 of the RBNZ Act provides for forward-looking accountability through an annual Statement of Intent (SOI) and reporting in relation to the SOI in an Annual Report, including as to prudential matters (s 162AB(1)). The express purpose of the SOI is to promote the public accountability of the Bank by:

(a) enabling the Crown to participate in the process of setting the Reserve Bank's medium-term intentions and undertakings;

(b) setting out for the House of Representatives those intentions and undertakings; and

(c) providing a base against which the Reserve Bank's actual performance can be assessed (s 162AA(a)).

65. There is also a requirement for six-monthly Financial Stability Reports, which are mandated for the purpose of showing what the Reserve Bank is intending and undertaking in relation to its statutory purposes of soundness and efficiency, to enable "*an assessment to be made of the activities undertaken by the Reserve Bank to achieve its statutory prudential purposes…*" (s 165A). These have been a key part of transparency and of policy development and assessment.

66. These provisions contain a number of references to their accountability purposes and the responsibility in that regard of the Minister of Finance (and by extension the Treasury). Among other things, the Reserve Bank must assess the regulatory impacts of prudential policies under Part 5 and give those reports to the Minister. The provisions relating to the Reserve Bank's SOI contemplate comments from the Minister (s 162C).

67. In addition, section 68B of the RBNZ Act enables the Minister to provide formal directions to the Reserve Bank as to government policy in relation to the prudential mandate.

68. It is clear from the above that the conduct of prudential policy was never intended to be isolated from scrutiny or broader economic policy. The complexity and specialist expertise inherent in prudential policy-making create challenges, so it is important that the organisational architecture provides a basis for improvement through time. Part of this is a continued focus on transparency and rigour in policy development (including a clear articulation of purposes, options, and costs and benefits).

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

69. Yes, refer to our comments above. Another significant issue that should receive more attention, as recommended in the recent IMF FSAP, is appropriate coordination under home-host arrangements, for example with APRA. These arrangements are crucial in underpinning financial stability, promoting a Single Economic Market, giving effect to the intent of the existing Act's trans-Tasman coordination arrangements, and as a touch point for emerging best practice.

70. Further, this is a point that goes beyond the longstanding relationship with Australia, as New Zealand's registered banks include entities whose home, or parent's home jurisdictions include the Netherlands, China, Japan, Hong Kong, the United States, India and South Korea. In each case, co-ordination under home-host arrangements will be important for the reasons highlighted by the IMF.

71. This is addressed to some degree in Chapter 5 on Crisis Management, but is of broader significance.

Question 1D: 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?

72. We submit that this should be addressed primarily by Standards (Option 2) and by Regulations (Option 3) for matters which are of particular significance or which are influenced by or impact on other core elements of the prudential regime – for instance crisis management.

73. In each case, this should be augmented by statutory mechanisms empowering flexibility and – given that prudential policy is constantly evolving and is not yet a 'settled science' – providing a process for periodic review.

74. A further advantage of this approach is that it would engage the Parliamentary Counsel Office in relation to more significant policies, where there is benefit in greater precision that comes from professional drafting. It would also enable a clearer separation between rule-making and guidance. This would be consistent with the framework successfully employed under the FMCA and related regulations, which are supplemented by FMA guidance. As noted above, the key matter is for the legislation to set out a clear framework of principles for making determinations about which regulatory instrument is the most appropriate and what overall objectives are intended to be achieved.

Question 1E: 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?

75. Because they are grounded in the powers to impose conditions of registration, the current accountability mechanisms (essentially 'natural justice' style appeal rights) are designed for rules applying to individual institutions, which are not fit for purpose for rules applying on a general basis to all banks or classes of banks. There are significant limitations in resting accountability on individual rights of 'appeal' or judicial review, where impacts are not confined to a particular institution.

76. Where rules apply generally, there should be a rigorous process for promulgating them, they need to be drafted with appropriate precision, and they should be subject to periodic review.

Question 1F: 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?

77. The breach reporting requirements are based on the existing structure of undertaking prudential regulation through conditions of registration, and must be assessed on, and designed for, the new prudential and accountability regime (including, for example, decisions made about executive accountability frameworks which are addressed under the next question). The model that is appropriate will depend on those policy choices. Any reporting regime will need to provide for appropriate materiality thresholds.

Question 1G: Is there a need to increase executive accountability?

78. Bank directors and executives are subject to executive accountability, in the sense of scope for individual liability as directors or as persons 'involved in a contravention', under legislation including the FMCA and Credit Contracts and Consumer Finance Act 2003 (**CCCFA**) (and in the latter case, this is currently being expanded considerably under the Credit Contracts Legislation Amendment Bill).

79. As such, there are two distinct components to this question:

    (a) *Are there any material gaps in existing obligations and enforcement tools in the RBNZ Act, when viewed in the context of other financial system regimes (including those under separate enactments including the FMCA, CCCFA and the Anti-Money Laundering and Countering Financing of Terrorism Act 2009)?*

    This is the focus of Chapter 3, and is addressed in particular in Question 3.E, where the key points are to ensure proper coordination across those regimes and also to review on a first-principles basis the existing sanctions regime under the RBNZ Act (relating to disclosure, attestation and compliance with conditions of registration and the Banking Supervision Handbook).

    (b) *Would executive accountability (EA) frameworks, such as Australia's Bank Executive Accountability Regime (**BEAR**) and UK's Senior Managers and Certification Regime (**SMCR**), complement and improve the effectiveness of these conventional rules-based enforcement regimes?*

80. It is this second question we address in this part, in particular because the answer to that question involves a clear understanding of the particular contribution that EA regimes are intended have to broader compliance and enforcement arrangements, <u>which is to act as a governance overlay, providing transparency to regulators and creating accountability at the corporate level for ensuring that robust overall compliance programmes are designed and carried out</u>. They are not, and should not be, another layer of grounds for personal liability of directors and executives, because they are intended to act as a complement to such provisions (including in relevant circumstances by enabling personal liability to be sheeted home), to be principles-based, and to encourage a proactive approach to compliance and customer focus, rather than generalised and socially costly risk aversion.

81. The question of the costs and benefits of introducing such a regime will be heavily dependent on making carefully considered design choices about the scope and dimensions of an EA regime (refer "Design features and choices" under Question 1.H). But the most significant factor in assessing whether an EA regime confers a net benefit to the prudential regime will be in recognising in

scheme design that the rationale for, and contribution of EA regimes, is to increase transparency and help transform governance.

Integration of the multiple EA regimes existing or under consideration

82. In this context, it is also important to note that a number of recent reform initiatives have, in one way or another, put forward the idea of introducing EA regimes in their particular contexts. In addition to the Phase 2 proposals:

    (a) The MBIE Options Paper on the Conduct of Financial Institutions contains proposals for an EA regime.

    (b) The Credit Contracts Legislation Amendment Bill would create a new statutory duty for directors and senior managers of a lender to exercise due diligence to ensure compliance with the CCCFA, backed by substantial pecuniary penalties, and with little guidance on the extent of diligence required by any particular person or collectively.

83. To this should be added the accountability arrangements already in place under the FMCA, which provides for deemed liability for directors in certain circumstances, and more broadly for those 'involved in a contravention', subject in each case to defences based on the adequacy of procedures implemented to prevent breach. There are very substantial inconsistencies among these existing and proposed regimes.

84. The most pressing priority is that these new initiatives, and the existing regime under the FMCA, must be coordinated and aligned so that, taken together, they contribute positively to conduct, culture and customer outcomes. While this is always true of regulatory regimes that might otherwise be duplicative, over-lapping or inconsistent, it is fundamental in the case of EA regimes because of their nature as a governance overlay applying to the responsibility for all key aspects of compliance across a regulated entity.

85. For similar reasons, EA regimes would generally be incompatible with oversight by multiple regulators, or at the least would require a very high level of transparency and coordination.

EA regimes in a prudential context, including director attestation

86. In the prudential regulation context, a further matter that must be taken into consideration is the existing requirement for directors to attest to the bank having systems in place to monitor and control the material risks of the group. As noted in an independent review of bank attestation arrangements, little guidance has been given on what constitutes an adequate risk management framework for this purpose. This was a matter pointed to in the IMF FSAP, and has also been identified as a key factor in escalating the cost of implementing the SMCR in the United Kingdom.

87. In this regard, both the UK SMCR and Australian BEAR regimes contain a "reasonable steps" standard, and the individual accountability inherent in EA regimes in general calls into question the place of due diligence defences which are designed around collective action, which also arises in the context of bank director attestations.

88. It is therefore possible that a coordinated approach by the regulatory agencies and industry to agreeing, in this context, what constitutes reasonable steps and an 'adequate risk management framework' could add considerably to the consistency and quality of regulated entities' compliance and assurance procedures. There is good precedent for an approach of this nature in the industry initiative in the context of the Mixed Ownership Model privatisations process to agree best practice for due diligence under the FMCA, which benefited by engagement with the FMA.

89. In this respect, a well-designed EA regime should operate to underscore and bolster the sorts of procedures that would ground due diligence defences (for example in sections 499 to 503 of the FMCA), since these involve demonstrating that the regulated entity: "had laid down a proper system to provide against the contravention of the Act and that it had provided adequate supervision to ensure the system was properly carried out".[3]

90. As noted, this would also help in resolving issues with the attestation regime raised in the IMF's review as to what constitutes an "adequate risk management framework". Another useful point of reference in this context may be the expectations laid out in APRA's CPS 220 as to risk management frameworks.

Development of executive accountability regimes internationally

91. Beginning in 2016 with the UK's SMCR, a number of jurisdictions have developed EA regimes. In a local context, this has also come into view with a number of New Zealand banks implementing compliance with the Australian BEAR.

92. Other regimes include:

(a) **Hong Kong** (the Manager-in-Charge regime)

(b) **Singapore** (proposed guidelines on Individual Accountability and Conduct)

(c) **Ireland** (Senior Executive Accountability Regime proposed by Central Bank)

93. While there are variations, core features of EA regimes involve identifying senior managers whose roles impact on the regulated entity's risk profile, allocating responsibilities to them, and coordinating those into a 'responsibility map' for the firm.

94. Key distinguishing features of EA regimes include that they:

(a) Are intended as a governance overlay to complement broader financial laws and to facilitate effective engagement of prudential and conduct regulators.

(b) Extend beyond 'obligation-specific' duties to broader governance and culture accountabilities, and in this way are intended to impact incentives and outcomes.

(c) Do not of themselves generally involve new individual civil or criminal sanctions.

95. In relation to the last point, this is significant for reasons of the underlying rationale for EA regimes noted above, and also because it is inappropriate from the perspective either of fairness or of incentives to apply penalties for breaches of principles-based duties.

Rationale and objectives

96. As noted, the first EA regime was implemented in the UK, which had a number of bank failures during the GFC. A key motivating factor for EA regimes against this backdrop was frustration of regulators in identifying particular individuals within complex organisations who were responsible for compliance failures, making it difficult to hold individuals to account. It was also spurred by a more general desire to align incentives with long-run financial stability and cultural change – hence the focus on remuneration structures.

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[3] *Universal Telecasters (Qld) Ltd v Guthrie* (1978) 32 FLR 360. A consistent but more detailed framework is set out by the House of Lords in *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153.

97. Particular purposes specified for the various EA regimes encompass to a greater or lesser degree:

(a) Financial stability (aligning incentives, controlling risk)

(b) Facilitating open and constructive dialogue with supervising authorities

(c) Improving culture and trust

(d) Acting in the best interests of customers

(e) Operational risk (cyber, AML, etc)

98. Part of the underlying rationale for EA regimes is also to better coordinate enforcement and supervision to serve the aims of the broader legal and policy framework. This is explained by the Central Bank of Ireland as follows:[4]

> *Enforcement complements regulation and supervision, and should not be considered in isolation. All three components are intrinsically interconnected, and work as part of a complementary strategy aimed at improving behaviour, embedding ethical standards and deterring misconduct. Regulators require a coherent, robust and well-drafted legislative framework which allows for adaptive responses to suspected breaches of regulatory requirements.*

99. There is also significant emphasis in EA regime design on achieving a more structured and transparent approach to governance, and embedding this through the whole organisation through more rigorous delegation, oversight, and employee vetting and training.

EA in a New Zealand context

100. The focus of EA regimes internationally is consistent with the approach taken in the FMCA, which was designed to encourage strong governance and compliance procedures, backed up by the policy applied by the FMA to enforcing those laws, which is aimed at encouraging "willing compliance" and a customer-centric culture.

101. Because those objectives are already being pursued by the industry alongside the Reserve Bank and FMA, a well-designed EA framework could contribute to the goals in section 1A of the RBNZ Act if it has the features described above and if care is taken in selecting design features so as to improve governance practices while avoiding unnecessary compliance costs.

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

102. The most logical starting point would be the BEAR regime applying in Australia, in part because there is already experience in giving effect to that regime in relation to New Zealand directors and executives of Australian-owned banks. Some consideration should also be given to the approach taken in Hong Kong and Singapore, which as much as possible builds on existing supervisory practices and underlying conduct rules, to avoid duplication and unnecessary costs.

103. Ultimately, however, each offshore regime has features reflecting the broader regulatory approach and context of those jurisdictions, and a New Zealand regime should be designed to fit with New Zealand's conditions and regulatory ethos, while drawing on the early experience with offshore regimes.

Considerations underlying effective design

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[4] Central Bank of Ireland *Response to the Law Commission Issues Paper "Regulatory Enforcement and Corporate Offences"* (December 2017). The response included a proposal for an EA regime.

104. Key considerations which would underlie a well-designed executive accountability (**EA**) regime include:

(a) Recognising the key features distinguishing EA from other compliance and enforcement regimes – the key contributions of EA in this regard being on transparency and facilitating regulator engagement.

(b) Substantive conduct obligations should build on and complement existing laws and guidelines as much as possible (refer for example the approach taken in Hong Kong and Singapore).

(c) Objectives which reflect clearly articulated and coherent principles, clearing communicating the regime's purpose, scope of application and enabling an assessment of its costs, benefits and effectiveness.

(d) Designing the regulatory perimeter so as to discourage regulatory arbitrage.

105. All overseas regimes are new and relatively untested – the first (UK's SMCR) having come into effect in 2016. Early experience with implementation of EA regimes emphasises:

(a) The need to coordinate relevant supervising agencies (prudential and conduct, along with 'home' supervisors).

(b) Achieving a correct balance between driving aligned incentives and positive culture vs. a tick the box approach with heavy administrative and reporting requirements.

(c) Supplementing with clear guidelines or feedback about matters of judgement, such as what is required to establish "reasonable steps".

Design features and choices

106. Some specific design matters that will need to be addressed are set out below. Making a careful assessment of each will be an important determinant of whether an EA regime would have benefits that exceed its costs.

(a) **Scope of objectives**: Refer above for the range of objectives covered by offshore EA regimes.

(b) **Perimeter (which institutions?)**: The regulatory perimeter for EA requirements generally corresponds to prudentially regulated firms, beginning with banks/ADIs, and then expanding to insurers. For this reason, it corresponds to the breadth of the overall prudential regime – for example in the UK including regulated "investment firms". Given that the requirements and corresponding compliance costs are significant, this is likely to exacerbate existing regulatory arbitrage issues and the question of the regulatory perimeter, addressed in the first round of Phase 2. For example, a case could be made for expanding EA requirements to significant non-bank 'Registered Finance Corporations', if such a regime is adopted in New Zealand (refer to Chapter 4 of Consultation Paper 2a).

(c) **Coverage (which executives/functional scope?)**: Senior manager coverage normally includes the board (all of it in Australia, a subset in the UK), key executives responsible for overall management (e.g. CEO, CFO, CRO), and heads of various specified control functions and of some business lines. The specific requirements tend to involve a combination of principle (control or capacity to add to risk or otherwise create significant harm) and prescription – e.g. under BEAR accountable persons are to include heads of risk, operations, IT/information management, internal audit, compliance, human resources, and AML.

(d) **Relationship between individual and collective/corporate accountabilities**: including, e.g. due diligence and governance provisions under FMCA and CCCFA.

(e) **Administrative formalities**: Formalities among overseas regimes (e.g. certification, accountability statements and maps) vary considerably, and are likely to be a key determinant of compliance and regulatory monitoring cost. A common feature of regimes is in clearly specifying and allocating responsibilities by:

(i) Requiring individual statements of responsibility; and

(ii) Preparing an overall map of how those responsibilities fit together for the firm.

(f) **Requirement for external approvals or vetting**: Regimes generally require firms to assess that senior managers are 'fit and proper' for their roles, differing primarily as to the degree of supervisor intervention in this process. In some cases (e.g. UK SMCR), approval of the prudential supervisor is required; in others (e.g. BEAR) only registration is required. The Hong Kong and Singapore regimes are less formal, building the requirements into overall supervision. Choices here will have both cost and regulatory philosophy (self-discipline) impacts.

(g) **Certainty and procedural fairness**: imposition of obligations on individual natural persons (compared to on legal persons such as companies) will be accompanied by an even stronger requirement for natural justice, including of certainty as to the rules to be complied with, and for procedural fairness in determining whether or not those rules have in fact been complied with. Failure to take this into account risks undermining respect for the system involved and the authorities administering it. In this regard, a key matter is the relationship to due diligence defenses for those 'involved in a contravention', as applies to broader financial regulation under the FMCA. This would reflect the approach taken in the United Kingdom.

Conduct rules

107. Conduct rules are another critical design feature, and a number of approaches are taken internationally. As an overall matter, they tend to be broad and high level, as befits the place EA is intended to occupy in the broader compliance and accountability framework. For example, under BEAR, accountable persons are required to:

(a) Conduct business with honesty and integrity and with due skill care and diligence.

(b) Take reasonable steps to comply with the law and prevent matters arising which affect the prudential standing or reputation of the ADI.

(c) Deal with APRA in an open, constructive and co-operative way (without displacing legal professional privilege to the extent permitted by law).

108. The UK's SMCR broadly corresponds, with senior managers required to "take reasonable steps" to ensure the firm is controlled effectively, complies with regulatory system requirements and standards, and that delegations are appropriate. Individual conduct rules are to: act with integrity, due skill, care and diligence; be open and cooperative with the regulators; treat customers fairly; and observe proper standards of market conduct.

109. Both Hong Kong and Singapore's regimes drive off conduct obligations set out in existing Securities & Futures Commission and Monetary Authority of Singapore codes and guidelines rather than originating new conduct rules.

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

110. Following the GFC, a key factor identified among the causes of financial crises was excessive credit growth. Therefore, in principle, macro-prudential and other time-varying or state-varying tools (such as countercyclical buffers) ought to be important components of the prudential toolkit with the Reserve Bank given the necessary powers as the prudential regulator, to promulgate and deploy these tools.

111. There are, however, a number of challenges in undertaking interventions of this sort. They include that it is a new tool, so there is only limited evidence about its efficacy and impacts. There is also little consensus around the data that could reliably underpin an assessment that the economy is in a dangerous “boom cycle” or that assets are being mispriced. A further challenge is in ensuring that interventions are properly designed and correctly timed to avoid triggering or exacerbating a disorderly correction.

112. It has also been cautioned that macroprudential interventions can involve some risks as well as benefits, including potentially political risks for the central bank, due to potential distributional consequences or because they may ‘pull against’ broader Government policies (for example in relation to housing).[5] These considerations likely formed part of the rationale for the Memorandum of Understanding on macro-prudential policy between the Reserve Bank and the Minister of Finance.

113. Nonetheless, empirical research is emerging that suggests macroprudential tools designed to curb excessive credit growth can add value in the prudential toolkit.[6] Analysis of the impact of the high LVR restrictions implemented by the Reserve Bank in October 2013 indicates that the New Zealand experience could be regarded as a positive example of that.[7]

114. For all these reasons, it is important to take a measured approach to the development and use of macro-prudential tools, informed as much as possible by data, and to ensure that the impact of tools as they are implemented are closely monitored and are adaptable according to experience. The Macroprudential Policy Framework recently published by the Reserve Bank (building on the framework published in 2013) reflects these considerations, and the ex post review conducted by the Reserve Bank has also helped in analysing the impact of these policies in practice, which will contribute to assessing their use in future.[8]

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5 Charles Goodhart (with comments by Randall S Krozner) “The Changing Role of Central Banks” (BIS Working Papers No 326, November 2010).

6 Pierre Richard Agénor, Leonardo Gabacorta, Ennise Kharroubi and Luiz A Pereira da Silver “The Effects of Prudential Regulation, Financial Development, and Financial Openness on Economic Growth” (BIS Working Papers No 752, October 2018).

7 Bruce Lu “Review of the Reserve Bank’s Loan-to-Value Ratio Policy” (Reserve Bank Bulletin, Vol 82, No. 6, May 2019).

8 Piers Ovenden “Macroprudential Policy Framework – Mitigating the likelihood and severity of boom-best cycles” (Reserve Bank, 22 May 2019); and Bruce Lu in the previous footnote.

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

115. The new objectives in the RBNZ Act to "promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy" emphasise the importance of ensuring that prudential policy-making is well coordinated with overall economic policy.

116. The foundation of this is ensuring that the Treasury, as the principal adviser to the responsible Minister, has appropriate capability and resource to fulfil the role as monitor of the RBNZ Act, and to give effect to the in-principle decision made by the Minister in this regard. There are concerns that the Treasury would not currently be adequately resourced to fulfil its role as monitor, resulting from a comparative lack of focus on prudential policy in the past.

117. This is addressed in more detail in our submissions under Question 3.C of Consultation Paper 2a.

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

118. While there is a need to address the shortcomings identified in the IMF FSAP, it is not clear that intensive supervision model *in all cases* is the correct approach (i.e. delivers greater financial stability overall or otherwise has benefits which exceed its costs). Empirical evidence from the experience of other jurisdictions conducting very intensive supervision models raises legitimate questions about whether this element of the prudential toolkit is more effective in preventing, or minimising the impact of, financial crises than elements preferred by the Reserve Bank under its current regulatory approach.[9]

119. In some cases, the benefits of more intensive supervision are likely to outweigh the costs and lead to better outcomes and a greater degree of confidence, by the regulator, the banks and their customers and the broader community. In particular, it is likely to result in greater clarity in interpreting rules and creating benchmarks. As with other key elements in the prudential framework, this is significantly influenced by the level of resourcing available to the Reserve Bank, which can hinder effective and efficient supervision – e.g. the IRB model backlog and the lack of capacity to review alternative capital instruments under "no objection" arrangements.

120. In relation to enforcement, please refer to our comments under Question 3.E.

Question 3B: Do you think that the Reserve Bank's planned approach to the supervision and management of climate change-related risks is appropriate and adequate?

121. There is a growing recognition of climate-change related risks, including their impact on governance responsibilities as well as increasing financial impacts for customers. The Reserve Bank's Climate Change Strategy is an important signpost of its focus on this issue. We welcome the Reserve Bank's commitment to engage with banks in responding to climate-change challenges.

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9 Donato Masciandaro, Rosaria Vega Pansini, Marc Quintyn "The Economic Crisis: Did financial supervision matter?" (IMF Working Paper WP 11/216, November 2011), Andrea Beltratti and René Stulz "Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation" (ECGI Working Paper No. 254/2009, July 2009), James R Barth, Gerard Caprio Jr, and Ross Levine "Bank Regulation and Supervision: What Works Best?" (unpublished working paper, 2001).

122. One component of the Reserve Bank's policy is to monitor the development and operation of capital markets to identify any impediments to the efficient provision of finance for 'green' investments. In connection with this, it has also committed to engage in cross-agency work streams and with other regional central banks to explore opportunities to develop the green bond market in the Asia-Pacific region.

123. We support those initiatives, particularly given the expansion of the pan-Asian capital market and the rapid pace of innovation in other markets in the region. After a slow start by comparison with Australia and other jurisdictions, the New Zealand green and sustainable investment market has recently begun to pick up pace and scale, including by market-leading programmes by Auckland Council, Contact Energy and Housing New Zealand. Banks have also been proactive in helping arrange those programmes and in creating their own green loan programmes to underpin customers' climate-change or climate adjustment initiatives.

124. There remains a large untapped potential, however, and much scope for innovation and market development, such as securitisation programmes specifically channelling funding to projects with positive environmental or social benefits. More broadly, banks are likely to have an increasingly important contribution to make in underpinning the massive infrastructure and other investments required to respond to climate change and other environmental challenges, as well as by their own policies and practices as institutions.

125. In New Zealand, policy work in this area has been led primarily by the Productivity Commission. In its *Low Emissions Economy Final Report* (August 2018), the Commission addresses the required re-orientation of public and private investment away from emissions-intensive activities and towards those that support and catalyse low-emissions energy, land use and other activities. Green bonds were noted as one of the four key financial instruments that have the greatest potential to encourage low-emissions investment.

126. While noting that the foundation of a stable and credible climate policy is vital, the Commission pointed out the following additional barriers to low-emissions investment:

(a) Information and inertia barriers

(b) Coordination failures – both within government and between government and private actors

(c) Technology and market risks

(d) Scale-of-investment barriers

127. This will be a rapidly evolving area which will benefit from the engagement approach suggested in the Reserve Bank's Climate Change Strategy. In particular, Government initiatives for enabling private financing of large scale infrastructure investments will benefit from investigation and input from the Reserve Bank, including as to the prudential treatment of bank financing in connection with those arrangements.

Question 3C: 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)?

128. As we have noted in other submissions, coordination is a particularly important factor in prudential supervision, both with other agencies operating as regulators of banks in their financial markets and lending activities (i.e. with the FMA and the Commerce Commission respectively) and with supervisors under home-host arrangements.

129. Although this can be encouraged by legislative provisions (such as the Trans-Tasman Cooperation provisions in section 68A of the RBNZ Act), at the heart of achieving this is resourcing and regulatory philosophy.

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

130. The attestation and verification model has an important role in promoting confidence in the prudential regime and supporting self-discipline and market discipline. But, reflecting that the focus on the prudential mandate has expanded significantly since the Act was passed, these elements have either been drawn out of slender foundations (e.g. the extensive prudential rules contained in the Banking Supervision Handbook derive from the power in section 74 to impose conditions of registration) or been added piecemeal over time (the Disclosure Statement regime). In either case, they have not been the subject of rigorous principles-based legislative design – including their interconnections and their relationship to a more highly-evolved sanctions regime (addressed under Question 3.E). It is important to take this opportunity to review the model on that basis.

131. We are in favour of more regular engagement, which can help to improve Reserve Bank's understanding of banks' businesses at the same time as helping banks to understand the Reserve Bank's regulatory priorities.

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

132. As a matter of general principle, regulators require a coherent, robust and well-drafted legislative framework that allows for a toolkit of varied and adaptive methods by which to promote a culture of ethical compliance by firms and individuals and to respond to suspected breaches of regulatory requirements.

133. Emerging best practice is to have available a carefully constructed enforcement pyramid, such as that set out on pg 65 of Paper 2b. This is a feature of more recent regimes, such as the FMCA. Because the current legislation was drafted in a time before this practice evolved, it is comparatively unsophisticated and blunt in the formal remedies available (although in practice the Reserve Bank is able to, and does, use a broader range of tools in its capacity as prudential regulator and licensor).

134. In considering the enforcement toolkit applying to banks and other deposit-taking institutions, particular regard must be had to the broader context of laws regulating their business:

(a) as financial markets participants, where they are heavily regulated under financial markets laws and associated licensing regimes, in particular under the FMCA; and

(b) as lenders, where they are subject to similarly extensive regulation under the CCCFA (including new sanctions and remedies proposed under the Credit Contracts Legislation Amendment Bill).

135. The regime in the RBNZ Act will need to work in with these complementary regimes and be coordinated with the areas of responsibility of their enforcement agencies. Particular tools should be designed by reference to the particular responsibilities – e.g. disclosure should broadly replicate the structure of the FMCA, which assigns clear accountability and, through a proportionate range of enforcement tools and carefully designed due diligence defences, encourages strong compliance systems and enables targeted and proportionate regulatory responses. This would also be consistent with the focus on the adequacy of risk management frameworks in bank directors' attestations.

136. Because the focus of the Reserve Bank is a systemic one, based on financial stability rather than micro-prudential matters, there is more limited scope in practice for enforcement tools such as those required by the FMA as conduct regulator of banks and other market participants. The prudential regulatory context also means that enforcement tools should not be considered in isolation but as intrinsically connected with, and complementary to, regulation and supervision. Reflecting the macro-prudential setting, the focus will primarily be on robust systems, procedures and oversight arrangements. Partly for this reason, it is unlikely that infringement notices (for example) would have a significant role in the toolkit, and in any event care would need to be taken to ensure they are appropriate and not disproportionate in consequences.

137. The latter is particularly true of the arrangements for compliance with banks' conditions of registration and the Banking Supervision Handbook. The current Act was passed at a time when prudential regulation received comparatively little attention, which did not make adequate arrangements for the extensive obligations that now flow out of conditions of registration, through the Banking Supervision Handbook. These are connected in an incidental but significant way to the criminal and civil liability sanctions in connection with disclosure statements (sections 89A and 90 of the RBNZ Act) via the requirement for directors to attest each year that the bank has complied with its conditions of registration. Neither was contemplated when the Act was originally passed and it is important that they are aligned with modern principles and with the more highly evolved frameworks under companion Acts such as the FMCA.

138. In short, the enforcement regime needs to be designed in such a way as to create a coherent and complementary framework with companion legislation, and also to reflect the prudential context and purpose of promoting and enhancing financial stability. An important component of this is to ensure that any executive accountability regime that is proposed, either in the context of the Phase 2 review or of other contemporaneous reform initiatives, is appropriately aligned and coordinated both at the level of its design and in implementation – by nature, such a regime is unlikely to be compatible with multiple agency oversight. Please refer to our submissions in this regard under Questions 1.G and 1.H.

139. As noted in the Paper, these frameworks are designed to encourage willing compliance and effective systems. In this regard, the broad toolkit also must be aligned with a transparent and targeted approach by relevant regulatory authorities to engagement and enfocement. As an example of this, the FMA publishes clear guidance as to its enforcement policies and priorities.[10] This also has resourcing implications, as discussed elsewhere in this submission.

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

140. The significant impacts of the direction power and deregistration require this level of oversight and accountability. The primary context for directions is crisis management (and s 113 of the existing Act) – please refer our comments on Chapter 5.

10 Refer https://www.fma.govt.nz/about-us/what-we-do/how-we-regulate/enforcement-policy/

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

141. We agree with the analysis and proposals contained in Chapter 5 in relation to the core features that New Zealand’s crisis management regime must have in order to support financial stability.

142. Resolution tools (and the underlying crisis management regime) form a critical part of the financial safety net, affecting (and being affected by) the other key components of the net, including by:

(a) the presence of a deposit protection scheme affecting the resolution of distressed banks (on which an in-principle decision has been made under Chapter 5 of Consultation Paper 2a);

143. the provision of central bank liquidity, e.g. to support a distressed bank after the resolution authority has conducted a bail-in where such bank, while solvent, has only limited access to capital markets;

(a) regulations requiring banks to be transparent, to manage risk-taking behaviour, to be resilient and to be prepared if losses are so great that they render a bank non-viable (e.g. by requiring them to prepare for potential resolution scenarios); and

(b) regular supervision and monitoring providing the resolution authority with the knowledge base required to ensure that relevant regulations are being adhered to and to resolve banks, if required

144. Given this interconnectedness, it is essential that all parts of the financial safety net are taken into consideration when designing the details of individual parts. Failure to do so may lead to unintended consequences and, in the worst case, elements of the financial safety net may conflict with, and undermine, other parts of the financial safety net.

In-depth work required to develop a fit-for-purpose crisis management regime

145. Crisis management (which includes the resolution of distressed banks) is a highly complex area that requires an in-depth analysis of detailed proposals. We agree that the current timeline for the Phase 2 Review provides insufficient time to adequately design and assess a crisis management regime appropriate for New Zealand. There will need to be an ongoing work programme leading on from the proposed timetable for introduction of a Bill or Exposure Draft for Phase 2 laws. These matters will also need to be the subject of a separate, detailed consultation. Although issues with aspects of the present regime are clear, and there is also an emergent best practice internationally to draw on:

(a) There remain significant issues of principle, legal structure and mechanics that need to be worked through even at the framework level.

(b) Legal and institutional structures have to be tested not only on their net benefit in contributing to stability, but also on their feasibility in light of prevailing legal and institutional structures (including, for example, the prevalence of offshore ownership of many banks and the mutual structure of others).

(c) Because a crisis management regime sits at the juncture of broader corporate laws (and their associated liquidation and directors’ duty regimes) and financial market laws, detailed legal assessment will be required across a wider statutory and institutional framework.

(d) A great deal of coordination will be required with other domestic agencies (such as the FMA (which can make a recommendation for statutory management under the Corporations (Investigation and Management Act) 1989) and the Department of Justice (which normally overseas insolvency regimes) and significant 'home' country regulators, encompassing key principles such as pari passu and non-deprivation.

(e) The regime will need to take into account or draw on the significant frameworks and workstreams underpinning the current resolution strategies. BS11 and Open Banking Resolution (OBR) arrangements have their own existing legislative objectives, requirements and defined terms, and banks have invested substantial resource into compliance (including separation planning) – as has the Reserve Bank. A crisis management regime (with additional recovery and resolution options) might require a significant rethink and review of current resolution planning and testing requirements under BS11 and OBR. The existing timeframe for preparing separation plans will need to be reconsidered if new recovery and resolution strategies impact those plans.

146. As such, we support approaching the matter in this phase of the Reserve Bank review as a framework one, with further details to be fleshed out in legislative or regulatory phases to follow the timetable set generally for Phase 2.

147. Notwithstanding the above, we have endeavoured to reply to the questions asked in the chapter on crisis management. These replies should be seen as preliminary thoughts on the various topics raised rather than fully fledged answers. The Association and its members would welcome the opportunity to work alongside the Phase 2 team in addressing these matters, which we submit may benefit from a workshop approach similar to that being undertaken for the RMO initiative.

Role in supporting efficient capital and funding instruments

148. Crisis management frameworks can, and in our submission should, support a broader set of prudential instruments which address the core market failure of moral hazard and which can:

(a) operate to support bail-in arrangements which ensure that resolution takes place with the support of the bank's non-deposit investors, rather than taxpayers; and

(b) create a risk-averse constituency of institutional investors with "skin in the game" and strong incentives to monitor banks, underpinning the market discipline pillar and providing credit-sensitive pricing signals to support going-concern resolution.[11]

149. Creating alternative capital instruments which have these characteristics requires consideration of current best practice design, including emerging standards with respect to total loss absorbing capital (TLAC), and will need to incorporate flexibility to respond to developments through time.

Adapting requirements to the range of financial institutions

150. As a general remark, any crisis management regime will have to cater to three types of banks:

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[11] Refer John C Coffee Jr "Systemic Risk after Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight" (2011) 111 Columbia Law Review 795; Mark J Flannery "Stabilizing Large Financial Institutions with Contingent Capital Certificates" (October 2009), SSRN Working Paper; and Charles W. Calomiris and Richard J. Herring "Why and How to Design a Contingent Convertible Debt Requirement" (November 2011), Wharton School Working Paper.

(a) systemically important domestic banks for which liquidation is not a realistic resolution action due to the flow on effects their liquidation would have on the rest of the financial system;

(b) other banks which could, at the point of non-viability, be liquidated without endangering the financial system as a whole; and

(c) banks, including ones that are systemically important for the New Zealand financial system, that are part of international groups and for which any non-viability in a New Zealand context would likely form part of wider group issues and be subject to offshore, and likely multi-jurisdictional, resolution arrangements.

151. The resolution of systemically important banks requires particular resolution tools being available, in particular bail-in. Given that a number of New Zealand banks have been identified as domestically systemically important banks (DSIBs), any future crisis management regime should provide for the tools required for resolving those type of banks, in line with international best practice.[12]

Key attributes

152. The Financial Stability Board Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes) specify a number of key attributes that a crisis management regime should have. We propose that both resolution objectives and resolution tools of the New Zealand resolution authority are guided by these Key Attributes. Such resolution tools include the ability to bail-in liabilities or to temporarily stay termination rights under derivative contracts.

153. These tools are key features of new resolution and recovery regimes instituted in the wake of, and drawing on lessons from, the GFC, most notably the Bank Recovery and Resolution Directive (BRRD) in the European Union, FDIC receivership and Orderly Liquidation Authority in the United States and APRA's powers under the Banking Act 1959.

Relationship with capital requirements

154. Introducing additional resolution tools may have flow on effects on the capital composition of banks. While the Consultation Paper describes banks' capital requirements as being outside the crisis management regime, there are nonetheless important contact points. In particular, for a bail-in to be successful, a bank's balance sheet must provide for clearly identifiable types of liabilities that can be bailed in without undermining the systemically important functions of the bank (which is now a familiar part of banking systems worldwide and is well-understood by institutional investors).

155. The introduction of particular capital requirements for bail-in purposes can serve that purpose, as well as create an additional investor group with an interest in monitoring banks' performance and providing early-warning signals when a bank falls into distress.

International coordination, including home-host arrangements

156. Finally, the high proportion of New Zealand's financial system that is internationally connected emphasises the importance of international cooperation between resolution authorities. With the four largest New Zealand banks being

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[12] Refer for example Michael Schillig "Financial Stability, Systemic Risk, and Taxpayers' Money – the Rationale for a Special Resolution Regime" (in *Resolution and Insolvency of Banks and Financial Institutions*, Oxford University Press, 2016, pg 39-68), Joesph H Sommer "Why Bail-in? And How?" (FRBNY Economic Policy Review, December 2014), Martin Ćihàk and Erlend W Nier "The Need for Special Resolution Regimes for Financial Institutions - The Case of the European Union", IMF Working Papers WP/9/200, September 2009.

subsidiaries of major Australian banks, co-ordination between Australia (APRA) and New Zealand is particularly important.

157. Resolution action with respect to the Australian parent or the New Zealand subsidiary will likely affect the other as well. Uncoordinated actions will likely result in the unnecessary destruction of value not only for those entities but also for other participants in New Zealand's (or Australia's) financial system, including customers. Cooperation and coordination would also be in line with the Key Attributes which strongly encourage cross-border coordination and cooperative solutions, and are recognised at a trans-Tasman level in existing provisions of the RBNZ Act and the memorandum of understanding between the Reserve Bank and APRA. In this regard, we agree with the analysis of home-host arrangements in Chapter 5 of Consultation Paper 2b.

158. However, as indicated above, this is a point that goes beyond the longstanding relationship with Australia. New Zealand's registered banks include entities whose home, or parents' home, jurisdictions include the Netherlands, the United Kingdom, China, India, the United States, Japan and Korea. In each case, co-ordination with home regulators, both within the realm of crisis management and in other areas, will be important to maximise both financial stability and efficiency in the interests of all participants in the New Zealand financial system, including customers.

Question 5A: What are the most important objectives for New Zealand's resolution authority?

159. The Reserve Bank resolution function's objectives should be guided by and aligned with the overall objective, being, as proposed in this submission, to "*protect and enhance the stability <u>and efficiency</u> of New Zealand's financial system*". The preamble of the Key Attributes can provide useful guidance on any further resolution-specific objectives. Such objectives could include ensuring continuity of systemically important financial services and payment, clearing and settlement functions, the prevention of severe systemic disruption and the protection of insured depositors.

160. However, before any objectives are incorporated in the crisis management regime they will have to be analysed in light of the particular circumstance of the New Zealand financial system and their exact content will have to be specified further in a subsequent consultation. Furthermore, as an additional guiding principle, the Reserve Bank's resolution actions should also be guided by proportionality, with the intrusiveness of resolution tools mirroring the severity of a bank's troubles.

Question 5B: Is the proposed resolution authority function for the Reserve Bank specified appropriately?

161. We agree with the proposed resolution authority function as specified in the Consultation Paper. In particular, we agree that the resolution authority function should, in principle, be operationally independent. Such operational independence should be subject to the same safeguards as the Reserve Bank's operational independence when conducting prudential supervision discussed in Chapter 3 of Consultation Paper 2a. We further support the resolution function being situated in a structurally separate division of the Reserve Bank. Such division should be formally separated from the day to day supervision of banks (so as to limit the risk of regulatory forbearance) but closely cooperate with the day to day supervisor.

162. Resolution actions can have far-reaching consequences for the bank concerned, such as the market losing confidence in the bank's viability, potentially worsening a bank's troubles. These can also impact on the financial system more broadly. Accordingly, such decisions should be taken at the highest levels of the Reserve

Bank, i.e. the board. However, as, circumstances may arise where resolution action needs to be taken on very short notice, the entire board will likely not always be available in time. We thus support the creation of a specialised division or committee of the board that is available permanently at short notice and has the authority to open resolution proceedings. This board committee could also take a lead in overseeing initial and ongoing coordination arrangements.

Question 5C: 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?

163. We agree that the specification of the Reserve Bank's resolution authority and powers in legislation, with resolution objectives and stronger accountability mechanisms, requires a rebalancing of the Minister's role. The exact scope of the Minister's role will have to be specified in light of, and be informed by, the outcome of the governance arrangements of the Reserve Bank discussed in Chapter 3 of Consultation Paper 2a. In general, any requirement of ministerial approval or consultation must ensure that the speed that may be required in resolution proceedings is not compromised.

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

164. We support in principle the approach suggested in the Consultation Paper that the Reserve Bank, as resolution authority, is given resolution powers without requiring it to appoint a statutory manager. Appointment of a statutory manager would constitute an unnecessary additional step if the resolution function is situated in an adequately resourced division of the Reserve Bank that has the knowledge and skill to fulfil such role. Our support therefore assumes that the resolution function fulfils these criteria, which would include not only the capability and capacity to competently review and test resolution plans (failure of which may lead to substantial costs, both for the relevant bank and the wider financial system) but also a statutory manager's technical skills to manage a corporation in distress.

165. Although statutory management is intended to be a control and management tool that preserves the business and provides "breathing space" to enhance orderly resolution,[13] it has a number of significant drawbacks in the context of bank resolution and recovery:

(a) The regime is unique to New Zealand and is not well understood in an international context. This can exacerbate the already significant challenges in coordinating with international regulators and insolvency officials and in maintaining confidence of overseas investors or other creditors who could be affected by the regime.

(b) Statutory management has been the subject of considerable and sustained criticism, including on the grounds that it can give rise to moral hazard, interferes with creditors' rights (including by preventing secured

[13] Refer *Batkin Holdings Limited v DFC Ventures Limited* [1994] 1 NZLR 629 (HC): "although the powers of a statutory manager provided in the Act are wide, it seems that what is primarily intended is the "management" of a bank, not its liquidation." Refer also *Equiticorp Finance Ltd v Equiticorp Holdings Ltd; Morris v Equiticorp Finance Ltd* (1990) 5 NZCLC 66,465 (HC) and *Wilson v Aurora Group Ltd* [1990] 1 NZLR 61.

creditors exercising their contractual rights, with no time limit), and lacks any systematic basis for transparency and accountability.[14]

(c) Statutory management is relatively untested in a financial system context and, in particular, there is little basis for assessing how it would work in an inter-connected globalised setting.

(d) Statutory management has proven in many cases to be a costly and lengthy procedure – DFC was subject to statutory management for over nine years.

166. It is therefore timely and important to review the place that statutory management has in New Zealand's prudential management regime.

167. If the appointment of a statutory manager is no longer a precondition to bank resolution (including BS11), changes to BS11 will be required, which may negatively impact banks' ability to deliver BS11 on time. Also, because statutory management is central to the operation of the OBR regime, it will require a re-evaluation of the design of that regime (something which in any event is necessary in response to the in-principle decision to adopt depositor protection).

168. As to the resolution powers that the Reserve Bank should have, we support the proposals to give the Reserve Bank a broad range of resolution tools so as to enable it to react in a timely way and with proportionate measures to troubles that a bank may face, in line with the Key Attributes. This assumes that those powers have appropriate controls around their use to ensure they are used in a proportionate and transparent manner. The resolution powers should enable the resolution of both smaller banks and DSIBs.

Question 5E: In principle, should the Reserve Bank have the power to 'bail in' specified categories of unsecured liabilities in order to recapitalise a failing large bank after its owners have absorbed maximum losses, and to minimise the need for taxpayer support? Should the recapitalisation of a failing large bank be funded through industry-wide levies?

169. We support giving the Reserve Bank a formal bail-in power, in line with international developments (including in Australia). While the concept of bail-in, and the associated question on which types of assets would constitute total loss absorbing capacity (**TLAC**) and be bailed in, have not yet been considered in depth in published materials in a New Zealand context, we note the following:

(a) Bail-in is a tool which is central to both the Key Attributes and to significant resolution regimes in offshore jurisdictions;

(b) Bail-in as a resolution tool primarily becomes relevant if a failing bank is too big or interconnected to be resolved by liquidation (and with bailout a resolution mechanic that should be avoided at all cost), i.e. is a DSIB;

(c) New Zealand is expected to have (at least) four banks that will qualify as DSIBs for which liquidation or bailout would be not generally be feasible;[15] and

(d) Bail-in more generally may be useful as a first step procedure to enhance recovery of non-DSIB institutions, where it could repair balance sheets to the extent required to avoid costly insolvency proceedings.

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[14] Refer for example Law Commission advisory report *Insolvency Law Reform: Promoting Trust and Confidence* (May 2001), paras 258-266 and Annalise Vucetich "RBNZA and CIMA: Acronyms for Disaster? Crisis Management in the New Zealand Financial System" (October 2008, Otago University honours dissertation).

[15] Refer footnote 12.

170. In principle, it is therefore important to explore more fully the inclusion in the legislation of bail-in as part of the resolution toolkit.

171. Introducing a bail-in tool will have flow on effects on several other areas. These include:

(a) Preparation of resolution plans ahead of any crisis as the effectiveness of a bail-in will greatly depend on the speed with which it can be enacted (to break the downward spiral that a distressed bank may find itself in);

(b) Existence of liabilities on the balance sheets of banks that can be bailed in without endangering the systemically important functions of banks. While the Consultation Paper specifies that banks' capital requirements is a separate topic from crisis management, an effective resolution regime that is not reliant on taxpayer support can be significantly enhanced by bail-in instruments.[16] Such assets can be created by requiring banks to hold a part of their capital requirement in instruments that will be first to be bailed in, with corresponding acknowledgments by creditors. Such creditors will also have an interest in monitoring banks' performance and, by their actions, may provide early-warning signals when a bank falls into distress.

(c) Given the importance of DSIBs for the entire banking group, coordination with the home regulator of such banking group is furthermore essential to achieve the most efficient resolution outcomes.

(d) Finally, given the substantial derivative exposures underpinning New Zealand's international funding, provisions in derivative legislation that enable the resolution authority to temporarily stay termination rights while it conducts a bail-in are of particular importance.

172. With regard to the use of levies for recapitalisation of failing banks, we refer to the discussion in Question 5.H below.

Question 5F: Do you agree with the proposal to allow continuous disclosure-to-market requirements to be suspended temporarily, subject to conditions and safeguards?

173. Disclosure obligations can potentially undercut, and must be taken into account in, the execution of resolution plans, e.g. the disclosure of an upcoming bail-in could incite a market panic.

174. Furthermore, to the extent that a bank's directors are issued directions by the Reserve Bank (including regarding disclosure obligations), crisis management legislation should shield directors from liability arising from such directions, e.g. under company law. Given that the disclosure obligations arise under different regimes such as the FMCA and the NZX listing rules, any such safeguards will have to be aligned with the relevant regulators of such regimes.

Question 5G: Should the resolution authority always be required to respect property rights (including the hierarchy of creditors in liquidation)?

175. As for the crisis management system in general, safeguards for property rights should be designed in line with international standards. They become of particular relevance if the resolution authority conducts a bail-in, as a bail-in, by definition, will extinguish certain property rights.

176. Accordingly, in order to enable the resolution authority to use the full set of resolution tools, we recommend inclusion of a "no creditor worse off" (**NCWO**)

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16 Òscar Jordà, Björn Richter, Moritz Schularick, and Alan M Taylor "Bank Capital Redux: Solvency, Liquidity, and Crisis" (NBER Working Paper 23287, March 2017).

principle rather than absolute protection of property rights, consistent with international norms. Under such NCWO principle, creditors of a failing bank would have a right to be compensated if they are worse off than they would have been in a bank liquidation. Ensuring that any impact on property rights is in line with international standards is also essential from the perspective of the entire New Zealand financial system, as it may affect counterparties' willingness to deal with New Zealand entities long after the distressed bank has been resolved or liquidated.

177. However, in bail-in scenarios, a key lesson from the GFC is that it is essential to move quickly. The statutory provisions thus need to ensure that creditors cannot block resolution plans with injunctions and any compensation claims can only be made once the bank is no longer in resolution proceedings.

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

178. There are material issues in principle and in practice with designing a system that reflects differences in scale and credit, and does not have adverse incentive effects or spill-over consequences, and more generally has benefits which exceed its costs. Any industry-funded resolution fund would require prudent banks to essentially pay for the more profligate ones.

179. Furthermore, using the assets of such fund in connection with the resolution of a systemically important bank (if it is resolved by way of bail-in) would potentially substantially increase the required size of the fund. It would also run counter to the principle of bail-in that losses should be borne by shareholders/creditors and not by other banks and increase the risks of contagion by putting further stress on otherwise healthy banks by requiring them to fund such fund.

180. Accordingly, we are sceptical about the benefits of an industry-funded resolution fund.

181. For a more general discussion regarding the use of levies, we refer to the discussion in Chapter 7 of Consultation Paper 2b.

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

182. Cross-border resolution is of particular importance if a bank (be it a DSIB or a smaller bank) that is a subsidiary of a foreign bank has to be put in resolution. A New Zealand DSIB that is a subsidiary of a foreign bank will often be a material subsidiary of the foreign parent, with the foreign parent's regulator closely interested in any resolution action taken regarding the New Zealand subsidiary. However, the resolution of a smaller bank that is a subsidiary of a foreign bank will also interest both the foreign parent's regulator and the Reserve Bank, given that its failure could lead to a loss of confidence both in the foreign parent bank and its group and in the New Zealand prudential supervisory and financial system as a whole, thus risking contagion to other New Zealand banks. In addition, the failure of a large subsidiary of a foreign bank could also have consequences under New Zealand banks' obligations under BS11.

183. In line with the Key Attributes, we support the legal framework strongly encouraging the Reserve Bank to coordinate its resolution actions with the relevant home regulator, in particular in resolution scenarios, in order to achieve optimal resolution outcomes. Ideally, the Reserve Bank and the home regulator would establish and maintain a crisis management task force for the purpose of improving dialogue, pre-planning coordination strategies for cross-border resolution actions and ensuring the notification of resolution actions to the Reserve Bank (and vice versa). Any future consultations should also consider whether there should be a formal process for recognising home resolution

authority actions, an ability for the Reserve Bank to take actions that support home resolution action and a means to prevent home country resolution actions triggering contractual rights for termination.

184. As for the general pre-planning of resolution actions, introducing crisis management groups will require the resolution function of the Reserve Bank to be adequately resourced. Furthermore, to ensure that a cross-border resolution plan can be implemented effectively, New Zealand should have the same toolbox of resolution tools available as other countries. Therefore, as discussed in our response to Question 5D, we propose that the Reserve Bank has resolution tools that are in line with international standards, in particular the possibility to bail-in liabilities.

185. Intensifying cross-border cooperation, in particular by way of crisis management groups that pre-plan coordination relating to cross border resolution actions, will require a rethink of existing policies regarding the implementation of BS11. Any separation actions taken under BS11 should be in line with the resolution plan agreed in the crisis management taskforce.

186. The international element and norms applying to cross-border insolvency also create legal challenges for crisis management which will need to be considered as the proposals are developed. For example, insolvency jurisdiction (proper law rules) and practical administration is generally a mixture of *domicile* (i.e. place of incorporation of entities, which is further complicated by the common use of branches) and *lex situs* (i.e. the applicable law where the property is situated – which is often difficult to determine in the case of intangible financial assets). The regime will need to recognise that there may be multiple jurisdictions with (potentially conflicting) interests in the outcome. This reinforces the importance of coordination and cooperation between the Reserve Bank and foreign resolution authorities. Such coordination and cooperation should occur in advance, in particular when analysing living wills and preparing resolution plans, and proactively address any potential conflicts.

187. International considerations will also arise in the context of key financial markets infrastructures which underpin payments and derivatives systems, the latter reflecting the significant derivatives reforms internationally under the G20 Pittsburgh and Cannes Accords. These are crucial in underpinning access to international funding markets and financial stability in New Zealand. Accordingly, New Zealand is currently in the process of introducing legislation addressing, among other things, a new regulatory regime for financial market infrastructures and has also recently passed an Act facilitating the fulfilment of initial margining requirements under certain derivatives.

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

188. In responding to the questions raised in the Consultation Paper with regard to what arrangements the Reserve Bank should have in place for coordinating across Government, whether they still remain appropriate and any possible options for reform, we consider that it is most appropriate to respond more generally on this issue rather than answering specific questions raised.

189. We have a particular interest in there being an effective level of coordination among the various agencies that are responsible for overseeing New Zealand's financial sector. Clearly, a twin peaks model (although see our comments below), with the addition of the Commerce Commission in a number of consumer-related areas, means that it is important to have proper coordination between the financial regulators to ensure efficiency of design, appropriate

coordination in implementation and the avoidance of duplication of engagement. In this context, we welcome the recent announcement that the Commerce Commission has joined the Council of Financial Regulators (CoFR).

190. While the legislative framework which may sit behind the coordination arrangements is relevant, more important is the way in which the arrangements operate in practice. If the CoFR has a relatively “hands-off” approach regarding the level of coordination between the various financial regulators, then it is of limited relevance what structure is used.

191. It is clearly desirable that there is a positive approach taken to coordination given that there are a number of areas of financial regulation where no single regulator has exclusive jurisdiction. At a macro level, areas such as general consumer law, competition law, overall economic policy and the impact of climate change on the environment all need a level of coordination. More specifically, and of particular relevance currently, is the approach to conduct and culture issues. For example the proposal to develop a number of overarching duties would potentially overlap with a number of existing legislative regimes that are overseen by different regulators. In addition there is a need for coordination between the proposals for an executive accountability regime for directors and senior management currently being considered by MBIE in the context of improving conduct and culture and the proposals for accountability under the CCCFA, and how these fit with the proposals for a “fit and proper” test for directors in Consultation Paper 2b.

192. It is also worth noting that although the New Zealand financial markets regulatory regime is described as being based on a twin peaks model of financial regulation, it cannot truly be described as being a twin peaks model that is comparable with those models implemented in other jurisdictions, including Australia, the United Kingdom, the Netherlands and most recently South Africa, where there is a clear delineation between, on the one hand, a regulator specialised in the prudential monitoring of regulated institutions, and, on the other hand, a regulator that has oversight of business conduct.

193. In contrast, there are a number of significant overlaps and gaps between the regulatory regimes in New Zealand. For example, the Reserve Bank is responsible for the prudential supervision of only some financial institutions, with the FMA having a prudential supervisory role under its licensing regime in respect of others (e.g. derivatives issuers and corporate trustees). Furthermore, while FMA is the primary conduct regulator in the financial market, the Reserve Bank and Commerce Commission are also focused on conduct issues. The lack of a true twin peaks model arguably makes it even more important that there is coordination between the various regulators. While it is outside the scope of this consultation, we would recommend that the Review Team considers the benefits of New Zealand moving to a true twin peaks approach.

194. In addition to improving the consistency of outcome, coordination also allows regulators to draw on centres of expertise and experience that exist between them, and apply and enhance best practices that are currently used by the regulators. For example, the FMA’s approach to enforcement and priorities could be of particular benefit in the development of a broader “tool box” of enforcement tools in the context of the regulation of banks. Finally, improved coordination among the financial regulators can assist in enhancing the effectiveness and efficiency of engagement between domestic and offshore regulators. A coordinated approach by the New Zealand financial regulators which avoids an unnecessary duplication of engagement with overseas regulators would be desirable. Developing a strong level of “home – host” co-operation, that works effectively and efficiently, is particularly important in the context of developing a functional crisis management regime. We discuss this further in our comments on Chapter 5 of Consultation Paper 2b above.

195. With regard to whether we have a preferred option for the structure of the CoFR, the preference would be for option two, that is an increased structure and formality for coordination, but not going so far as a legislative body. The latter raises a number of the concerns particularly around complexity, accountability and practical operation.

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

196. The question of how the Reserve Bank is to be funded and resourced was identified as a significant issue in the 2017 IMF FSAP.[17] We note that over the past decade, in particular, a significant number of responsibilities have been added to the Reserve Bank's supervisory role without resourcing always keeping pace with this increase. This has been compounded by the fact that there has been a reluctance to use existing statutory provisions to amend the five-year funding agreement model in order to respond to such increased responsibilities. Overall the existing model has had significant drawbacks, and, as the Consultation Paper notes, appears to have resulted in the Reserve Bank tending to underspend on its funding agreements.

197. This also needs to be considered against a backdrop of the fact that during this period prudential regulation has become considerably more complex and has been subject to continuous adaptation. The need for the Reserve Bank to be familiar with international developments and to undertake research to identify best practices means that more time and resource is required by the Reserve Bank just for it to maintain the current quality of the prudential regulation, let alone for this to improve.

198. However, it is important that the questions around the resourcing of the Reserve Bank are not considered on a standalone basis. As indicated in the key themes section at the start of this submission, resourcing, governance and objectives are highly inter-related issues. While we support increased funding of the Reserve Bank, it is vitally important that it is applied efficiently and effectively in addressing the under-resourcing apparent in parts of the Reserve Bank's responsibilities. Likewise, with increased resources comes a greater importance of accountability.

Question 7A: Do you agree with the potential issues identified in the current funding model?

199. We broadly agree with the potential issues that have been identified by the Review Team with the current funding model. We consider that both the structure of the existing model and the reluctance to apply it operationally in a flexible way has resulted in the Reserve Bank taking a conservative approach to resourcing. We are particularly concerned that the existing accountability arrangements in relation to the use of resources have not delivered the desired outcomes. However, it is hoped that with a change in the governance structure for the Reserve Bank this will improve over time.

200. The fact that the Reserve Bank has, on a number of occasions, had to prioritise matters over planned initiatives, and has had limited ability to fund new strategic priorities as they arise has been a significant disadvantage of the existing model.

[17] See for example the Recommendation "Increasing supervisory resources for all financial sectors is key" on page 7 and Principle 2 of the Recommended Actions on page 70.

This has even been recognised by the Reserve Bank itself[18] and is highlighted in various other papers released in the context of the current review of the RBNZ Act.

201. The lack of resource to fund investigations into new developments is a particular concern. The lack of any meaningful investigation of the total loss absorbing capacity (TLAC) regime or analysis of international best practice with regard to alternative capital instruments by the Reserve Bank in the context of the Capital Review has meant that the onus has been on industry stakeholders to provide the Reserve Bank with analysis on such issues. Stakeholders' concerns around the Reserve Bank's rigour and timing of cost-benefit analysis for particular strategic consultations provide further concerns with the inadequacy of the current funding model. This has been apparent most recently in the context of the Capital Review, but was also a concern in the context of the BS11 Outsourcing Review.

Question 7D: 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?

202. We generally support the introduction of an industry levy if this will result in the Reserve Bank being better resourced and able to operate more effectively.

203. In developing a levy structure it is important that best practice is followed, including taking account of the Legislation Design and Advisory Committee Guidelines.[19] For example the structure should be designed so that any levies should bear a proper relationship to the cost of the Reserve Bank performing its prudential supervisory role and not exceed those costs. Equally important is the need to avoid cross-subsidisation. This is a particularly important element to be borne in mind when designing the levy structure, given that the Consultation Paper is considering a range of possible levies in addition to industry funding of prudential supervision, such as for a depositor protection scheme and a resolution fund.

204. In determining a new model it will be important to take account of the various examples from around the world. We consider that more structured arrangements, where there is a clearer identification as to what the levies relate to, would seem to be better models.

205. For example, the United Kingdom's Prudential Regulatory Authority uses a model which raises the levy from three distinct sources:

(a) application fees – where the cost of processing applications or variations is determined by level of complexity;

(b) annual fees – which are based on a more general measure of the size of the supervised entity and the general costs of regulation; and

(c) special project fees – where banks are individually charged on an hourly basis for specific regulatory work that is carried out for the benefit that entity or its group.

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[18] See the Reserve Bank Financial Policy memorandum titled "*Monkey on our back*" dated 14 March 2016 released as part of the Information release: Capital Review proposals by the Reserve Bank on 25 January 2019.

[19] Legislation Guidelines: 2018 edition - Chapter 17 - Authorising the charging of fees and levies.

206. In contrast, models that have less “focussed” fee structures,[20] for example where the levy is based purely on the size of institutions and are a rough approximation for the amount of time that the prudential regulator needs to allocate to regulating such entities, would seem to have less transparency and run a greater risk of not meeting best practice.

207. One of the other benefits for considering an industry levy is that it places more focus on the accountability and transparency of the Reserve Bank in respect of the use of funds. In addition to the improved oversight and accountability through the revised governance model for the Reserve Bank, thought will need to be given to the approach to accountability at a parliamentary or governmental level. Clearly, accountability to Parliament for the allocation and use of funds would provide greater transparency and comfort to industry stakeholders.

[20] For example Sweden, Ireland, The Netherlands – See Masciandaro, D, Nieto, N and H Prast (2007) 'Who pays for banking supervision? Principles and practicies', DNB Working Paper No. 141/2007 Page 16.

Submissions on Consultation Paper 2a

208. **It is important that our specific submissions are read in conjunction with the key themes set out at the start of this submission, as the key themes outline important inter-relationships between various specific submissions.**

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

The statutory context of the prudential objectives

209. The objectives of the RBNZ Act were amended in March 2019 under Phase 1 of the Review, setting the over-arching aim "to promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy".

210. This is the touchstone of the Act, including of the purpose provisions under consideration in Phase 2. The purposes for particular functions – monetary policy, prudential policy and other – are set out beneath this over-arching purpose, and are intended to contribute to its fulfilment. The question to be addressed in this part is what formulation of the *prudential* objective will best do so.

Giving effect to the in-principle decision

211. The Phase 2a paper records that an in-principle decision has been taken:

> *Replacing the Reserve Bank's existing 'soundness' and 'efficiency' financial policy objectives with a single overarching 'financial stability' objective.*

212. A key issue in implementing this decision is that there is no settled meaning of the term "financial stability".[21] This creates an ambiguity which is acknowledged in the 2a Paper, along with the associated consequence that "*having a financial stability objective is not enough on its own to guide the Reserve Bank*" (pg 18). It leads to the crucial questions:

    (a) What meaning is to be given to "financial stability" to provide such a guide?

    (b) What is the place for efficiency within the framework, particularly given that financial stability is described in the paper as a "multi-dimensional objective", "which encapsulates the most relevant aspects of soundness and efficiency"?

    (c) What other purposes, not encompassed within the meaning as determined, should be added to guide the Reserve Bank's prudential mandate?

213. The approach taken in the Paper is not to offer a definition or other direct clarification of the core "financial stability" concept,[22] but rather to add an array of secondary purposes, which are intended (as noted above) to install the focus that the core term lacks. The net result is to move from the purpose that is currently encapsulated in two words – "sound" and "efficient" – to one that is proposed to have up to 26 component parts. Even on the assumption that these will be

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[21] Refer Garry J Schinasi "Defining Financial Stability" (IMF Working Paper WP/04/187, October 2004), at pg 3: "*Unfortunately, there is no single, widely accepted and used definition of financial stability*."

[22] As for example is undertaken in the Resource Management Act 1991 to clarify the meaning of the central guiding principle in that Act, "sustainable management".

winnowed to a more manageable set, this would belie the simplifying intent evident in the in-principle decision, and would counteract many of the benefits the Paper suggests will result from switching from a soundness/efficiency objective to a stability one.

Centrality of efficiency to financial policy and the Act's overarching objective

214. In taking this approach, the authors appear to have deliberately avoided using the term "efficiency",[23] despite the fact that this term has underpinned prudential policy for 30 years, is recognised as integral to the concept of "financial stability",[24] is central also to the over-arching objectives in section 1A of the RBNZ Act to promote prosperity and contribute to a sustainable and productive economy,[25] is commonly employed in both purpose and substantive provisions of other statutes,[26] and is plainly a cornerstone of sound financial policy-making.

215. Another important aspect of the word "efficiency" in this context is that it carries two concepts that are each fundamental to sound prudential policy:

(a) First, in the context of stability, it serves as a *characteristic* of the way that stability is to be achieved – i.e. that stability policies are effective and have net benefits (including in relation to alternative options that achieve the same, or greater, stability). This derives from the ordinary meaning of the word, which is paramount in statutory interpretation.

(b) Second, it is an *objective in its own right*, here meaning that the financial system is performing well its key functions and thus contributing positively to economic development and prosperity.[27]

216. In an apparent endeavour to work around the definitional difficulties common to efficiency and financial stability objectives, the Paper proposes including supplementing the stability purpose with specific secondary objectives that address some, but not all, components of efficiency.

217. The result is a great deal of complexity, which obscures the core purpose of the prudential mandate, and would likely amplify, rather than resolve, the largely theoretical difficulties with precisely defining efficiency (which, as noted, apply equally to financial stability). Moreover, as noted under Question 2.A, those issues do not arise under conventional principles of statutory interpretation, which are grounded in ordinary meaning and contain appropriate latitude for regulatory judgement.

218. The proposed formulation of the objectives in the Paper derives from three assumptions that are open to challenge:

(a) *That terms used in statutory purpose provisions must be capable of precise definition*. This is not correct. As befits their place in the statutory framework, purpose provisions often utilise relatively abstract or high level terms – for example the FMCA's purposes include both

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[23] This term is confined to the way in which the Reserve Bank employs its own regulatory resources.

[24] Refer Garry J Schinasi "Defining Financial Stability" (IMF Working Paper WP/04/187), October 2004.

[25] Refer Chris Bloor and Chris Hunt "Understanding financial system efficiency in New Zealand" (Reserve Bank of New Zealand Bulletin, Volume 74(2), June 2011); Asli Demirgüç-Kunt and Ross Levine "Finance, Financial Sector Policies, and Long Run Growth" (Commission on Growth and Development Working Paper No. 11, 2008).

[26] Refer for example section 3 of the FMCA, the companion Act under the 'twin peaks' model.

[27] Refer Bloor and Hunt, footnote 25, at pg 26, 28.

'fairness' and 'efficiency'. These words may be defined or clarified in the statute, but usually are not.

(b) *That a clear hierarchy must be expressed for dual or multiple objectives*. This is not correct. Where the statute does not specify a priority order, the responsible agency is given latitude as to the weighting applied to the factors, so long as it is "within the bounds of reason".

(c) *That, to underpin clarity of function and accountability, the purpose provisions should direct the responsible agency as to how the aims of the Act should be carried out.* This is not correct. A purpose clause explains *why* the law is enacted. It is for the substantive provisions to show *how* the purpose will be implemented.

219. More fundamentally, as discussed in more detail in our submissions under Question 2.F, the objectives put forward as proxies for a general efficiency concept have been drafted in a highly prescriptive and constrained way, which excludes the core dimensions of that term under the Reserve Bank's own analysis and regulatory practice,[28] omits the core elements identified by the IMF,[29] and would not meet Cabinet standards for an analysis of the net benefits of a policy.[30] It also results in a set of purposes which are complex, opaque, and inflexible, by comparison with the objectives currently underlying the prudential mandate.

220. This approach to defining the core purpose also appears to run counter to the over-arching objective in section 1A of the RBNZ Act, as reconfigured in March. This is evident from the Reserve Bank's analysis of financial system efficiency in a New Zealand context:[31]

> *The primary function of the financial system is to facilitate the allocation of society's scarce resources, both across the economic system and over time, in an environment of inherent uncertainty.* ***If the financial system performs this role well, then it will be contributing to economic growth and prosperity in a positive way.***
>
> [Emphasis added]

221. The rationale given in the Paper for this approach revolves primarily around an issue identified in the first Phase 2 paper, at pg 24, that "*the Reserve Bank and stakeholders have struggled to interpret the Reserve Bank's efficiency objective*". The arguments given in the Chapter elaborating on that issue are unconvincing, and are addressed in more detail under Question 2.A.

222. In any event, the sorts of expert analysis and judgement involved in assessing efficiency are inescapable in the conduct of financial policy, and defining the prudential mission in a way that excludes them would improve neither policy-making nor accountability. Nor would such a formulation reflect how the Reserve Bank actually conducts its formulation, consultation engagement, and review of policy.

223. The Paper acknowledges that financial stability incorporates efficiency. The inclusion within the purpose provisions of only select and narrowly circumscribed components of efficiency by implication excludes other elements of that term as generally understood. This has the effect of altering the normal meaning of

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28 Refer Bloor and Hunt, footnote 25, and Reserve Bank consultation paper "*Capital Review Paper 4: How much capital is enough?*" (14 December 2018), among others.

29 Refer IMF/Schinasi, footnote 24, and further under Question 2.A.

30 Refer *Guide to Cabinet's Impact Analysis Requirements*, and Treasury's *Regulatory Impact Analysis Handbook* and *Guide to Social Cost Benefit Analysis*.

31 Refer Bloor and Hunt, footnote 25, at pg 26.

"financial stability", and excludes the elements of efficiency that are most significant for policy formulation, analysis, and accountability. It would be surprising if such an outcome would be regarded as mandated by the in-principle decision. The attempt to decompose efficiency into precisely defined parts also seems at odds with the apparent intent to simplify the objectives, and adds clarity only at the expense of completeness.

Other issues with the objectives proposed

224. Statutory drafting guidelines stipulate that a purpose provision is intended to supply the "why" of an enactment, not (other than at a very high level) the "*what*" or the "*how*".[32] This is manifested by the universal practice in New Zealand of introducing the objectives with the phrase "*The purpose(s) is/are* …", followed by a concise statement of those purposes, rarely amounting to more than one or two paragraphs.

225. The Paper takes a different approach, setting out an array of highly specific (but ultimately incomplete) directions as to how the prudential regulation is to be conducted and a series of matters which must be taken into account in doing so, apparently to set out the basis for specific accountability. Yet, as indicated by the Law Commission's guidelines, this is not the role of purpose clauses, which are not synonymous with KPIs, but rather of substantive accountability provisions such as those contained in Part 6 of the existing Act.

226. This departure from normal practice is more than just a question of style, but results in prescriptive and complex provisions that obscure the significant policy issues the Act is addressing. The purposes are also directive in nature, reducing the scope of discretion and judgement that are essential to effective prudential policy-making and supervision. The overall effect is for the purpose provisions to operate as a charter, which limits the Reserve Bank's discretion in matters core to prudential supervision, and expands its remit into areas which are not. Please refer our submissions on this aspect under Question 2.C.

Importance of clear and coherent statutory objectives

227. Well-thought out and clearly expressed purpose provisions have become an indispensable part of legislation, in:

   (a) forming a carefully considered basis to drive the design of the substantive provisions that follow, a factor given significant emphasis in the Cabinet Manual;

   (b) establishing the basis for the interpretation of the Act's detailed provisions, particularly in the event of ambiguity;

   (c) guiding the implementing agency's priorities and actions; and

   (d) setting the policy foundation for secondary legislation, standards and instruments promulgated under the Act.

228. In the context of a process such as the Phase 2 review, it is very important that the new legislation is anchored by a concise and readily understandable statement of its purposes. The existing framework in section 1A has these characteristics, beginning with the overall economic and societal goals, and cascading down into a concise expression of the particular contributions to be made by monetary and prudential policy respectively.

229. The formulation suggested in Chapter 2 represents a marked shift from the approach and language reflected in those provisions. We do not think that

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[32] Law Commission *Legislation Manual – Structure and Style Guide* (May 1996), pgs 11-12.

formulation improves on the current objectives for financial policy or that it gives effect to the simplifying intent behind the in-principle decision.

Overview of our submissions on this part

230. We agree that financial stability is the more modern and widely used term, and in that sense we support its use. Because efficiency considerations are integral to its meaning, it also seems to be a perfect swap for the existing 'soundness and efficiency' objective.

231. The issue, however, is that it has no clear definition. In seeking to resolve this, the Paper has put forward for consideration a complex array of secondary objectives and "regulatory principles", detracting from clarity and obscuring the focus on the core prudential objective.

232. More importantly, the objectives have been formulated in a prescriptive way that would narrowly circumscribe the dimensions of efficiency otherwise inherent in the concept of financial stability. The only recognition given in the purposes to 'positive' aspects of efficiency (i.e. those not solely focused on avoidance of crisis) are the secondary purposes in the Deposit Takers Act (**DTA**) relating to:

    (a) The need to use the Reserve Bank's regulatory resources in the most efficient and economical ways.

    (b) The need to avoid unnecessary compliance costs and ensure that any burdens imposed on the financial sector are proportionate to the benefits.

    (c) The desirability of effective competition in the market for Reserve Bank-regulated services, and the need to set regulations, where possible, in ways that facilitate effective competition in the financial system.

233. The first two of these deal with matters that represent only a small component of the impact, in either benefits or costs, that prudential policies may have on the performance of the financial system.

234. The third, competition, is the component of efficiency described by the Reserve Bank as being the most ambiguous in terms of its contribution to financial stability.[33]

235. None of them attempts to incorporate in the purposes any of the three key components of efficiency – allocative, technical and dynamic – identified by the Reserve Bank as being most relevant to financial policy or (which is particularly relevant to the over-arching objective in s 1A) the performance of the financial system in contributing to "*economic development and prosperity*".[34]

236. In effect, the efficiency objective – in the sense that term is generally understood and which is most significant in the context of prudential policy – has been jettisoned without any satisfactory explanation.

237. While the precise dimensions of efficiency in economic theory may be difficult, that does not mean it is not important. As noted by the Reserve Bank, efficiency is ultimately the yardstick for assessing how well the financial system is performing the functions that are essential in contributing to economic development and prosperity. This is conceptually straightforward, and accords with the ordinary, and dictionary, meaning of efficiency as something "*effective, producing the desired result with the minimum wasted effort*".

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[33] Refer Bloor and Hunt, footnote 25, at pgs 31-32.

[34] Refer Bloor and Hunt, footnote 25, at pgs 28-30.

238. In addition, the endeavour to resolve definitional or analytical problems *ex ante* in an indirect way through multiple specific purpose provisions is likely to create problems far greater than those it is trying to solve. For example, it would result in a mismatch between the Act's objectives and the way that the Reserve Bank is required to, and does, prepare the Regulatory Impact Assessments required under s 162AB of the RBNZ Act for prudential policies.

239. Consistent with the in-principle decision, appropriate recognition to the elements of efficiency that are most relevant to prudential policy could be undertaken by defining or otherwise clarifying the meaning of financial stability within the purpose clause, adopting an approach similar to that for the key 'sustainable management' objective in the Resource Management Act 1991 (**RMA**). This would have the advantage of keeping the focus squarely on the core objective.

240. However, defining in any precise way the key elements of financial stability gives rise to the same challenges as defining the key elements of efficiency. In any event, as a drafting matter, this level of precision is neither necessary nor usual in the context of statutory objectives.

241. Another option, if subordination of efficiency to stability is the key driver, would be to include an immediate secondary objective to "*protect and enhance the efficiency of New Zealand's financial system*", in place of the incomplete formulations suggested in the Paper. However, this would result in an artificial and clumsy formulation, and is unnecessary because, under New Zealand law, the weighting given to dual or conjunctive objectives is for the responsible agency to determine.

242. Ultimately, the desired modernisation can be achieved if there is a simple formulation of the prudential purpose to "*protect and enhance the stability <u>and efficiency</u> of New Zealand's financial system*". This would result in objectives that are clear and readily understandable, while concisely incorporating a concept that is integral to the meaning of "financial stability" and fundamental to sound prudential policy.

243. In our submission, either of the alternatives suggested in paragraphs 239 and 241 would be an improvement on any formulation which expressly or by implication excludes or constrains the pursuit of efficiency in service of stability and in its own right (that is, in ensuring that the financial system is optimally performing the functions identified by Bloor and Hunt as key to contributing to economic development and prosperity). But they would be second best to a simple stability and efficiency objective.

244. Because, as noted previously, efficiency is integral to the adopted criterion of financial stability, this approach would be more consistent with the in-principle decision than one which removes or substantially confines efficiency considerations. For similar reasons, it is the option which best gives effect to the Act's over-arching purposes and reflects the Reserve Bank's actual policy-making and regulatory practice.

245. Finally, although of lesser significance, we submit that the Act should not contain multiple second tier objectives, and that any secondary objectives should be expressed as purposes (the '*why*') rather than directives (the '*how*'). Any relevant matters can be addressed in substantive provisions where appropriate, or in accountability documents, but should not be allowed to confuse the focus on the core prudential objective.

A suggested way forward for statutory objectives

Although we have focused on principles and policy issues rather than drafting as such, we thought it would be useful to set out some options which we think would best contribute to the overarching objectives in section 1A, together with our preferences among them. In our view, any of these options would give effect to the in-principle decision and the thinking behind it. The drafting is conceptual/indicative.

Preamble/setting

In each case the prudential objective would, as currently, sit beneath the overall objective in section 1A: "*The purpose of this Act is to promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy, by providing for the Reserve Bank of New Zealand, as the central bank, to be responsible for—"*

Option 1 – Definition consistent with IMF, taking the RMA approach:

protecting and enhancing the stability of New Zealand's financial system.

In this Act, references to ***stability*** *include:*

- *(a) protecting and enhancing the resilience of the financial system;*
- *(b) protecting and enhancing the efficiency of the financial system in:*
  - *(i) facilitating an efficient allocation of economic resources;*
  - *(ii) enabling assessment, pricing, allocation, and management of financial risks; and*
  - *(iii) continuing to perform these key functions in the event of a severe economic downturn or a disruption affecting the financial system.*

Option 2 – Incorporating efficiency as sole, or primary, secondary purpose:

protecting and enhancing the stability of New Zealand's financial system, including as [an] additional purpose[s], by:

- *(a) protecting and enhancing the efficiency of New Zealand's financial system;*
- *(b) [avoiding unnecessary compliance costs;]*
- *(c) [providing information to assist members of the public to make informed financial decisions; and]*
- *(d) [coordinating with other agencies and prudential authorities internationally to achieve the above purposes.]*

Option 3 – Modernising to stability while incorporating efficiency:

protecting and enhancing the stability <u>and efficiency</u> of New Zealand's financial system;

We prefer Option 3 because it is the most concise and readily understandable to properly incorporate a concept that is fundamental to sound prudential policy-making and in particular captures other important concepts that otherwise have to be set out separately, detracting from overall clarity and focus. Our rationale for this, including how it corresponds with the in-principle decision above, is explained more fully above.

Question 2A: What other objectives should the Reserve Bank have?

246. This question asks what *other* objectives the Reserve Bank should have, in view of the in-principle decision to adopt financial stability as the single high-level policy objective. However, because – as noted above – this term has is no clear definition, there is a significant ambiguity about the meaning intended by the in-

principle decision that would need to be resolved before considering what further objectives should be added to it.

247. The Paper does not seek to resolve this question directly, for example by offering a definition of financial stability. This is understandable in the acknowledged absence of a settled, widely-accepted definition of that term. IMF has defined this concept as follows:[35]

> *Broadly, financial stability can be thought of in terms of the financial system's ability:*
>
> *(a) to facilitate both an efficient allocation of economic resources – both spatially and especially intertemporally – and the effectiveness of other economic processes (such as wealth accumulation, economic growth, and ultimately social prosperity);*
>
> *(b) to assess, price, allocate, and manage financial risks; and*
>
> *(c) to maintain its ability to perform these key functions – even when affected by external shocks or by a build-up of imbalances – primarily through self-corrective mechanisms.*

248. It is clear from this that efficiency is regarded as integral to stability, including efficiency concepts that are far broader than the very narrow formulations advanced in the Paper. The components of efficiency highlighted align with those identified by the Reserve Bank as being the most relevant in analysing financial system efficiency under its current mandate. Equally it is clear that, if a statutory definition were adopted on this basis that is both precise and readily understandable, it would entail complexity in relation to a term that has a well-understood ordinary meaning, even if the technical economic aspects of it are not readily susceptible to precise expression.

249. While it may be possible in principle to reflect relevant efficiency concepts inherent in the meaning of financial stability by appropriately worded secondary objectives, this is not the approach taken in the Paper. Rather, as noted above, the statutory objectives put forward include only a narrowly circumscribed subset of the normal components of efficiency, and none of those singled out by either the Reserve Bank or the IMF as being most significant to the conduct of financial policy or the performance of the financial system.

250. As such, the formulation of the core financial stability objective omits one of its most important elements. At the same time, the prescriptive (but incomplete) proxies for efficiency that are included result in a more complex framework, obscuring the core objective.

251. The question whether the above outcome is justified depends on the validity of the criticisms levelled at the efficiency element of the existing formulation, and whether a single 'financial stability' criterion performs any better according to the same analysis. We address those questions below.

Rationale given for subordinating and circumscribing efficiency

252. As noted previously, the key issue identified in the first Phase 2 paper, at pg 24, is that "*the Reserve Bank and stakeholders have struggled to interpret the Reserve Bank's efficiency objective*". Chapter 2 of Paper 2a elaborates on this concern, and contrasts this with a financial stability objective. The key points are noted below with our comments.

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35 Refer Garry J Schinasi "Defining Financial Stability" (IMF Working Paper WP/04/187, October 2004), at pg 8.

253. ***Meaning of efficiency***

254. We query the suggestion that the Reserve Bank struggles to interpret the efficiency component of its mandate. The analysis of Bloor and Hunt already referred to presents a clear expression of the Reserve Bank's approach to financial system efficiency and the analysis that it undertakes to ensure that the financial system is functioning properly.

255. Policy papers routinely make reference to efficiency and cost-benefit considerations in a way that indicates that they are clearly understood and applied. To take a recent example, the Reserve Bank's macroprudential policy framework paper, which notes that: "*As with all prudential policy decisions, the Reserve Bank takes efficiency costs into account … [and] consults on its cost benefit analysis prior to using the instruments*."[36]

256. Other public statements about the concept are also clear and consistent. For example, in its May 2014 Financial Stability Report, the Reserve Bank noted:

> *An efficient financial system is one that enables economic resources to be allocated to their best use across time and space without imposing unnecessary costs (or 'rents') on households and businesses. … [A]n inefficient financial system can hamper economic prosperity by imposing unnecessary costs on households and businesses … and misallocating resources.*

257. Similarly, Deputy Governor Geoff Bascand recently gave the following interpretation:[37]

> *The efficiency goal means different things in different contexts: we minimise compliance costs; we support innovation and operate a regime that is open to new entrants; we avoid creating unnecessary frictions in the supply of credit to the economy; and we ensure that financial resources are allocated in a productive (and not harmful) way to maximise long term economic growth.*

258. ***Absence of precise definition***

259. A key criticism of efficiency is that it is incapable of precise definition, but it is acknowledged in the Paper that the same issues apply to financial stability. In any event, abstract terms, such as "efficiency" or "fairness", are common in statutory purpose statements, which by their nature are overall guides as to why the law has been enacted, and do not need to be (and in our submission should not be) drafted with the sort of detail and specificity associated with substantive functional provisions.

260. ***Clarity and focus***

261. A suggested benefit of financial stability is that it provides the clarity that efficiency lacks. The Paper (pg 18) suggests the financial stability goal has the benefit of:

> *providing a more relevant, focused, and clear goal to guide the Reserve Bank's behaviour and enable the public to hold it to account for its actions.*

262. At the same time, it is conceded that stability lacks a clear definition such that the objective "*is not enough on its own to guide the Reserve Bank*" (also at pg 18). These two statements are incompatible.

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36 Piers Ovenden "Macroprudential Policy Framework – Mitigating the likelihood and severity of boom-best cycles" (Reserve Bank, 22 May 2019).

37 From a speech entitled "Financial stability – risky, safe, or just right?" delivered to the UBS Australasia Conference in Sydney (13 November 2018).

263. ***Accountability***

264. If the very specific purpose provisions proposed in response to the above issue are meant to ground public accountability, the questions would be "*which one(s)*" and "*to what extent*"? There would be no straightforward way to resolve these questions and it is not superior to accountability for clear concepts. As discussed under Question 2.C, it is also not the point of purpose provisions, and is better addressed in accountability documents, including transparent policy development and analysis through the Financial Stability Reports.

265. ***Weighting***

266. It is argued that inclusion of a single financial stability objective would remove the "*ambiguity over how to weight objectives*" (pg 3). At the same time, financial stability is described as a "*multi-dimensional objective that incorporates a number of intermediate goals*" (pg 17). These statements are contradictory. In addition, addressing the lack of clarity in the meaning of financial stability by supplementing it with a multiplicity of secondary objectives would significantly exacerbate issues about weighting, compared with those arising under the current two-part formulation.

267. ***Impetus for inefficient interventions***

268. It is suggested that the concept of allocative efficiency might impel the Reserve Bank to undertake interventions that substitute for a market-based credit allocation. That is plainly incorrect, as evidenced by the fact that the Reserve Bank currently does not interpret its mandate in this way.

269. In any event, the criticisms levelled in the Paper at efficiency would apply equally to financial stability, which (like efficiency) is described as a 'multi-dimensional' objective. The suggested answer to this of utilising very precise and narrow formulations ignores both the aims behind purpose provision and the part they play within the statutory framework. For example, the FMCA objectives include "fairness" (and efficiency) and there is no suggestion that the FMA is incapable of understanding or pursuing that objective.

270. This is acknowledged in the Paper, and is sought to be resolved by the creation of an array of prescriptively defined secondary objectives. This is not appropriate for prudential policy-making, which inherently involves exercise of expert judgements balancing multiple considerations, and in which best practice is continuously evolving.

Other issues with the approach taken to the statutory objectives

271. To address the issues with the single "financial stability" goal, the Paper sets out a complex hierarchy of statutory objectives, potentially spread across two Acts. This has resulted in the current two-part statutory mandate for financial policy and prudential supervision being replaced with a multi-layered set, comprising up to *twenty-six* separate statutory objectives in support of the overall purpose in section 1A, plus provision for matters that may be specified in policy remits.

272. Whatever its benefits, baking nuanced prudential principles into statute is also at the expense of flexibility. The Reserve Bank must be allowed to weigh relevant factors. Its approach in doing so can be informed by existing accountability provisions and documents (notably the Statement of Intent, Annual Report and Financial Stability Reports), as may be enhanced by additional arrangements introduced under the Phase 2 reforms.

273. None of these dilemmas arise if the drafters choose words with well-understood meanings, set out concisely.

274. Without 'efficiency', there is nothing to anchor 'stability' (or soundness). It would be consistent, for example, with a banking system 100% funded by equity, which

would also be a world without deposits. Although this is an extreme example to illustrate the point, none of the narrow formulations of efficiency components in regulatory principles (1) to (3) for the DTA would require a different conclusion or provide any relevant guidance.

275. Because efficiency in its ordinary sense is largely synonymous with effectiveness, it is also inaccurate to suggest that soundness (or stability) and efficiency inevitably involve trade-offs. In most cases those components of the mandate will be complementary. To the extent that efficiency considerations arise in a financial stability context, they direct that stability should be achieved in a way that provides the greatest net benefit and so are shorthand for 'good policy'. There is nothing novel in this suggestion, which reflects the way that the Reserve Bank in fact thinks about and presents its policy initiatives, and is the basis on which they are debated.

276. The absence of a general efficiency criterion would also mean that there is no underpinning within the purpose provisions for the analysis that would conventionally underlie the Regulatory Impact Assessment required under s 162AB RBNZ Act for prudential policies. Cost-benefit analysis is the basis for policy development, both in New Zealand and internationally.[38]

Issues do not arise under statutory interpretation principles

277. The interpretative issues discussed in the Paper are focused on particular components of the meaning of efficiency in economic theory. This issue does not arise under conventional principles of statutory interpretation, which:

(a) Begins with the ordinary meaning – how would most people understand the meaning of the words? In this sense, efficiency is readily understood as meaning effective, without waste.

(b) Is coloured by context, and in particular with other words used in association (here, soundness/stability).[39] As such, in the current formulation, "efficiency" would be defined by reference to "soundness", and vice versa.

(c) Where there are a number of parts, involves an exercise of judgement (including as to the relevant weight to be given to each part), for which latitude is provided in law.[40]

278. In relation to the last point, although efficiency has a number of component elements which are understood and analysed in economic theory, there is nothing *requiring* the Reserve Bank to elevate any one of these over another – it does not do so at the moment in relation to an objective that has been in place for more than a generation. It involves aiming for policy interventions that have a net benefit to the economy and society.

279. As a matter of law, interpretation is made more challenging where an Act contains multiple, potentially conflicting purposes. This is less of an issue where a word has an ordinary meaning which is generally understood, because this is the cornerstone of statutory interpretation.

Conclusion

280. The arguments supporting omission of any concept around efficiency in the generally understood sense are unconvincing, and are outweighed by the

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[38] Refer Reserve Bank consultation paper "*Capital Review Paper 4: How much capital is enough?*" (14 December 2018) and the various international studies cited therein.

[39] *A-G v HRH Prince Ernest Augustus of Hanover* [1957] AC 436 at 461 per Viscount Simonds.

[40] *Vodafone New Zealand Ltd v Telecom New Zealand Ltd* [2011] NZSC 138, [2012] 3 NZLR 153.

consequences of that omission. By formulating "stability" in a way that excludes these characteristics, it implies that efficiency considerations are no longer relevant in the formulation and performance of financial policy. This seems to contradict the over-arching objective in section 1A, which came into effect in March 2019.

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

281. Climate change obligations are important but can be more flexible and dynamic if conferred less formally than in primary legislation (i.e. considerations). This means they can be updated in the future as it evolves, not locked in and less agile. Climate change should be informed by Government bodies and councils already tasked with informing Government, to avoid duplication and potentially conflicting views. This would also avoid any implication that the Reserve Bank is impelled to active interventions which are a substitute for a market-based credit allocation and may conflict with the core financial stability objective (addressing concerns similar to those noted at pg 17 of the Paper).

282. Another potential issue with including such purposes is where they leave the Reserve Bank's role in relation to other desirable objectives – for example the "governance" and "social" aspects of ESG.

283. With these considerations in mind, we agree with the approach taken by the Reserve Bank in its Climate Change Strategy, which takes place under its existing statutory mandate and has been further affirmed by the amended over-arching objectives in s 1A RBNZ Act.

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

284. The approach taken in the Paper to the purpose provisions is unconventional, in organising the objectives into sets of directives (indicated by the words "by", "shall", and "must"), and would not comply with legislative drafting instructions.[41] These state that:

> *the purpose clause explains **why** the law is being enacted; the remainder of the text shows **how** this purpose will be implemented. … [Drafters must] Ensure that the purpose provision is not in effect saying how the purposes are to be implemented.*
>
> [Emphasis in original]

285. The approach taken asks the purpose provisions to do too much, failing to sufficiently recognise the hierarchy in the policy formulation and accountability in a legislative context:

    (a) **Purposes:** Explain *why* the law is being enacted. Concise and high level.

    (b) **Substantive provisions:** Shows *how* the purpose will be implemented. Specific, detailed.

    (c) **Policy-making:** Policy development is undertaken by the agency in accordance with the purposes and the substantive provisions, informed and shaped by:

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41 Law Commission *Legislation Manual – Structure and Style Guide* (May 1996), pgs 11-12.

(i) ongoing engagement with the responsible Minister (e.g., through the Statement of Intent (ss 162AA, 162A-162E));

(ii) coordination with other Ministries or agencies (s 67B (Trans-Tasman Cooperation) is currently the only example of this);

(iii) periodic input from the public and industry (e.g. consultations, Financial Stability Reports prepared under s 165A); and

(iv) Government policy comments (s 162C) and formal directions (s 68B).

(d) **Transparency and accountability:** These elements are addressed in the substantive provisions, including (currently):

(i) the requirement for "accountability documents", including a Statement of Intent and Financial Stability Reports, in Part 6 of the RBNZ Act;

(ii) the obligation to report periodically, by way of annual reports, to Parliament and the public on the performance of the prudential function (s 163); and

(iii) extra-legislative monitoring and accountability arrangements, including scrutiny through the budgetary process (by way of 5-year funding agreements (s 159)) and periodic IMF financial system assessments.

286. The formulation of the purposes proposed in Chapter 2 of Paper 2a confuses these by seeking to provide in the purpose provisions for matters better addressed in other parts of the legislative and administrative framework. This is not necessary, nor is it desirable since it results in a very lengthy and complex objective set, obscuring the core underlying purposes of this part of the Reserve Bank's mandate.

287. The extensive and precise nature of the proposed objectives set would also be at the expense of their durability through time – a particularly important attribute for financial policy – and their adaptability to a range of, or changing, circumstances. The latter is essential to the effective conduct of a prudential mandate, because of the judgements and trade-offs that are inherent in it.

Multiplicity of objectives

288. The approach of including a complex array of objectives (the Paper is consulting on 26 of these in total) would also be out of step with the normal legislative approach in New Zealand. In legislation enacted, or substantially amended, during the period that purpose provisions became a key part of legislative practice, the only statute we could identify with an analogous approach is the Oranga Tamariki Act 1989 (as amended in 2019). But that Act differs in the important sense that it does not contain directive ('how') provisions – we could find no other New Zealand statute which employs the purpose provisions in this manner.

Hierarchy of objectives

289. The Paper proposes a hierarchy of objectives, split by the degree to which they are mandatory or are things that must be 'taken into account'. As noted previously, there is an underlying issue that these are structured as "how" provisions, not "why" provisions, it is possible to arrange purposes into a hierarchy (typically done by setting out the "main purposes" and "additional purposes").

290. Before looking at the specific objectives (addressed under Question 2F), there is an overall question about whether this approach is the correct one. Issues to consider include that it:

(a) Creates additional complexity, potentially obscuring the core aims (noting that the purposes are currently encapsulated in two words: “sound” and “efficient”).

(b) Could give rise to questions about the relative part to be played by things that are not mentioned and may also give rise to the impression that the stipulated secondary objectives are things that must be pursued in their own right. In particular, including as mandatory considerations some, but not all, of the components of the prudential toolkit may create doubts whether the particular matters called out are intended to be elevated in focus or importance above other tools or approaches that contribute to financial stability.

(c) Can undermine, rather than contribute to, public accountability. Where there are up to 26 separate and prescriptive objectives, the question would arise which particular one(s) the supervisor should be accountable for in a given context, and to what extent? This is particularly challenging in a financial policy context, given the interconnected and complementary nature of prudential tools and approaches and the inherent balancing exercise involved in applying them.

291. There are a number of statutes that split into main and subsidiary purposes (e.g. the FMCA, as noted further below, and the Parliamentary Privilege Act 2014). Where this is done, the formulation is a straightforward division into ‘main purposes’ and ‘additional purposes’, rather than a complex hierarchy of directives and considerations. More precise details about how the Reserve Bank should carry out its functions should be reserved to the substantive functional provisions of the Act.

292. There is also precedent for using purpose provisions to define or clarify key terms used, particularly where (as here) they lie at the heart of the Act – a notable example being the Resource Management Act 1991 (**RMA**), which is based on the concept of “sustainable management”.

Relevant examples from other statutes

293. Guidance can be drawn from the FMCA, which uses a hierarchy of purposes and also purposes related to specific parts of the Act, and the RMA, which operates on the basis of a central concept, which is clarified concisely in the accompanying test. We set out these examples below.

294. **FMCA**

295. The purpose clauses in the FMCA are:

> ***3 Main purposes***
>
> *The main purposes of this Act are to—*
>
> *(a) promote the confident and informed participation of businesses, investors, and consumers in the financial markets; and*
>
> *(b) promote and facilitate the development of fair, efficient, and transparent financial markets.*
>
> ***4 Additional purposes***
>
> *This Act has the following additional purposes:*

> (a) *to provide for timely, accurate, and understandable information to be provided to persons to assist those persons to make decisions relating to financial products or the provision of financial services:*
>
> (b) *to ensure that appropriate governance arrangements apply to financial products and certain financial services that allow for effective monitoring and reduce governance risks:*
>
> (c) *to avoid unnecessary compliance costs:*
>
> (d) *to promote innovation and flexibility in the financial markets.*

296. Section 229 of the FMCA sets out additional objectives specific to the part of the Act relating to dealing in financial products on markets.

297. Key points to note include that the FMCA statutory objectives are:

   (a) expressed simply as purposes, divided into "main" and "additional", rather than as mandatory considerations;

   (b) use abstract words, such as "fairness" and "efficiency"; and

   (c) relatively concise, despite the vast coverage of the FMCA.

298. **RMA**

299. The purpose clause in the RMA is as follows:

> ***5 Purpose***
>
> (1) *The purpose of this Act is to promote the sustainable management of natural and physical resources.*
>
> (2) *In this Act, sustainable management means managing the use, development, and protection of natural and physical resources in a way, or at a rate, which enables people and communities to provide for their social, economic, and cultural wellbeing and for their health and safety while—*
>
> > (a) *Sustaining the potential of natural and physical resources (excluding minerals) to meet the reasonably foreseeable needs of future generations; and*
> >
> > (b) *Safeguarding the life-supporting capacity of air, water, soil, and ecosystems; and*
> >
> > (c) *Avoiding, remedying, or mitigating any adverse effects of activities on the environment.*

300. Like the FMCA, this is clear and concise relative to the scope and complexity of the Act. Most significantly, the Act is guided by a core term – sustainable management – the meaning of which is clarified by three further high level concepts. Subject to our comments below, the same approach could be taken to the similarly central concept of financial stability.

Take-outs from the statutory examples

301. In our submission, each of the above examples provides a useful precedent to a how the statutory objectives for the prudential function should be drafted:

   (a) the RMA, where there is a core term which requires a more precise definition in order to perform the aim stipulated in the Paper of providing a "*clear goal to guide the Reserve Bank's behaviour*"; and

   (b) the FMCA, where it is thought useful to set out secondary objectives.

302. In our submission, however, the key matter in relation to prudential policy is giving proper recognition to the importance of efficiency in contributing to the over-arching statutory purpose. This could be achieved more concisely by providing that the objectives are to "*protect and enhance the stability <u>and efficiency</u> of New Zealand's financial system*".

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

303. No, we submit that the purposes should be set out transparently in the legislation, in a way that is sufficiently principles-based to be durable and adaptable.

304. The existing "soundness and efficiency" criteria have these features, guiding New Zealand's prudential framework during a thirty-year period which began the year after the first Basel Capital Accord and encompassed the Global Financial Crisis.

305. For the reasons given under Questions 2.A and 2.F, we do not think the objectives put forward in the Paper would have those characteristics. Having provision for remits *as to purpose* would not eliminate the issues with the proposed objective set, and may exacerbate them.

306. With reference to the matters specified as examples for possible content of a remit – a "risk appetite statement", Government economic priorities, and macro-prudential policy – we think there may be merit in an enhanced level of engagement on the first and third of those matters. The appropriate platform for doing so is likely to be via a robust accountability framework building on the existing provisions of Part 6 of the RBNZ Act. This could be supplemented by a remit if circumstances require it (such as a desire for greater specificity or formality), but the effect should not be to establish new purposes other than through a legislative process, since it is fundamental to the scheme of the Act.

307. With respect to the Government economic priorities (examples given including capital market development and green finance), the new Act will set out "financial stability" as the key Government economic priority *for the prudential function.* It is essential that the Reserve Bank continues to prioritise pursuing that objective. We do not think there is a workable analogy to be drawn here to the remits (formerly Policy Target Agreements) contemplated for monetary policy, because of the different characteristics of those mandates.

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

308. This is primarily a question of legislative design. The key policy issue will be to avoid duplication and conflict, particularly of objectives.

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

309. As noted in our answers to the previous Questions in this part, we submit that the objectives should:

    (a) be clear, concise and readily understandable to the public; and

    (b) avoid being directive as to particular courses of action and policies that should be carried out by the Reserve Bank in pursuing the main objective in section 1A.

310. As such, we disagree with the approach of having an extensive and highly specific array of secondary objectives.

311. We have also argued that it is inappropriate as a general matter to place in a purpose clause provisions that are directive as to particular ways the Reserve Bank should (or must not) pursue the statutory purpose. The place for such directives or guidance is in the substantive functional provisions, as may be supplemented by accountability documents or remits.

312. As a general matter, it is preferable for prudential policies to be subject to development and discussion in Financial Stability Reports and other publications, and subject to the other accountability mechanisms in Part 6 of the Act, as is

currently the case. We do not see a justification for elevating such policies into the core purposes of the Act. If anything, such policies should be set out in substantive provisions of the Act, but this would also detract from their flexibility and in any event they are not usually susceptible to the sort of precision required for statutory language, beyond high level principles such as stability, soundness and efficiency.

313. Subject to those comments, we set out below some high level comments on the specific objectives put forward in the Phase 2a paper.

Reserve Bank Act purposes

314. **Monetary policy:** This part was amended in the Phase 1 reforms and it is unclear why it would be revisited so soon after that policy process or whether the changes suggested are necessary. The substantive changes are:

(a) to make specific reference to the MPC, which is unnecessary because the MPC forms part of the Reserve Bank; and

(b) the requirement to "have regard to" (a) *financial stability*, which is directive as to a matter which should form part of the Reserve Bank's judgement and accountability; and (b) a *remit*, which is redundant given the existing provisions of section 10. In addition, neither of these is a 'purpose'.

315. **Prudential policy:** We presume that, consistent with the existing section 1A, the prudential purposes will be set out beneath the primary objective, so will begin with the words "formulating and implementing" (and submit that it should be). We do not agree with any of the four sub-paragraphs under "including by" or, for reasons already given, with the directions as to what the Reserve Bank must "have regard to". In relation to the various inclusions, we note:

(a) They would result in the prudential function (which itself is a subdivision of the overall purpose in section 1A) being guided by up to a further *twelve* subsidiary purposes under the DTA, which is confusing and could create the scope for multiple conflicts and ambiguities.

(b) As discussed previously, to the extent that the concept of "financial stability" needs to be unpacked, this should be done in a similar way to the clarification of the core purpose term "sustainable management" in the Resource Management Act 1991.

(c) The monetary-prudential policy dynamic is a complex matter that should not be addressed in purpose provisions.[42]

316. **Immediate sub-objectives:** In relation to the particular subsidiary objectives proposed:

(a) *Enhancing "financial resilience"* is a synonym for "financial stability" which adds no further clarity to the term.

(b) *Enhancing the resilience of regulated firms* is micro-prudential regulation, suggesting a 'zero failure' doctrine, which then must be counteracted by prudential purpose (6) in the DTA. The net effect of these provisions is to create an internal contradiction, which conveys no

[42] There is a large and evolving literature on this question. Refer for example Ashley Dunstan "The Interaction between Monetary and Macroeconomic Policy" (RBNZ Bulletin, Vol 77, No. 2, June 2014), Misa Tanaka "How Do Bank Capital and Capital Adequacy Regulation Affect the Monetary Transmission Mechanism?" (CESIFO Working Paper No. 799, July 2002), and Stephen G. Cecchetti "Monetary, prudential and fiscal policy: how much coordination is needed?" (November 2016).

clear meaning, tends to obscure or disaffirm the market discipline pillar, and fills no gap.[43]

(c) *Mitigating excess variability in the financial cycle*: This is unnecessary since mitigating such variability is an implication of the term "stability" under its ordinary meaning. If it is singled out, and other key components of the prudential toolkit are not (for example, capital, liquidity and stable funding requirements), it would create the impression that time-varying or state-varying interventions are the preferred approach, detracting from the Reserve Bank's flexibility and accountability. This is particularly relevant given that time-varying tools are relatively new and untested, and no consensus has yet emerged on their efficacy relative to, or in combination with, other tools.

(d) *Enhancing public confidence*: This would involve revival of a superseded term[44] and no clear rationale is given in the discussion for this policy reversal (refer A.4, pg 21, of Consultation Paper 2a). It is best viewed a product of other purposes (stability), of substantive provisions that are clearer in their intent and operation (for example as to transparency and accountability), or of the Reserve Bank's performance more generally.

317. **Transparency; Coordination:** This covers matters included elsewhere in the substantive legislation (refer for example Part 6 (*Financial and Accountability Matters*) and s 68A (*Trans-Tasman Cooperation*)). It would be useful to include this concept, but expressed as a purpose.

Deposit Takers Act (DTA) purposes

318. **Structure and approach:** As noted in more detail under Question 2.D, the matters suggested as "regulatory principles" for the DTA are not expressed as purposes but as directives as to principles the Reserve Bank "must take into account". We know of no other statute which takes this approach, which contravenes the core principle in the drafting of purpose provisions that they explain *why* the law is being enacted, with the question of *how* the purposes will be implemented addressed in the subsequent provisions of the Act.[45]

319. This departure from normal practice is more than just a question of style, but results in narrowly drafted and complex provisions that obscure the significant policy issues the Act is addressing. The resulting items, while they may work as accountability directives (for example in the context of a Statement of Intent or remit), do not fulfil the role of purposes. Because they are not are not clear, concise or readily understandable, they do not support accountability *to the public*. They are also directive in nature, reducing the scope of discretion and judgement that is essential to effective prudential policy-making and supervision.

320. **Treatment of efficiency:** The attempt in purposes (1) to (3) of the proposed DTA to unpack, and restrict, the consideration of efficiency is unnecessary and undesirable, for the reasons given under Question 2.A above. It leaves the implication that efficiency in its normal sense is no longer relevant in formulating and implementing financial policy. That would contradict the over-arching

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43 Supervision of particular institutions is self-evidently within scope of the Reserve Bank's powers and there was no suggestion, for example, that the culture and conduct review undertaken alongside the FMA was outside the Reserve Bank's prudential remit. Equally, the failure of a LDT would be the responsibility of the Reserve Bank as resolution authority, as would the question about whether any such failure would imperil financial stability, and what to do about that (within the parameters of the crisis management regime).

44 Refer section 38J Reserve Bank of New Zealand Amendment Act 1986.

45 Law Commission *Legislation Manual – Structure and Style Guide* (May 1996), pg 11.

purpose in section 1A of the RBNZ Act to "*contribute to a sustainable and productive economy*". This would also be at odds with the meaning given to "financial stability" in international prudential practice and literature, which emphasises the role performed by financial systems in underpinning a productive and efficient economy.[46]

321. In relation to the sub-components of the normal concept of efficiency, we comment as follows:

(a) **Regulator efficiency:** It is unclear why the question of how the Reserve Bank employs its resources should be elevated to a core purpose of the Act, particularly when those resources are modest relative to the size of the financial system and its importance in underpinning economic development and prosperity (in our submission, too modest – refer under Question 7.A). The key issue is efficiency *of the financial system* and the impact of prudential policies on the performance of that system and the broader economy. This is recognised by the Reserve Bank:

> An efficient financial system is one that enables economic resources to be allocated to their best use across time and space without imposing unnecessary costs (or 'rents') on households and businesses. … [A]n inefficient financial system can hamper economic prosperity by imposing unnecessary costs on households and businesses … and misallocating resources.

We submit that this is a matter that should be (and currently is) addressed in the accountability provisions of the Act. The purposes of the Act should be focused on efficiency in its broader sense, as is implicit in the primary objective in s 1A and in the accepted meaning internationally of "stability".

(b) **Compliance costs:** Regulatory efficiency, in the sense of minimising unnecessary compliance costs, is a worthwhile *secondary* goal, so long as the primary meaning of efficiency is placed above it in the hierarchy.

(c) **Desirability of competition:** The decision about this should be informed by the previous analysis undertaken by the Reserve Bank as to the relationship between competition and financial stability.[47] Those issues are less pressing where competition considerations are remain as part of a broader consideration of efficiency.

322. **Informing the public:** We agree this is a useful subsidiary objective and is consistent with existing law and policy initiatives (such as the dashboard).

323. **No 'zero failure' doctrine:** There may be merit in this, but the relationship with public confidence purposes (if they are to be included) creates difficulties.

324. **High standards of finance and governance:** These matters are addressed primarily in the FMCA and the recent culture and conduct review indicates there is no gap in the Reserve Bank's existing mandate.

325. **Fair treatment:** This provision appears to contain two distinct parts – a purpose around "level playing field" and the "need to explain regulatory actions clearly" – whose relationship is unclear. Although the first of these principles is unexceptionable at first sight, it is unclear how it may impact on operational or

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[46] Refer for example Garry J Schinasi "Defining Financial Stability" (IMF Working Paper WP/04/187, October 2004); Asli Demirgüç-Kunt and Ross Levine "Finance, Financial Sector Policies, and Long Run Growth" (Commission on Growth and Development Working Paper No. 11, 2008); and James R Barth, Gerard Caprio Jr, and Ross Levine "Financial Regulation and Performance: Cross-Country Evidence" (unpublished working paper, 1998).

[47] Refer Bloor and Hunt, footnote 25, at pgs 31-32.

other decisions taken in respect of particular institutions and not to the market at large (whether under individual conditions or registration or otherwise), particularly if a more intensive supervisory regime is to be mandated as suggested in another part of the Paper.

326. **Crisis management purposes:** As previously noted, we submit these principles should be expressed as purposes, not in the form of directives. We would expect the particular purposes to be expressed more concisely, particularly as some may be regarded as obscure (e.g. preventing contagion), internally conflicting (e.g. the relationship between depositor protection and market discipline is difficult to resolve in the context of high level purpose provisions), or less relevant in a prudential context (e.g. client assets and funds are dealt with in the FMCA). Ultimately, crisis management – like all other parts of the prudential framework – is intended to support financial stability.

Chapter 3: How should the Reserve Bank be governed?

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

327. The in-principle decision by the Minister of Finance that a Financial Policy Committee (FPC) will not be established to assist the Reserve Bank Board on prudential matters places added importance on ensuring that an effective governance board is created for the Reserve Bank given the broad range of governance, accountability and oversight functions that the board will have.

328. Key factors in establishing a successful governance board will be the need for clear independence from the Minister, Treasury and Reserve Bank management along with the need to have a broad range of skill sets to be able to effectively cover the board's responsibilities. These would be in line with the Basel Committee on Banking Supervision's Core Principles for Effective Banking Supervision.[48] In addition, the Board will need to be able to successfully challenge, and exercise accountability powers in relation to, the Governor, given the significant level of delegated authority that the Governor will have in practice.

329. The ability for the Board to be able to demonstrate that it has such powers will be crucial to stakeholders and industry having confidence in the Reserve Bank, and it being respected as an effective regulator. A sound model is provided by the FMA governance arrangements. We note that The New Zealand Initiative survey ranked the FMA as much more effective than the Reserve Bank and the Commerce Commission. This can be attributed in no-small-part to the strong, and more traditionally corporate style, governance arrangements. This helps to provide more effective checks and balances on management, leading to better decision making.[49]

[48] September 2012 – See Principle 2 that provides the supervisor needs to possess operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources

[49] See *Who Guards the Guards - Regulatory Governance in New Zealand* by Roger Partridge and Amy Thomasson, The New Zealand Initiative, 13 April 2018

Question 3B: What is the appropriate degree of delegation from the board to the Governor? Are there any decisions that should be reserved for the board? AND 3.F Are there any aspects of the board's operation would benefit from legislative clarity or guidance?

330. Without there being a FPC, it will be important that there are adequate checks and balances put in place to ensure that the Board has sufficient oversight and input into key in-principle decisions which would otherwise be made by the FPC.

331. Accordingly, the broad direction of the prudential framework, including material policy decisions in respect of its design, should be overseen by the Board. In addition, key decisions in relation to the development of resolution powers, including the crisis management regime, and the commencement of substantial enforcement proceedings should also fall within the range of decisions that are reserved to the Board.

332. To ensure that the governance structure of the Board can adapt over time, it is essential that the allocation of reserved powers to the Board are not locked into a legislative framework. Rather the Board should have the ability, through the development of charters and delegated policy frameworks, to design the allocation of delegations to the Governor in a way that allows it to take account of the expertise, skill-sets and competencies of the Board from time to time. Moreover, the Board needs to be able to set these without undue interference from the Minister or Treasury or, given the central position that the Governor as Chief Executive will play within the organisation, the Governor.[50]

333. In addition, such charters and delegated policy frameworks will need to be publicly available, so as to enhance the transparency of the Board's responsibilities and its dealings with the Governor and the management of the Reserve Bank.

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

334. We support the in-principle decision by the Minister that the Treasury, as the Minister's principal policy adviser, should assume the role of administering the RBNZ Act.

335. In our view this a cornerstone of the new accountability arrangements and of ensuring that prudential policy is properly aligned with broader economic policy so as to contribute to the RBNZ Act's new objectives to "*promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy*" (see section 1A RBNZ Act).

336. We agree with the Review Team that this role should be something more than an administrative function. It should also involve monitoring the Reserve Bank's "*strategic direction, its contribution to the Government's goals for the sector, and its performance against its statutory objectives*".[51] In our view, such a role is implicit in the existing accountability arrangements in Part 6 of the RBNZ Act.

337. However, in supporting the in-principle decision, we note that, in order for Treasury to be able to carry out its monitoring role effectively, Treasury will need to be more actively engaged in its relationship with the Reserve Bank than it is at the moment. The establishment, and on-going maintenance, of a good

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[50] In this context we note the recommendation in the 2017 IMF FSAP that there is a need to and clarify the scope for government to unduly interfere in the responsibilities and routine tasks of the Reserve Bank – Principle 2 – Recommended Actions on Page 70

[51] Consultation Paper 2A – page 52

relationship between the two will require continual focus on the relationship. This will require further resourcing for the Treasury with appropriate/relevant expertise. This will need to be factored into the broader resourcing question that is raised in Chapter 7 of Consultation Paper 2b.

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

338. Of the three proposed Crown entity frameworks suggested in the Consultation Paper, the independent Crown entity structure would seem to be the best suited for the Reserve Bank. The independent Crown entity framework provides the flexibility to accommodate the unique features of the Reserve Bank, especially the degree of independence that it requires in relation to prudential matters, both in terms of limiting the level of direction from the Minister and the need for the Board to be an effective oversight body.

339. In this regard we note that, through the requirement that any direction powers of the responsible Minister need to be specifically set out in the relevant establishment legislation, the independent Crown entity model ensures that there is clear visibility of the extent to which the Minister can be directly involved in how the Reserve Bank operates, whether in relation to specific activities (e.g. directions in the context of crisis management or the deregistration of a bank), or more generally in relation to financial policy remits.[52]

340. Relevantly, we note that the FMA is an independent Crown entity. This would seem to be a useful base from which to develop the Reserve Bank's new governance structure, especially given the level of satisfaction among stakeholders of the effectiveness of that organisation and the relationship between the Board, Chairperson and CEO.[53]

Question 3E: Arrangements for the new governance board

341. In order to ensure the full independence of the Board, we consider that the Board should only comprise, or substantially only comprise, of non-executive members, with the Governor being the only executive member on the Board.

342. As already identified, it is important that the members of the Board have the right mix of skills. It is, therefore, important that in establishing the criteria for appointment to the Board, this is guided by high quality analysis of the skill sets required. Members will need to have the competence and experience to not only be able to challenge the Governor, but also have the expertise to fully understand, and interrogate, analysis provided by the Reserve Bank staff. Given this, most, if not all, members will need to have experience in prudential regulation matters.

343. In addition, it is crucial that there is a sufficient number of non-executive members available to be on the various Board committees that are likely to be required to assist the Board in meeting its various responsibilities. In addition to the more standard types of standing committees, such as audit, risk and remuneration, standing committees may be required for prudential management matters and the exercise of crisis management power.

344. An over reliance on a limited number of non-executive members to act as experts on such committees may potentially undermine the effectiveness of the committee process, for example through time pressures on particular individuals.

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52 See section 105 of the Crown Entities Act 2004. We assume that the ability to provide directions to support a whole of government approach in section 107 Crown Entities Act 2004 would be excluded, given the nature of the Reserve Bank

53 See the comments in relation to The New Zealand Initiative's survey above.

Such committees will need to be equally robust in the approach in their dealings with Reserve Bank personnel, in order to avoid “capture” by management.

345. In the context of the above, it is important that Board does not have any reticence in obtaining further specialist advice for complex issues where it is felt needed, including hiring suitable external advisers or setting up an advisory committee outside the normal Board committee structure. The Board will need to have sufficient administrative resource and funding available to it to not feel constrained in its ability to use such options.

346. We question whether there would be material value in having a member of the FMA in an observer role on the Board. In particular, if the appointment of an FMA observer was to result in a reduction in the overall number of non-executive directors in order to avoid creating an unwieldy governance structure, then the preference would be that FMA involvement would be better dealt with through improved coordination at the level of the Council of Financial Regulators.

347. With regard to how members should be appointed to, and removed from, the Board, we prefer the approach of either a “double veto” (where the Minister appoints the member based on a board recommendation), or an independent nominating committee nominates the person to be appointed).[54] We consider that this approach helps to strengthen role and independence of the Board. Reflecting this, the Board should also have a significant, if not determining, role in the appointment of the Governor given the nature of the relationship that will exist between the Board and the Governor after the appointment.

348. However, if it is considered more appropriate that the Minister decides on appointments/removals of board members and/or the Governor, then concerns that this may result in a loss of Board independence could be countered by having a statutory specification of skillsets/qualifications that are required across the Board as a whole and an obligation on the Minister to formally explain how the Board reflects that composition when the Minister appoints a new board member. By way of example, we note that the Minister can only recommend persons to be board members to Guardians of New Zealand Superannuation if, in the opinion of the Minister, they have substantial experience, training and expertise in the management of financial investments.[55] The same could apply equally to the appointment of the Governor. The retention of a level of independence of the Board could be bolstered by ensuring that the terms of the appointments of Board members are sufficiently long to straddle an election cycle (for example 5 or 6 years), to reduce the possible impact of any political influence.

Chapter 4: How should the regulatory perimeter be set?

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

349. It is important that regulatory perimeter is aligned with the scope of the deposit protection scheme to prevent regulatory arbitrage, also regarding type of deposits

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[54] The nominating committee process for the appointment of board members to Guardians of New Zealand Superannuation is a useful precedent

[55] See section 55 of the New Zealand Superannuation and Retirement Income Act 2001

covered by scheme. As a practical matter, there may be challenges in this regard if the deposit protection scheme is developed on a different timeline.

350. As a more general comment, the definition of the regulatory perimeter ought to be driven by risk assessment – which activity creates risks for the stability of the financial system? As such, the regulatory perimeter should be set on a principles- and activities-basis, should be adaptable to emerging systemic risks (at a minimum, the supervisor needs to have access to data from outside the regulatory perimeter to assess those risks on an ongoing basis), and should minimise the scope and incentives for regulatory arbitrage. While there are challenges in applying prudential regulation to wholesale, non-deposit-taking models, international best practice in this regard should be monitored at the same time as market developments and emerging financial stability risks.

351. Furthermore, it should be considered whether certain supranational organisations (such as the World Bank or the European Stability Mechanism) should be explicitly carved out from the entire prudential supervision regime.

352. The revised regulatory perimeter also requires a rethink of the prohibition on restricted words currently set out in section 64 of the RBNZ Act, with banks broadly falling into three categories

(a) Banks that take retail deposits and thus fall within the regulatory perimeter – these should be able to freely call themselves “banks”, given that they will be supervised by the Reserve Bank.

(b) Banks that are active only in the wholesale area and have no contact with New Zealand retail customers – if these want to call themselves “banks”, they should have to specify that they are not covered by the New Zealand deposit protection scheme and that they are not supervised by the Reserve Bank.

(c) Banks that have sporadic contact with New Zealand retail clients – examples could include banks with account relationships with retail clients established while abroad that were maintained when the retail client returned to New Zealand – these should be able to benefit from a class authorisation under section 65 of the RBNZ Act, allowing them to use the word “bank”, along with disclosure similar to the one used for banks active in the wholesale area.

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

353. At a minimum, New Zealand should implement a regime along the lines of the Registered Financial Corporation regime in Australia, providing for periodic financial reporting. This will enhance transparency about the financial system and enable emerging financial stability or other risks outside the regulatory perimeter to at least be assessed.

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

354. Avoiding regulatory arbitrage is an important element in ensuring financial stability. Where any financier is in economic substance a deposit-taker, clearly the regime should be applied – this is simply an anti-avoidance matter. Although, as noted in our comments under Question 4.A, there are challenges in designing a prudential model suitable for wholesale-funded non-deposit taking lenders, the

Phase 2 reforms include consideration of the range of legislative instruments that may be used to support elements of the framework, and this context is one where that consideration would be appropriate.

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

355. It is important to ensure that application of macro-prudential tools (such as high LVR restrictions) is competition-neutral, to give effect to the policy intent behind macro-prudential interventions and to reduce the scope for regulatory arbitrage. There is no policy reason why these interventions should be entity-specific – the tools should apply to all entities in the business of lending, whether or not they are regulated as deposit-takers.

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

356. As set out in the Consultation Paper, a deposit protection scheme is commonly regarded as one of several key elements of an effective financial safety net, evidenced by its universal deployment in other OECD jurisdictions. If it is implemented, it needs to be aligned closely with the other elements of the net, in particular with the crisis management framework. Properly designed it can support crisis management in several areas, including by reducing the risk of public money being at risk and by making resolution more predictable and flexible. Depositors would have the guarantee that their deposits are safe up to the insured limit, thus reducing their incentive to withdraw them and instigating bank runs that could worsen a failing bank's troubles by creating a liquidity crisis.

357. In this regard, it is important to note that the whole point of a depositor protection scheme is to reduce the likelihood that it will ever be invoked, by counteracting the conditions that can create self-fulfilling bank runs.[56] This recognises that financial crises generally begin as liquidity and confidence events, and the GFC was no exception.[57] Nonetheless it is imperative that a depositor protection scheme is carefully designed, and operationally supported, against the eventuality it might need to be implemented, however remote that risk might be.

358. For the stability benefits of depositor protection to come to fruition, it is essential that depositors have the assurance that their deposits will actually be protected in a time of crisis. This will require public confidence in the scheme, including that its scope is known and understood by depositors from the outset. As with other parts of the financial safety net, international standards (in the form of the IADI Core Principles for Effective Deposit Insurance Systems (Core Principles)) can provide a useful assistance in the design of the scheme.

359. Key Core Principles that should be taken into account when designing the New Zealand deposit protection scheme include the following:

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[56] Douglas W Diamond and Philip H Dybvig "Bank Runs, Deposit Insurance, and Liquidity" (Journal of Political Economy, Vol 91, No. 3, 1983). Ultimate losses in asset terms are often comparatively small – the economic costs of financial crises arise primarily from disruptions to the flow of credit and from effects on confidence; refer Basel Committee on Banking Supervision Working Paper 37 "The costs and benefits of bank capital – a review of the literature" (June 2019).

[57] Gary B. Gorton *Misunderstanding Financial Crises: Why we don't see them coming* (Oxford University Press, 2012).

(a) the deposit protection scheme should have the objective of protecting depositors and contributing to financial stability, thus aligning with the general objective of prudential regulation;

(b) the mandate and powers of the deposit insurer should be clearly specified in legislation and it should have strong governance;

(c) the scheme should ensure public awareness by informing the public on an ongoing basis of the benefits and limitations of the scheme;

(d) the scheme should closely coordinate with the other participants of the financial safety net and, if there is a material presence of foreign banks, the deposit insurers of the relevant foreign jurisdictions. Its payouts should naturally also be incorporated in any resolution plans;

(e) the depositor protection scheme should have funds (and a funding mechanism for any shortfalls) readily available in order to enable it to make payouts promptly, with a clearly stated trigger that would trigger payouts; and

(f) the scheme should have a claim against the failed bank to recover its payouts, in accordance with the statutory creditor hierarchy. The value of such claim (and thus ultimately the cost of the scheme) will heavily depend on where deposits are located in such hierarchy.

360. As to the insured amount, we note that, in absolute numbers, New Zealand's proposed protection limit is low when compared to other jurisdictions (e.g., EUR 100,000 (or equivalent) in European Union countries and A$250,000 in Australia). Implementing a low limit increases the risk of the scheme failing to prevent bank runs, given that there would still be a significant amount of deposits at risk, and any doubts about the operation of a scheme can also counteract its effectiveness. However, the issue of determining what level of deposits should still be at risk is not straightforward. It is worth noting that the Core Principles support keeping a substantial amount of deposits at risk, in order to reduce moral hazard.

361. With regard to such increase of moral hazard that a higher limit could entail, we consider this to be limited. As shown by the Review Team's own survey (as described in Chapter 5 of Consultation Paper 2a), a majority of respondents was not aware that their deposits are at risk in case of a bank failure. It appears unlikely that a control function by depositors that failed to activate when deposits are not guaranteed at all would work better when deposits are guaranteed up to a certain limit.

362. With regard to funding the scheme by way of industry levies, we refer to our general remarks set out in relation to Chapter 7 of Consultation Paper 2b.

363. Concerning the scope of the scheme, it is essential to align it with the regulatory perimeter discussed in Chapter 4 of Consultation Paper 2a so as to reduce the potential for regulatory arbitrage. Ideally, decisions on the deposit protection scheme and the regulatory perimeter are taken at the same time. Should that not be feasible, decisions on the scope of the scheme have to be taken in light of the future regulatory perimeter.

Depositor Preference

364. Introducing a depositor preference could lead to a range of issues arising from the different funding models that banks use, and in particular could create significant issues for the banks operating under a mutual model. A potential future depositor preference would need to ensure that it treats the different banks and funding models fairly and in a way that avoids distortions or other unintended consequences. Finding such an approach will likely require further work on the

exact features that such a depositor preference should have, which is a complex task in its own right.

365. A further factor to take into account is that regulatory capital confers a de facto preference on depositors that does not suffer from the complexities or design issues of a formal preference regimes – increased capital requirements under the Capital Review not only contribute to financial stability but increase the extent of that preference. This result is achieved to the same extent by bail-in instruments, whether in the form of Alternative Tier 1 or Tier 2 capital or of TLAC-compliant instruments more generally, since these involve an explicit agreement by the noteholders to subordination to all senior debt, including deposits. These factors would have an important impact on the cost-benefit of depositor preference.

366. In addition, depositor preference may also affect the NCWO principle. As a general matter, introducing a formal depositor preference into the law could:

(a) be difficult to reconcile with widely recognised *pari passu* and anti-deprivation principles (which are also a core part of New Zealand's insolvency regimes); and

(b) give rise to difficult questions about the relationship to existing priorities set out in Schedule 7 to the Companies Act 1993 (including the priority among those claims and the effect of exclusions for 'revolving assets' – which would likely include deposits as "accounts receivable" to the account holder).

367. Notwithstanding the above, a preference for depositors could nevertheless substantially reduce the costs for the scheme by increasing the likelihood that the deposit insurer (which will take the place of depositors it has paid out in a liquidation of a failed bank) will fully recoup its payouts. This would prevent it from having to rely on additional contributions from banks to re-establish the deposit insurance fund.

368. Furthermore, without a preference, depositors will be in the same position as other unsecured creditors (such as wholesale investors) in a bail-in scenario. Accordingly, to the extent that part of the unsecured creditors have to be written down for a bail-in to be successful, depositors (or, up to the insured limit, the deposit protection scheme), will share in such loss. This may make a bail-in harder to pursue given the type of creditors affected, in particular given the (when compared internationally) low limit for insured deposits.

369. Finally, depositor preference is not unusual internationally, having been introduced both in the European Union and the United States.

370. On balance, we consider that the complexities and other disadvantages of introducing a depositor preference are likely to substantially outweigh the benefits.

Next steps

371. We would be happy to discuss this submission or provide further information.