The Treasury

Reserve Bank Act Review Phase 2 Submission Information Release

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PAPER 2A

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

No follow-up questions.

Comment: With it having been decided that bank supervision should stay with the Reserve Bank, the challenge now is to forge legislative and institutional arrangements that address the concerns that gave rise to proposals to shift prudential supervision to a separate institution. This includes a need for a legislative structure that fosters greater integration of what hitherto have been separate (siloed) 'monetary policy' and 'financial stability' functions, and governance arrangements that help to reinforce that integration.

The 1989 Act established the Reserve Bank as primarily a monetary policy institution, focused on maintaining 'price stability'. The governance and associated institutional arrangements were designed for that role. Bank supervision was intended as a secondary and very limited, 'clip on', role.

Since 2003, the Reserve Bank's supervision role has expanded considerably, but without governance and institutional arrangements appropriate for that role. In some respects this has left the Reserve Bank in its supervisory role comparatively 'rudderless'. It has left it to successive governors to chart a course for the Bank in that role; reflected in the emphasis given by Dr Brash to disclosure; the emphasis given by Dr Bollard to banks' national (New Zealand) 'stand-alone' capabilities; and by Mr Wheeler to the macro-prudential aspect of bank supervision). All within essentially the same statutory framework.

The current review of the Reserve Bank Act provides the opportunity for Parliament to provide the Reserve Bank with legislation that both more clearly prescribes the policy framework within which the Bank is to carry out its supervisory responsibilities, and in a way that helps to strengthen the Bank as an institution, by:

- putting the monetary policy and bank supervision roles onto a more integrated footing; and
- providing a governance framework appropriate for a supervisory institution.

The following responses to the questions in raised in Consultative Papers 2A and 2 B are framed by those two considerations.

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

2. What other objectives should the Reserve Bank have?

   - Which of the objectives discussed in Chapter 2 should feature in the Reserve Bank Act, and why?
   - Are there any other objectives not covered in Chapter 2 that should be considered?

I would like to see a rewrite of the existing section 1 A of the Reserve Bank Act to bring greater coherence to the statement of the Reserve Bank's purpose. That section currently reads:

1.A Purpose

(1) 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—

(a) formulating and implementing monetary policy directed to the economic objectives set out in subsection (1A), while recognising the Crown's right to determine economic policy; and

(b) promoting the maintenance of a sound and efficient financial system; and

(c) issuing bank notes and coins in New Zealand to meet the needs of the public; and

(d) carrying out other functions, and exercising powers, specified in this Act.

(1A) The economic objectives are—

(a) achieving and maintaining stability in the general level of prices over the medium term; and

(b) supporting maximum sustainable employment.

(2) This section does not limit the functions or powers given to the Bank by any other enactment.

There is nothing there about maintaining the stability of the commercial monetary system, through which the Reserve Bank's monetary policy is transmitted. Without that stability, the Reserve Bank's ability to achieve its statutory <u>economic objectives</u> is seriously compromised.

A cleaner and more integrated formulation would be along the lines:

1. Purpose

(1) The purpose of this Act is to provide for the Reserve Bank of New Zealand to maintain monetary stability in New Zealand consistent with promotion of the prosperity and well-being of New Zealanders through a sustainable and productive economy; by being responsible for formulating and implementing policies to:

(a) maintain stability in the general level of money prices whilst supporting maximum sustainable employment; and

(b) maintain the stability of the system of money and credit and for making monetary payments, consistent with supporting those systems in catering for the needs of firms and households to save, borrow and to make payments.

(c) carrying out other functions, and exercising powers, specified in this Act.

(2) This section does not limit the functions or powers given to the Bank by any other enactment.

The existing sub-clause 1A (1)(c) should be deleted. Issuing notes and coin is just one possible way in which a central bank can issue its monetary liabilities – where the policy it follows in setting the terms and conditions on which it does that being its 'monetary policy'. Singling out issuance of its liabilities in the form of notes and coin does not warrant statutory specification, any more than does, for example, that the Reserve Bank "will issue reserve deposit liabilities to meet the (settlement, i.e., payments) needs of the commercial banks". Indeed, the Act should be flexible enough in its prescription of the Reserve Bank's purpose to recognise the possibility in the decades ahead of a move more substantially away from central bank issued notes and coin, toward electronic tokens (either central bank issued or commercial bank issued) and/or electronic commercial bank deposit-based means of payment. The statement of purpose in the Act should be technology neutral.

The revised formulation proposed would recognise that maintaining monetary stability is about both:

- the policy followed by the Reserve Bank in issuing its liabilities, whether that is expressed in terms of the price (interest rate) at which it does so, or the quantities in which it issues – what we generally refer to as 'monetary policy'; and

- maintaining stability in the commercial banking system through which the central bank's 'monetary policy' is transmitted to firms and households. That requires stability in the terms and conditions upon which commercial banks, in turn, issue their liabilities (deposits) to firms and households, in essence, stability in their banks' credit policies. Without those being reasonably 'anchored' to the 'monetary policy' of the central bank,[1] the latter is not capable of "*maintaining stability in the general level of money prices whilst supporting maximum sustainable employment*". [2]

In the first of these roles, the central bank directly uses its own balance sheet, whilst in the second it plays a less direct, supervisory role, in its capacity as 'banker to the banks'. There is a range of views on how extensive or active the latter role needs to be. Some take the view that 'market disciplines' are, or can be, sufficiently effective that there is little, if any need, for central bank oversight of the commercial part of the monetary system i.e., the commercial banking system. Others, see a need for a more active supervisory role, recognising at the least that there can be times when loss of confidence in the commercial banks requires the central bank to step up with its own balance sheet in a re-financing role (act as 'lender of last resort'), so as to maintain overall 'monetary' and therefore macro-economic (price and employment stability). To play that role without de-basing its own currency the central bank needs to have a good basis for judging the solvency of the banks to which they may at times find themselves having to lend.

Indeed, therein lies much of the origins of central banking – the need for there to be a 'banker to the banks'. The Federal Reserve System in the United States was established in 1913 in the wake of

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[1] Central banks set their monetary policy mainly in terms of the price at which they issue, whilst holding their credit policy (collateral terms) conservatively stable (although they did relax their credit terms during the GFC). Commercial banks, by contrast, set their monetary (credit) policy more in terms of the credit terms on which they lend (issue their deposit liabilities), with limited scope for variation in their pricing (margins). But, as for any bank that pegs its liabilities to those issued by another, commercial banks have to keep their own policies reasonably tightly tethered to those of the central bank.

[2] This integrated conception of a central bank is consistent with the 'Tane Mahuta' analogy that the Reserve Bank has been using, to illustrate how the financial system is a system – just as a tree is a system, comprising roots, a trunk, branches and sap. One might quibble over exactly what in the financial system corresponds with each of those elements, but I think the analogy is quite powerful in terms of highlighting that it is a system, and the corresponding value in a central bank taking an integrated view of its role in that system.

repeated banking crises and associated sever macro-economic instability, with its statutory role (retained to this day) expressed as:

> *To provide for the establishment of federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish more effective supervision of banking in the United States, and for other purposes.*

The Bank of England has a longer history, going back over 300 years. Its origins lie as much in the Crown having an institution that could fund wars. But the emerging centrality of the Bank of England also saw it take on the role of lender of last resort as famously described by Bagehot in 1873. Implicit in this role was a Bank of England supervisory role, so as to be able to know in a crisis which banks are and are not solvent. That role, of banker to the banks, was played by the Bank of England without any explicit statutory recognition up until 1979 when, following the Secondary Banking Crisis, the Banking Act 1979 was enacted.

I dwell briefly on this history because it is foundational to the role of central banks in the monetary system. It reveals how central banks are more than just a collection of functions that happen to be grouped within an institution called the central bank, but could equally be located elsewhere. At the core are the roles of issuing 'the currency' (the terms and conditions on which that is done being the central bank's 'monetary policy') and acting as banker to the banks, with the latter necessarily involving oversight, or supervision, of the banks. These two 'functions' are 'joined at the hip'. [3, 4]

Whilst those are the core central banking functions, other functions are natural complements. Prudential supervision <u>for the purpose of protecting depositors/the deposit insurer</u> very substantially overlaps with the supervision that central banks need to undertake for their own purposes. And if the central bank is to be the prudential supervisor of banks, there is logic, especially in a small country, in it also being the supervisor of other financial institutions where there is a public policy case for prudential supervision e.g., of insurance companies, for the purpose of providing policy-holder protection. Other functions that can be natural complements to the core central banking functions include:

- banker and fiscal agent for the government;

[3] Which is not to say that the bank supervision has to be performed by the central bank itself. In other countries, e.g., Australia, the bank supervision function is performed by a separate, specialist, supervisory institution. However, these arrangements need to be understood more in terms of the central bank having 'out-sourced' the function than in terms of it being unconnected with the central bank. (The RBA makes clear that it relies on APRA for supervisory information.) It is, in a sense, a case of being able to 'take supervision out of the central bank, but not being able to 'take the central bank out of supervision'.

[4] Also worth noting is that monetary policy as we currently know it is a relatively recent phenomenon. It is only since around the 1970s, following the breakdown of the post-World War II Bretton Woods arrangements, that central banks have used 'monetary policy' actively as a macro-stabilisation instrument. And then that initially in many countries, was done by central banks/governments 'regulating' the commercial banks' balance sheets (what today would be called 'macro-prudential policy), rather than using their own balance sheet. Pre the 1970s, central banks 'monetary policies' under the Bretton Woods system were mostly about maintaining an exchange rate peg to the USD, with the USD linked to gold.

- provider of financial infrastructure. Some central banks provide payments clearing infrastructure (cheque clearing) and other similar infrastructure (e.g., the NZ Clear depository in the case of the RBNZ);
- a broader financial sector development policy role (which tends to be more prominent in developing countries).

Of these, the role as banker to the government comes closest to being a core function. There is a public policy case for the government banking with the central bank rather than a commercial bank(s) so as to avoid the government being seen to 'favour' one bank over the others or, perhaps more to the point, to avoid the 'conflict of interest' that could arise if the government's bank was in financial difficulty. Arguably a bank that the government depends on for its banking services is 'too important to fail'.

These considerations, I think, underscore the importance of taking the opportunity now to get the legislative framework for the Reserve Bank into the very best shape, for the next 30-40 years. Besides establishing a coherent framework for its own sake, these things matter in quite practical ways for how policy is shaped and developed, and for how an institution sees itself, and develops. By way of example, the 1989 Act, in my experience, fostered the development within the Reserve Bank of a culture under which bank supervision was subordinated to monetary policy, and within which the two functions were seen as quite separate (and separable) – sometimes referred to as operating in 'silos'. That culture seems to be a large part of what lies behind calls by some for the bank supervision function to be moved out of the Reserve Bank. While (from the outside) it appears that the silos have come down somewhat over the past decade or two, an inherent tendency for 'walls to go up' almost certainly remains (as it does in most organisations). That I think can only be detrimental to the Bank's effectiveness overall. Hence my view of the need for the new legislative framework to be founded on the Reserve Bank having an overriding responsibility for the <u>unified objective</u> of maintaining monetary stability. With that, I think the Reserve Bank's management is better placed to build an effective organisation.

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

The Reserve Bank should take account of climate change risks to the extent that these risks have implications for the thing for which it is responsible (monetary stability). For example, there will be various implications for risk-underwriting, and asset values, and those implications will need to be managed. Also, while realisation of the full effect of climate change may still be some time away, financial markets are forward looking and tend to bring future risks to the present. It is therefore appropriate that the Reserve Bank is now beginning to register climate change as something with potential financial stability implications.

That said, the Reserve Bank should not 'get ahead of itself'. Nor should it take on a responsibility for climate change objectives as such. While there may be areas where it has knowledge and experience that could be helpful in <u>supporting</u> those agencies that do have climate change policy responsibilities[5], the Reserve Bank should not take on policy responsibility for achieving 'climate stability'; the Reserve Bank's responsibility is for 'monetary stability'.

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[5] For example, knowledge and experience with clearing and settlement systems which could be helpful to those responsible for the operation of the emissions trading system.

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

It is not obvious to me that there is a need for any 'secondary objectives'. If there is thought to be such a need, the first step should be to check whether the objectives already prescribed should be adapted to incorporate the matter in question. If not, then I have reservations about including the objective in question at all.

That said, perhaps there is a place for providing 'second-level' clarification or elaboration of the prescribed objectives; for example, to make clear that the Bank can/should support other agencies where it has the relevant capability.

There may also be value in clarifying how the Bank should take account of 'economic efficiency' in performing its functions to "promot[e] the prosperity and well-being of New Zealanders through a sustainable and productive economy". Elements of that clarification might include that the Reserve Bank should:

- generally seek to avoid influencing the allocation of resources within the market economy i.e., the Reserve Bank generally should confine its own transactions, using its own balance sheet, to government- and bank-issued securities, and generally should avoid prescribing prudential standards that 'skew' the allocation of credit, or resources, within the market economy; and

- apply cost-benefit tests in the formulation, and administration, of policy, where 'costs' should include compliance costs, allocative distortions and impediments to innovation.

2.D 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?

I see merit in having a 'financial policy remit'. This may be a better vehicle than the Act for covering the kinds of matter mentioned under 2B and 2C above, or at least for giving more detailed and contextual expression to those kinds of matter.

Although, if there is to be a remit, does consideration need to be given to where that fits alongside things like a 'Statement of Intent' and a Minister's 'Letter of expectation'. Is there scope to rationalise these things?

2.E 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?

I see merit in separating out the statutory framework for the Reserve Bank's supervisory roles (deposit-takers/insurers; financial infrastructure) from the Reserve Bank Act itself; although that also depends on the 'style' of the supervisory regime to be adopted.

If it is to be a 'regulatory' regime, with prudential standards to be prescribed in statute/statutory regulation, then separating the statutory prescription from the Act that establishes the Reserve Bank as an institution I think definitely is to be preferred. The two 'parts' of the statutory specification in that case would be quite different in character and would not naturally fit alongside each other in a single statute. That already is the case with the present Act, with the parts that prescribe the Bank supervision powers being quite out of character from the rest of the Act. A further practical consideration is that there have been occasions in the past when it was considered desirable to make amendments to specific bank supervision/failure management provisions in the Act, but there was a reluctance to 'put a bill in the House' out of concern about 'opening-up' the whole Act to wider debate.

Even if the regime for supervision is to be less 'statutory' in character, and based more on, say, 'prudential standards' outside of the Act (my preference), I suspect that prescription of the resolution regime is something that unavoidably has to be 'hard-wired' in statute. That re-inforces the desirability of placing the statutory regime for supervision into separate Acts (say, for deposit-takers, insurers, and financial infrastructure).

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

No further comments.

Chapter 3: How should the Reserve Bank be governed?

3.A 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?

The key factors as I see them are:

- Clarity of statutory policy objectives/framework. The Board needs to be clear on what it is responsible for. That calls for careful crafting of the objectives/functions (see above).

- The capabilities of the Board members. Besides general governance capabilities, I think it vital that enough of (most?) of the Board members have knowledge and experience reasonably directly relevant to the business of 'central banking'. It is sometimes observed that a significant weakness in corporate governance in New Zealand is that not enough directors have enough knowledge of, and experience in, the industry in which the organisation they are responsible for governing is operating. Governance of the Reserve Bank's prudential functions will call for directors who:

  - have financial sector knowledge and experience;[6]

  - bring a public policy perspective to the role (directors who might be considered 'poachers turned game-keepers')[7]; and

[6] And not just any banking sector related experience – one of Australia's pre-eminent bankers, Don Argus, has been reported to have said 'you can't call yourself a banker until you have done credit', a sentiment with which I have a lot of sympathy.

[7] It was evident during my time at the Reserve Bank that directors (few if any with banking experience) tended to view supervisory matters as much if not more from the perspective of an 'industrialist' than as a 'banker'.

    - are known to exercise sound judgement (more than that they have technical expertise).

  The pool of such people in New Zealand is not large, particularly given that most if not all of the more significant financial institutions in New Zealand are now foreign-owned, with much of the retired talent associated with those institutions now resident abroad. This points to a need to be open to – if not actively to seek – directors from outside New Zealand (e.g., from Australia, Singapore, Hong Kong). There is the additional benefit from that of having the 'outside' perspective.

Further comment

A preliminary decision has been taken not to establish a Financial Policy Committee, whilst leaving the MPC as a statutory committee separate from the Board of the Bank. I can see some complications arising from that. Those include:

- issues arising from responsibility for 'monetary policy' resting with the MPC, but with responsibility for the Reserve Bank's balance sheet resting with the Board, with nothing to tie them together. As above, monetary policy is the policy by which the Bank manages its balance sheet.
- issues arising from the overlap of macro policy and prudential policy. The former will rest mainly with the (separate) MPC but governance of prudential policy will rest with the Board. Again, how does governance of these get knitted together?
- the way in which monetary policy and prudential policy at times of stress come together in the role of the central bank as lender of last resort. To be sure, during 'normal times' the monetary policy 'right hand' and the prudential policy 'left hand' can be assumed to be largely independent of each other, but at times of stress they become inseparable – and that is the very time when lack of coordination between right and left hands tends to be most damaging.
- The question touched on in the consultation paper as to whether prudential policy matters will receive the governance attention they need if included on the full board agenda along with those relating to governance of the Bank as an institution. There are big strategic issues in prudential supervision – of the likes of the trans-Tasman relationship, where to pitch prudential standards, where to pitch the 'style' of supervision ('regulatory compliance' versus 'judgment-based' risk management) – which require governance oversight.

I continue to think that the ideal governance structure would be one in which all the responsibilities of the Reserve Bank are vested in its Board, probably with the Board establishing a committee for governance of each of monetary policy (a MPC) and the Bank's prudential role (an FPC), but with the Board as a whole responsible for knitting it all together. Such a structure could be along the lines of a Board comprising:

- The Governor and Deputy Governor
- A couple of non-executives capable of bringing a governance perspective to the Bank's macro-policy role
- A couple of non-executives capable of doing the same in relation to the Bank's prudential role
- A couple of non-executives with strong governance reputations 'in the broad'.

With the committees comprising something like the Governors and the respective 'subject matter' directors, plus two-three others from outside of the Board, who could be ' internals' or 'externals' depending on the desired balance between the two. That would enable replication of the MPC as it now stands – subject to one or two of the externals on the MPC also being appointed to the Board. It would also make less call on 'externals' than presently is the case (a total of 6-8 externals, compared with the 6 non-executives currently on the Reserve Bank board, and 3 externals on the MPC). And I think it would provide greater assuredness of cohesive and integrated governance of the Bank, including in its core policy roles, than might result from what currently is proposed.

That said, the kind of structure I have outlined may well emerge from what currently is proposed, if:

- It is found desirable for one or two of the 'externals' on the MPC to be appointed to the Board as non-executive directors (as I expect it will be – how else are resourcing and prioritisation decisions at Board level to be lined up with the policy direction and issues?)
- The Board finds it desirable for a committee or 'division' of the Board to be assigned a lead role in respect of prudential policy – as I expect will be found to be the case.

In other words, if my view is broadly correct, then things might end up where I propose, albeit via a less direct route (and if I am wrong and they turn out differently, that may be no bad thing).

By way of concluding observation, I dwell on these things, on which 'in principle' decisions already have been taken because I think they are important. The Reserve Bank is a bank, and the arrangements for its governance are no less important than for any other bank. Indeed, we should expect nothing less of the governance of the Reserve Bank than the Reserve Bank expects of the Boards of the banks it supervises. In this whole review exercise, there are probably few things as important as getting the right people in the right roles and making them responsible for the right things. If that is got more or less right, much of the rest probably will fall into place reasonably well.

3.B What is the appropriate degree of delegation from the board to the Governor? Are there any decisions that should be reserved for the board?

If, as appears to be proposed, the power to govern the Reserve Bank is to shift from the Governor to the Board, I think that should be a 'clean' transfer – with all the powers of the Bank to be vested in the Board. It would then be for the board to determine the applicable delegations and reservations of authority. I envisage that the Board would comprehensively delegate to the Governor authority for running the day-to-day operations of the Bank (with appropriate reporting to the Board), but reserve to itself key matters of policy, strategy and sensitivity, for example:

- approval of key prudential standards (possibly with ultimate approval resting with the Minister); and
- the most critical prudential interventions, e.g., recommendation of the appointment of a statutory manager, material sanctions for major breaches of prudential standards, etc.

But, ultimately, it should be for the Board to determine those delegations/reservations of authority, including should it wish to adjust those if, for example, should there be a change in circumstances.

3.C 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?

In principle, I would envisage that monitoring by the Treasury of the Bank should be little, or no, different from that for (other) Crown entities. Generally one would expect that to be relatively low key. Given the responsibility vested in the Board for the performance of the Bank, the a priori expectation should be that the Board is adequately doing its job. There should be no need for the Treasury to be 'crawling all over things'. But, as for any (other) Crown entity, the Treasury's monitoring role would need to be 'stepped up' in the (unlikely/unexpected) event of things 'going awry'.

Ideally, Treasury monitoring of the Bank would encompass all of the Bank's (Board's) functions, including those assigned to (a) policy committee(s). That I think should include the Monetary Policy Committee, whether or not it is constituted as a committee of the Board, or remains as a separate, statutory, committee. But that monitoring should be focused on capability and process rather than on trying to second-guess policy judgements (although recognising that concerns about the latter usually will point to weaknesses with the former).

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

I don't have a strong view on whether, or not, the Reserve Bank should be brought within the 'Crown Entity' classification (and I don't have detailed familiarity with the Crown Entities Act). Perhaps this a matter more about form than substance, although getting the form right obviously can help in getting the substance right.

Although one (perhaps the only?) substantive issue arising from this question concerns who should chair the Board. I understand that under the Crown Entity model, standard practice is for powers to be vested in the board (as now proposed for the Reserve Bank), <u>with a non-executive chair</u> (appointed by the Minister). The 'tradition' in central banking has been for the Governor to chair the Board. However, in cases where the role of the board is confined more to an 'institutional monitoring' rather than a full 'governing' role, there are instances of the Chair being a non-executive, as currently the case for the RBNZ Board, and in the case of the Court of the Bank of England. (In the UK a non-executive chairs the Court, whilst the Governor Chairs both the MPC and the FPC).

I do not have a firm view on who should chair the Board, and see pros and cons with the alternatives.

Having the Governor as Chair of the Board would recognise the key leadership role of the Governor. Having a non-executive chair of what is to be a full governance board probably would either diminish the role of the Governor or, perhaps more likely, result in the Board playing less of a governance role than it should. That suggests that if the Governor is to be chair of the Board, it is all the more important that the non-executive directors play an effective role and have the capabilities and experience required to do that.

On the other hand, if the leadership role of the Governor is seen as being mainly in the context of policy leadership, then that role might better be played as chair of the policy committee(s) (MPC and FPC), leaving a non-executive director to Chair the Board. This has the advantage of being close to the existing arrangement; although it also assumes that governance of prudential policy will end up sitting, in the first instance, with a committee of one sort or another, i.e., a Board committee if not a statutory committee.

Of these alternatives, I think I probably could accept either, even though the first-mentioned breaks one of the cardinal rules of banking (an executive chairman of a bank is something of a 'no no'). I see value in the Governor of the central bank having the key leadership role – but if to be an excutive chairman, that would strongly underscore the need for a sufficiently strong cadre of non-executive directors to provide the counter-balance. If this can be achieved, one might get the 'best of both worlds' – strength in the position of Governor, combined with a strong board. The question then is how to be reasonably assured of achieving the latter? – without which one risks getting the worst of both worlds (a dominant chief executive with a weak board). Perhaps this points to extra special attention needing to be given to the specification in the Act of the capabilities needed of non-executive directors – although perhaps there is only so far one can go, with responsibility for appointments resting ultimately with who it is that makes the appointments (the Minister?).

3.E For the new governance board:

- what should the split of executive and non-executive members be?

I favour a clear majority of non-executive directors, along the lines outlined in response to question 3.A above.

- what skills and expertise should non-executive members have? Is there merit in having representation from the FMA and/or the Treasury?

If the Board is going to be a full governing board, including with respect to the Bank's core areas of policy responsibility, it is vital that the non-executive directors bring to the board a mix of capability that is aligned with the matters for which they have governance responsibility. As above, given the Bank's role and responsibilities, that points to a need for Board membership that covers both the monetary policy and prudential/financial policy bases, as well as governance of the Bank as an institution (to provide governance of resourcing, prioritising, maintaining and building capability, maintaining the building institutional reputation, etc). This is not to suggest a need for technical experts, but rather that the non-executive directors need to have enough <u>knowledge and experience</u> to be able to bring sound judgement to what is put before them by the Bank's management. (A cautionary note is that the mind-set of an 'industrialist' tends to be quite different from that of a 'banker' – and that of a commercial banker can be quite different from that of a central banker.)

If there is to be Treasury or FMA representation on the Reserve Bank board, I think it should be by way of cross-membership at non-executive level e.g., there may be advantage in a non-executive FMA director also being on the RBNZ board (and/or vice versa). I am less familiar with the role played by the Treasury's 'Advisory' Board, but perhaps again there could be value in cross-membership on the Bank's Board.

- how should members be appointed and removed? Should the board be able to appoint the Governor as CEO?

I think Board members should be appointed by the Minister, along the lines of current arrangements, but with a tightening up of the criteria according to which board selections are to be made, e.g., Board appointees to have demonstrable knowledge and experience relevant to the governance of the Reserve Bank of its roles and responsibilities (while recognising that interpretation of that ultimately has to rest with whoever is making the appointment).

I don't see a strong case for the Board, rather than the Minister, appointing the Governor, especially if the Governor is to be chair of the Board. If anything, I'd be inclined to shift in the other direction, and make the Minister more squarely responsible for appointing the Governor, along with all other board members; with the Minister carrying ultimate responsibility for their appointments.

3.F Are there any aspects of the board's operation would benefit from legislative clarity or guidance? In-principle decisions and follow up questions on the role of the Reserve Bank and how it should be governed.

No further comment.

Chapter 4: How should the regulatory perimeter be set?

4.A 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?

Establishing 'deposit-takers' as an institutional category will require 'deposit-taking' to be defined. I think the best approach to this question may be to focus on the boundary between a 'debt security', as defined in the Financial Markets Conduct Act 2013, and 'deposit'. That is, if it is not a 'debt security' issued by an issuer, and subject to the requirement for issuance to be by way of a prescribed offer document, then it is a 'deposit'.

That leaves a question whether such an approach would adequately establish a boundary between 'wholesale deposits' and debt securities issued to wholesale investors i.e., not to 'the public'. Under the old Securities Act, the boundary between issuing to 'the public' and to the wholesale market was not precisely defined, with issuers mostly having to make their own judgments, and being responsible for the judgements they made. To some extent it was, perhaps, a case of 'you know it when you see it', e.g., a subordinated debt issue I think would be widely understood as issuance of a debt security and, if open to retail investors, must be offered in accordance with the requirements of the FMCA. But what about issuance of a 'certificate of deposit' subject to the minimum subscription being not less than $1m?

This, presumably, is an issue that the Australian authorities will have addressed, in the context of both what is and is not covered by the Deposit Guarantee scheme, and the meaning of 'deposit' for the purpose of the statutory preference with respect to 'assets in Australia' for 'deposits in Australia'. I have never been clear on how, for the latter purpose, the Australian authorities define a 'deposit' (which prima facie seems not to be confined to a 'retail' deposit), nor 'in Australia'.

4.B 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?

I think it is appropriate for the Reserve Bank to keep abreast of developments in the financial sector beyond the 'supervisory perimeter'. This includes so that the Bank can keep a check on growth in 'shadow-banking' – development of institutional forms and arrangements that, in substance, should be inside the supervisory/safety net boundary but, in form, are outside of it (whether that occurs because of regulatory disintermediation, technological developments, or other factors). An example is 'money market' mutual funds in the US – which for all intents and purposes mostly are deposit-taking institutions but are not supervised or (formally) covered by deposit insurance (although the government stepped in with a comprehensive guarantee when in the GFC some funds 'broke the buck). For this purpose a general power under which the Bank can require financial institutions to provide it with information (along the lines of the existing s.36 power) should be sufficient.

I caution against getting back into creation of categories of institution that are subject to 'quasi-supervision' – such as the 'non-bank deposit-taker category' of recent years, or the 'specified institution category' created by the Reserve Bank Amendment Act 1986 (but dispensed with under the Reserve Bank Act 1989).

4.C 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?

In my view, the supervisory perimeter should be capable of adjustment (extension) only by legislation or, at the very least, statutory regulation.

4.D 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.

I do not see macro-prudential grounds for establishing a supervisory boundary different from that for defining which institutions are to be supervised. This reflects my view that (so-called) 'macro-prudential supervision' is much more about 'supervision' than it is about 'macro-economic management'. I elaborate on this in response to the questions raised on macro-prudential policy in Consultation Paper 2B.

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

5.A Are the interactions between depositor protection and the other parts of the financial safety net set out in Part I of Section 2 described appropriately?

I have not reviewed this material in any detail. But as a general observation, I see the introduction of 'deposit insurance' in reasonably simple terms. It, in effect, gives commercial bank deposit liabilities, up to the limit of the insured amount, essentially the same status in the hands of the holder as the central bank's liabilities. They can be treated as being as certain as central bank issued notes and coin. The corollary is that the insurer needs to make sure that insured deposits are good for that – or at least no less good than is consistent with the insurance premium charged.

5.B What objectives should the depositor protection regime in New Zealand have? Should its objectives be:

- to contribute to public confidence and financial stability?
- both of these?
- something else?

See preceding comment.

5.C The Minister has made an in-principle decision that the depositor protection regime should have a limit in the range of $30,000-$50,000. Given your answer to 5.B, what coverage level would be best within this range?

The $30,000 - $50,000 seems quite low – is it credible?

On the one hand, I understand that such a limit would cover a large majority of banks' retail deposits. But on the other, there will be a significant, if not sizeable, number of 'retail' depositors who will have substantially greater amounts on deposit, say having received an inheritance, or having sold their home with the proceeds having been 'deposited with the bank', pending purchase of another home, or in the case of the elderly, to be drawn down over time to pay rest-home fees. Will it be credible for the government to 'stand firm' and refuse compensation in these kinds of case? It seems that in the case of the Christchurch earthquakes, the Government ended up providing compensation in a range of situations not covered by the formal compensation arrangements. (The Swedish deposit insurance scheme makes provision for protection of 'temporary' high balances, up to the equivalent of about NZD800,000, where the balance is connected with a real estate transaction, divorce, retirement, dismissal, invalidity or death.)

There is also a question concerning whether the $30,000-$50,000 limit proposed goes far enough in levelling up the playing field as between the small local banks and the large international banks. Unless or until the phenomenon of 'too big to fail' is put firmly to bed, I expect that there will remain a tendency for deposit balances above the insured limit to be placed with 'big' banks. If that is the case, a relatively low insurance limit will continue to place small local banks at a funding disadvantage.[8]

5.D How would your preferred limit affect depositor wellbeing, public confidence, and depositors' responsibilities for their financial choices?

Deposit insurance will extend the ability to hold wealth in the form of 'money', without having to put cash under the mattress. For those who currently feel uncertain about the safety of their money in the bank (probably not much given 'too big to fail'), deposit insurance will improve 'well-being' by making people feel more secure. This may be most relevant to the elderly.

On the other hand, the 'moral hazard' risk introduced by deposit insurance is real, and should not be under-estimated. The Reserve Bank will need to re-think the nature and extent of its supervision, in particular of the small local banks.

5.E Do you think the New Zealand depositor protection regime should be supported by a preference for insured depositors? How would this affect the costs and benefits of a depositor protection regime in New Zealand?

[8] I expect 'too big to fail' will be put to bed only after a 'big bank' is seen to fail, at least in the sense of bail-in-able debt is actually having been 'bailed in'.

There is a case to be made for establishing a preference for deposits:

- it would be to recognise that deposits are akin to money held 'on trust' and, as such, are not part of the general funding of the bank (similar to how funds under management are not part of a bank's balance sheet funding).

- it would lessen the risk carried by the deposit insurer – and enable deposit insurance to sit much more in the background, as is the case in Australia.

However, it needs to be recognised that introducing a preference for depositors would 'subordinate' non-deposit funding. That is the formal position in Australia but how well it is understood I do not know, i.e., how credible would it be in a failure situation to prefer depositors over other 'senior creditors'? (There are also important definitional issues concerning what is and is not a 'deposit' and what are, and are not, 'assets in Australia'.)

I also think it worth considering introducing a depositor preference in the broader context of achieving, over time, some alignment with Australia. Given that around 85% of deposits in New Zealand are with banks with Australian parents, and given the extent of the trans-Tasman economic, financial and people-to-people connections, there is a question how credible it would be for depositors with a trans-Tasman banking group to be treated, in a group failure, substantially differently on each side of the Tasman.

PAPER 2B

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

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

Some history

As the Consultation Paper notes, the current 'model' in the Act for applying prudential standards, was not envisaged to operate as it now does. Initially there were to be no quantitative prudential standards, only a qualitative bank registration regime, and a failure management regime, with only monitoring, but not 'supervision', in between (See "*Financial Policy Reform,* Reserve Bank of New Zealand, 1986, Chapter 7.)

Over the years, however, policy has moved away from that conception, with a range of prudential requirements (quantitative and qualitative) having been introduced. Conditions of registration have been the instrument of choice for applying those standards – because the Act did not provide any alternative. The power to apply conditions was expanded, with constraints, under the Reserve Bank Act 1989, with the constraints having been largely removed by way of an amendment made in 2003.

Other aspects of the current 'model' are also the result of evolution. The prescription of the disclosure requirements for banks by way of Order-in-Council can be traced to those having their antecedents in the Securities Regulations 1983, which prescribed the prospectus disclosure requirements under the Securities Act, and to which the banks had been made subject under the Reserve Bank Amendment Act 1986. When in 1989 it was decided to introduce a new, alternative, set of disclosure requirements for banks, it was only natural for those also to prescribed by Order-in-Council.

The 'attestation' regime for registered banks also has its antecedents in the prospectus disclosure requirements that previously applied. Under the Securities Act directors were required to sign-off that, after having made due inquiry, they were satisfied that the information disclosed in a prospectus was not false or mis-leading, including by omission; with strict liability applying if the prospectus subsequently was found to be otherwise. This same formulation was carried over to the disclosure requirements for registered banks, but with a broadening of the range of matters to be attested to (including, for example, compliance with conditions of registration and with internal controls). As you will be aware, the 'strict liability' that applied under the Securities Act 1978 no longer applies under the Financial Markets Conduct Act 2013.

A future model

Of the broad alternatives outlined for setting prudential requirements, I favour a 'standard-setting' approach – subject to finding, within the framework of New Zealand law and practice, a regime that:

- can be formulated with sufficient clarity to be enforceable, yet is sufficiently flexible to accommodate the varying circumstances, business models, and other factors pertaining to individual banks. This points to a need for a well-crafted 'principles-based', rather than hundreds of pages of detailed regulatory prescription.

- has built into it sufficient checks and balances. Those need to include checks and balances:

- in the process by which standards are developed. Those checks and balances might best be provided by a policy committee ssign-off process (possibly the Reserve Bank Board, or a statutory committee (analogous to the MPC); and

- in the application of the standards, again pointing to the more significant enforcement decisions being vested in a committee. Such a committee could delegate enforcement of less important matters to Reserve Bank management, but with responsibility remaining with the Committee (say, with a requirement for all enforcement decisions to be reported to, and ratified by the Committee). Arguably institutions/individuals against whom enforcement action is taken also should have an avenue for appeal, although I find it less clear who an appropriate appeal authority might be.

I am quite strongly of the view that prescription of prudential standards – and disclosure requirements – for banks by statutory regulation is not to be preferred. That likely would result in a more detailed and legalistic approach, and engender focus, by the Reserve Bank and registered banks alike, on 'compliance' rather than on what is prudent in a substantive sense.

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

See answer to question 1.A.

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

I think the chapter covers the key issues well – although do see a challenge in finding a way to incorporate the 'policy framework' into legislation, but without that being overly detailed and prescriptive. The current section 73 and 78 listings of the matters the Bank's supervision is to address, and the s.75 requirement that the Bank publish the principles according to which it would do that, were an attempt to reflect the broad policy approach in statute. But, in their present form, I think are excessively vague and accommodating. Certainly they have accommodated quite major shifts in policy approach since 1989 – all within the same broad statutory framework. For example, no one in 1989 (nor probably even in 2003 when the scope of Reserve Bank's prudential powers was expanded) will have imagined that powers were being conferred on the Governor to introduce the LVR 'instruments' that have been applied since 2013.

Achieving an appropriate balance in the new Act will require some careful crafting. I should convey more clarity/detail on the policy framework that Parliament intends to be applied than reflected in the current Act – and I think needs to go further than just broad statements of 'objectives'. I think that should be capable of being achieved without a whole lot of 'technical detail' needing to be included in the primary legislation.[9]

An additional consideration that is mentioned in the consultation paper is the need for the Reserve Bank to have 'independence' in the formulation and application of prudential policy. The point is

[9] Certainly nothing like the amount of technical detail that one finds in tax legislation – where pretty much all detail is included in the primary legislation.

made that there is a need for a 'credible commitment' mechanism, so as to avoid elected governments from trading off long-run benefits for short-run (electoral) advantage. I think there is something in that, but not as much as the consultation paper would have it. Few would attribute the policy failures in the decade or two running up to the GFC to something so simple as elected governments having deferred necessary policy reforms so as to secure short-term electoral advantage. There was a whole lot more to it than that, including leading central bankers who were at the forefront of 'light handed supervision' and the effectiveness of 'market discipline' – scarcely a case of electorally susceptible politicians needing to be kept on the 'straight and narrow' by independent central banks!

Hence, I do not find overly convincing arguments to the effect that there is a need for the Reserve Bank to have relatively unfettered independence in the area of prudential policy, so as to avoid the 'time inconsistency' problem. What I find more convincing is the desirability of providing the Reserve Bank with sufficient 'degrees of freedom' to be able to apply prudential policy in a principled and flexible manner – a manner that enables more emphasis to be given to substance over form, but within the boundaries of a policy framework that has received the imprimatur of the elected government/Parliament.

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

As above, the use of 'conditions of registration' as the 'instrument' for applying prudential standards, in many respects, came about 'by accident'. But, despite that, it is an approach that think is not entirely without merit. I see a reasonably close parallel, in principle, between conditions of registration for banks as applied by the Reserve Bank, and the covenants that commercial banks apply to the customers on whom they have an exposure. Covenants are applied as a means to enable banks to manage the risks they have on their customers. A breach of covenant provides the basis upon which the bank can 'make demand' for repayment and, absent repayment, appoint a receiver/apply for appointment of a liquidator. Although taking that step is very much the exception rather than the rule; most often breaches of covenant are more technical than substantive, and a waiver is readily granted.

The parallels with conditions of registration will be readily apparent. But with one material difference: if a commercial bank is 'heavy handed' in the way in which it applies banking covenants, the customer can repay and go to another bank. There is no corresponding counter-weight in the case of 'heavy-handed' application by the Reserve Bank of conditions of registration.

Hence, I do see a need to reconfigure the regime for applying/administering prudential standards. The preferred approach, I think, would be for these to take the form of 'enforceable standards', formulated and either approved by the Reserve Bank Board (or a Financial Policy Committee, whether a committee of the Board, or a statutory committee), or recommended by it for the Minister's approval. These standards should be a disallowable instrument, but something less than the 'black letter' law of statutory regulation. The process for making (legally enforceable) accounting standards, as formulated and approved by the External Reporting Board/Accounting Standards Board, might provide a model.

The prudential standards themselves should be principles-based to the extent possible – recognising the need to strike a balance between achieving clarity and certainty on the one hand, but flexibility and avoidance of unnecessary prescriptiveness on the other. This seems to be the approach adopted with accounting standards.

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

Administration of prudential standards by the Reserve Bank should be subject to a 'due process' that provides reasonable assurance that the standards are being applied in a fair and proper manner. This is necessary both to bolster the legitimacy and authority of the Reserve Bank, and to provide banks with reasonable assurance that standards are being applied properly and consistently.

Whilst judicial review (or disallowance of the standards themselves by Parliament) are/should be available, these I would see as backstops only, to be exercised only as a last resort. The first line of assurance I would see as coming from the powers of the Reserve Bank being vested in the Reserve Bank Board/the Financial Policy Committee, with the more/most important administrative decisions being reserved to the Board/Committee, such that those decisions would carry the weight of a committee decision taken at the highest level.

Decision-making by a demonstrably capable committee would go a long way towards providing the necessary assurance on due process. The FMA appears to operate to some extent along these lines, with provision for a 'Division' of the Board, comprising at least 3 members, to deal with a matter or class of matter, determined by the Board or Chairperson.

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

Application of sanctions/a requirement to disclose breaches of prudential standards/disclosure requirements should take account of the materiality of the matter (something already in the process of being implemented by the Bank?)

Liability for false disclosures in disclosure statements should be aligned with the liability regime under the Financial Markets Conduct Act. That is, the existing regime of strict liability, which was imported from the Securities Regulaations 1983, should be revised to line up with the liability that now attaches to mis-statements by Directors under the disclosure requirements under the FMCA.

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

There is a case for increasing bank executive accountability, and models are available – the senior managers' regime in the UK and APRA's Banking Executive Accountability Regime (BEAR).   However, I do not have working familiarity with these regimes, so comment only in general terms.

There is a case for (limited) extension of 'accountability' to banks' most senior executives. Sanctions/fines applied to the 'institution' do not sharpen the mind as much as does personal accountability, and there is something perverse about the cost of such sanctions being borne by a bank's shareholders (who already are directly exposed to losses attributable to failures of governance/management).

But, equally, a bank executive accountability regime should not lessen the responsibility of the board for governance of the bank. Serious problems in a bank that result in executive culpability should normally result in culpability at board level (other than, for example, where the board has been seriously mis-lead by management). In other words a bank executive accountability regime should not 'let the board off the hook' any more than senior management should be 'off the hook' just because responsibility rests ultimately with the board.

I agree that a key element of a senior management accountability regime should be applied by the bank's Board, and through performance pay. Key to that is that there should be appropriately long vesting periods and/or the ability to claw back performance pay found to have been unwarranted. Steps in these directions have been taken in a number of jurisdictions post the GFC. But my sense is that they probably still may not go far enough. Banking (and insurance) is an industry where it is notoriously easy to grow profits in the short run, but only by 'putting on' additional risk that results in serious losses in the long-run. And the 'long run' can be quite long – perhaps as long as going on a decade. I have no difficulty with boards providing high levels of performance pay, provided that the regime is reasonably symmetric. Performance pay regimes under which reward for risk is rarely, and then only modestly, offset by losses when the risks crystallise do not have much credibility.

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

As the Chapter seems to be indicating, a 'senior managers' regime might provide something of a natural complement to, or a replacement for, the existing director 'attestation' regime. Ideally it might incorporate the latter (which could then be de-coupled from the disclosure requirements). However, if a 'senior management' regime was to be applied by the bank's board, alternative modalities would need to be found (it is hardly something that the board could apply to itself).

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

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

In my view, macro-prudential policy is, or should be, much more about good prudential supervision than about using prudential 'tools' or 'levers' as if they were macro-policy instruments. Accordingly, I think macro-prudential policy, as it seems to have come to be understood, should be phased back into 'prudential supervision'. Good prudential supervision entails the supervisor being able to tell a good credit policy from a bad credit policy – and responding accordingly (see Principles 17-19 of the Basel Committee's Core Principles for effective bank supervision).[10] This calls for the Reserve Bank to develop a prudential standard on credit risk and provisioning, to provide the basis for supervisory intervention when it considers that to be necessary, rather than the development of 'macro-prudential instruments' (or 'levers').

Resort to prescriptive, across the board, one-dimensional, 'levers', such as LVR and DTI requirements, can be both costly (in terms of unnecessary curtailment of credit provision that would be prudentially sound) and/or are of questionable effect. These are, to a greater or lesser extent, a 'one size fits all' approach (although it helps that the LVR limits imposed by the Reserve Bank have left banks with a (modest) margin for 'non-compliant' lending). They involve a 'paint by numbers' approach to credit, and undermine the benefits available from a commercial and competitive banking system, one that is responsive to the wide diversity of borrowers' credit needs and circumstances. They reinforce a credit-scoring approach to making credit decisions, one which largely removes human judgment from the process. The work of the FMA and Reserve Bank on 'culture and conduct' I take as signalling that credit scoring approaches have been taken a bit too far, and that now there is a need for a bit more human judgement in the process, so that banks can be reasonably satisfied that the credit they provide is in the interests of the customer. Increased use of macro-prudential 'levers' does not sit entirely comfortably with the current focus on strengthening 'culture and conduct'.

Macro-prudential rules imposed in a 'regulatory manner' also tend to result in banks becoming 'clones' of each other – offering more 'standardised' products (ones that comply with standard regulatory definitions).[11] There is a tendency for banks to become comparatively more focused on

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[10] Care is also needed with justifications for use of 'macro-prudential' policy instruments based on taking account of inter-linkages and 'the financial system as a whole'. If banks are appropriately controlling their inter-institutional exposures (credit, settlement, MRR exposure etc) exposures, the risk of systemic failure should be substantially mitigated. It seems that a large part of the 'systemic risk' that turned out to have been embedded in many country's financial systems, and within the global system, can be attributed to management of these risks having been relatively neglected, as well as to what may have been a fair bit of 'blind dealing' (not knowing the identity of your underlying counterparty).

[11] I further wonder whether some, if not a fair bit, of what appears in the data to have been the effect of the LVR limits will have been the result of banks paying closer attention to collateral valuations; for instance now getting an up-to-date valuation in cases where previously that was considered unnecessary (because, on an old/desk-top valuation, the margin for comfort was plenty adequate enough); but is now needed, more to meet compliance than prudential requirements. Perhaps more work for valuers, but for little benefit?

maintaining regulatory compliance and less on finding flexible ways to respond to customers' needs whilst, at the same time, maintaining prudential standards.

My reservations about use of macro-prudential 'instruments' are reinforced by what have been the 'instrument(s) of choice' – particularly LVR rules. LVR rules reinforce banking on collateral, rather than cash flow. Prudent lending, first and foremost, is about making prudent assessment of the borrower's capability to generate the cash flow needed to pay the interest and amortise the principal; not whether they have sufficient collateral to cover the amount of the loan should it turn out otherwise (see Minsky's typology of credit). Collateral should not be considered a substitute for cash-flow, but imposition of LVR rules tends to make it so.

DTI rules get closer to 'good banking' practice – in that the borrower's income enters the equation – but can still fall short. What matters is the assessment of future income, not just current or past income. And what matters is not the amount of debt, but the serviceability of the debt. That said, rules on serviceability, per se, probably would result in tendencies for lenders to favour 'interest only' (ever-greening) and 'interest capitalised' loans (these, on Minsky's typology of credit being, respectively, speculative and 'ponzi' lending). Such unintended consequences, were they to emerge, could result in less, not more, prudent lending.

All of which, I think, serves to caution against an approach based on imposition of 'credit control' by one-dimensional regulatory 'instruments'. While good credit management, in concept, is not particularly complicated, it does require all of (future) income, collateral, and the borrower's equity to be considered, together, and in a forward, rather than backward, looking context. (There is, I think,still something to be said for the 'three C's' of lending – character, cash-flow and collateral). In my view, principles-based supervisory oversight is more likely to engender that kind of approach by banks to lending than application of one-dimensional 'regulatory' instruments.

A further issue concerns the narrowness of focus of the current set of macro-prudential 'instruments' – focused mainly, as they have been, on lending secured by a mortgage over a residential dwelling.[12] While nowadays that comprises a sizeable share of banks' loan portfolios, residential lending, in many respects, is actually well spread (a very large number of quite small individual exposures) and diversified (the income to service the debt comes from across all sectors of the economy). That, combined with, in New Zealand (very little?) 'low doc' lending, or lending by banks against speculative residential developments (of the kind undertaken by finance companies in 2000s), causes one to wonder whether the LVR and DTI 'instruments' are the right ones to have (pride of place) in the tool-kit. The history is that bank lending that leads to crisis invariably is 'commercial' lending (including for residential property development, as in the cases leading up to the GFC of Ireland and a number of US states). Traditional (prime) mortgage lending for housing, underpinned by prudent assessment of the ability of the borrower to generate the cash-flow needed to pay the interest and amortise the principal, rarely if ever, has led to crisis.

For these reasons, I see a risk that focusing on 'traditional' residential mortgage lending could see growth in lending into other market segments 'go under the radar'. There is a need for the Reserve Bank to be alert to all areas of emerging risk and to respond appropriately. For example, during the past decade or so, perhaps the market segment where the greatest risk has emerged has been in the dairy sector (spanning all of family farms, corporate farms and dairy processing firms). In addressing the risks in this market segment, the Reserve Bank appears to have focused more on understanding

[12] Counter-cyclical adjustments to capital and core funding ratios are also in the 'tool kit' but have not been the subject of much attention.

banks' credit policies and practices, and to have engaged with banks boards and managements on the basis of those, rather than looked to the regulatory 'tool-kit'. That I think is the more appropriate and, in the long run, more effective, supervisory response.

I have less difficulty with the Bank adjusting capital and funding requirements in a counter-cyclical manner. This includes because these 'instruments' operate on the liability side of banks' balance sheets, and therefore do not skew the allocation of credit one way or another in the same way as do LVR and DTI 'instruments'. As suggested in response to question 2C in Consultation Paper 2A, I think avoidance of allocative distortions should be one of the basic principles to be incorporated into the specification of the Reserve Bank's 'objectives'.

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

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

See responses to question 2 A above.

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

See response to question 2 A above.

- Should lending standards apply only to deposit takers or to all lenders? The Reserve Bank's role in financial policy and how it should be resourced.

I recommend <u>against</u> extending application of 'macro-prudential' instruments to financial institutions that it is considered do not need to be supervised. That would be to go beyond 'macro-<u>prudential</u>' regulation and take us back to plain old 'financial regulation' or 'credit controls' – a return to the way in which macro policy was conducted in the 1960s and 1970s. At the very least, careful study of that previous experience should be undertaken before reverting to implementation of macro-stabilisation policy using financial regulation.

None of which is to say that the supervisory boundary should not be kept under review. If non-bank institutions evolve in a way that they are providing deposits that are monetary in character, then I would support those institutions being brought within the 'supervisory boundary'. A case in point is money market funds in the US, where a range of institutions offer both 'deposit' and 'money market' facilities that, so far as I can see, are next to identical. The latter are outside of the supervisory boundary and, formally at least, are not covered by deposit insurance, and that is a problem. Is there currently, or in the foreseeable future likely to be, any equivalent scenario in New Zealand?

- Should there be special governance arrangements for these tools?

No – because they should not be separate from the Reserve Bank's core supervisory role and hence, should come within the ambit of the standard arrangements for governance of the Reserve Bank's supervisory role (see responses above to questions in Chapter 3 in Consultation Paper 2A).

- Should the Reserve Bank reconsider its view that these tools should only be applied temporarily?

I think this question should be revised to: "Should the Reserve Bank reconsider how these 'tools' relate to its supervision function?" – to which I would answer 'yes'.

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

This question goes to the extent and nature of the Reserve Bank's 'independence' in its supervisory role. Key principles in that regard I think are that:

- The Government/Minister should not be involved in the supervision of individual institutions (other, possibly, in resolution situations where depositors face loss and/or there is systemic risk);

- Governance of decision-making on the setting of <u>prudential standards</u> needs to be such as to give the standards legitimacy. At the least, such standards should be subject to approval by the Reserve Bank Board, or a Prudential Policy Committee (either of the Board, or a statutory committee). I see some merit in the 'recommended by the Board, approved by the Minister' model. The resulting standards should be 'dis-allowable instruments'.

If macro-prudential instruments that affect the allocation of credit are to be retained, then I would see it as being for the Government/Minister to have the final say on setting/adjusting those 'instruments'. But my first preference would be to avoid having 'instruments' of that kind.

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

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

Issues I see with respect to the Bank's current approach to supervision and enforcement include:

- whether it is too 'compliance' focused, with insufficient attention to, or understanding of, the risks (including qualitative elements of those risks) to be managed by deposit-taking institutions (and insurers)?
- whether it is sufficiently focused on the underlying things 'that matter' or more focused on things that matter less, or are mainly symptomatic of what may be bigger underlying risks and issues?

These, in broader terms, are questions about whether the Bank adopts too much of a 'regulatory' rather than a 'supervisory' approach to its bank supervision role. Does the Reserve Bank see itself as a 'regulator'? Or as a 'banker' which, by virtue of having registered banks, and thereby given them access to the 'safety net' – as if it had extended to each a stand-by letter of credit?

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

I support the Bank being cognisant of the risks to financial stability from expected change in the climate. Even though the nature and extent of the impact of change in the climate remains uncertain, and the main effects may be some decades away, it is also the case that financial markets are forward-looking such that expected effects may be reflected in changing market values sooner rather than later. The Reserve Bank needs to be alert to such developments.

But it should not, in my view, take upon itself a role in actively supporting the government's contribution to the international effort to respond to climate change itself. The Reserve Bank's responsibility is for monetary stability, not climate stability.

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

Of the possibilities listed I see the greatest scope for improvement as coming from:

- resourcing; and
- relationships (particularly the trans-Tasman relationship).

Effective supervision, including effective supervisory enforcement, calls for high levels of capability (knowledge and experience). In my experience this aspect tends to be under-estimated. At my time at the Reserve Bank I worked, in roughly equal proportions, on monetary policy and in prudential supervision. I found the supervisory work to be a whole lot more demanding than that on monetary policy – including because the accountabilities are much more acute.

I think high priority should be given to undertaking an (independent) capability review of the Reserve Bank's supervision functions, to identify and capability gaps and ways in which those, over time, can be filled. This could be similar to the capability review of APRA earlier this year (Grant Spencer having been a member of that review panel). I see it as essential that such a review be undertaken before addressing resourcing shortfalls – given that the latter will be as much about the kinds of additional resources needed as the overall quantum (of additional funding) needed.

I also see scope for the Reserve Bank to leverage its relationship with APRA more than it currently seems to. With New Zealand's four largest banks (accounting for something like 85% of the NZ banking system) wholly-owned by Australian bank parents, it is inevitable, and desirable, that each of those banks operate within a structure of group governance and control. It has long been recognised that, within the right structures, and with effective home-host supervision, parent banks can – and should – be a significant 'source of strength' to a bank subsidiary, both in terms of providing an additional layer of governance and risk control, and in terms of being a source of capital if that is needed.[13] (See, for example, https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr189.pdf.)

Over the past decade or so, the RBNZ has moved in the direction of 'ring-fencing' the New Zealand subsidiary from the parent. That can be seen as having been a necessary first step in developing with the Australian authorities a more integrated approach to group supervision and group 'failure management. Developing such arrangements will only be feasible if there is adequate protection for each country's 'national interests' and, as things stood at the turn of the century, the necessary foundations from which to achieve that (at least for New Zealand) were not in place. The Reserve Bank's 'local incorporation' and 'outsourcing' policies can be seen as steps toward establishing the necessary foundations for effective home-host (or 'group') supervision.

But they should be seen as no more than a necessary first step. Most with experience with these issues would take the view that managing the insolvency of one of the Australian banks in New Zealand, at a time when the parent bank is not in a position to provide the recapitalisation required, on the basis of the two national authorities 'doing their own thing', would result in a highly unfavourable, if not damaging, outcome. The group's largest asset – its 'franchise' – would be seriously damaged (probably unnecessarily). By the same token, establishing cross-jurisdictional arrangements for an integrated approach, the so-called 'single point of entry' approach to failure management has its own, considerable, challenges. Without a strong political mandate at the highest level in both countries, and even with that, it may prove impossible. Although the UK and the US appear to have got closer to a workable set of arrangements than most. (See https://www.bis.org/bcbs/events/bartnf/avgouleasgoodhart.pdf) If the US and the UK can do it, perhaps it is not impossible between two other countries with something of a 'special relationship'. I guess one will know only by trying?

If progress could be made on this front, I see potential for New Zealand to derive significant gains:

- through more effective joint supervision of the Australian banking groups; including reinforcement of the incentives that parent banks have to be responsible for their New

[13] I am mindful that in the 'banking crisis' in New Zealand in the late 1980s/early 1990s, the New Zealand operations of at least four or five international parents were 'bailed out' by their overseas parents, in some cases more than once. Although it is to be acknowledged that in all these cases the New Zealand operation was small relative to the size of the parent, i.e., there was no question about the parent's ability to support its NZ subsidiary. That parental support is perhaps is less capable of being relied on where the subsidiary is large in relation to the parent but, at the same time, where that is the case, it makes it all the more important that there should be effective group governance and control.

Zealand subsidiaries (an incentive they already have given their financial and reputational investment in the New Zealand subsidiary).

- the benefits of the additional layer of oversight/control from 'head office'/the parent Bank board, including the benefit of the 'outside perspective' that brings. In my experience, risk managers who are 'one step removed' sometimes ask questions that those 'close to the local scene' can miss. The practice of some Australian banks of appointing a New Zealand subsidiary director to the parent bank board seems positive in this regard. None of this is to discount the value of 'local knowledge', but rather to suggest that the ideal is to have both – local knowledge and the benefit of outside perspective. These things are not binary.

- the corresponding benefits that the 'group supervisor' (APRA), working in collaboration with the local (NZ) supervisor, can provide including in terms of:

  - mutual interest in the effectiveness of governance of the parent bank/group, and how it links to governance at the local level. Here APRA's and the RBNZ's interests substantially overlap.

  - the much greater level of resources and experience available to APRA compared with what is, and probably can ever be, available to the RBNZ . There is potentially significant advantage to New Zealand from the RBNZ operating in a way that leverages those resources.

In short, with the right framework in place, APRA is a resource that the RBNZ, with its limited resources, can leverage. It is not clear whether the RBNZ, so far, has taken full advantage of this resource. The Governor just recently has posed the question:

> *Are we appropriately joined at the hip with the Reserve Bank of Australia and the Australian Prudential Regulation Authority…?* (reported in the AFR, 27 August 2019).

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

I have significant reservations about the effectiveness of the 'traditional' (US) approach to verifying information by on-site inspections (of the kind that involves going through loan files and detailed compliance testing). In my experience, about the only people who have much chance of picking up problems in that kind of way are people who have had long-experience as front line bankers, and therefore know most of the 'tricks of the trade' e.g., perhaps the reason why some international banks use semi-retired credit officers in a group inspection role!

The kind of supervision that I think can be effective is that based on a 'know your customer' based approach – one built on the supervisor developing a good understanding of a bank's business and of the people running it, in many respects similar to how commercial banks conduct the relationships they (should) have with the business and corporate customers on which they have an exposure. This requires the supervisor to be sufficiently knowledgeable and experienced to be able to exercise the sound judgment required. Good supervision involves getting the balance right between being informed and exercising judgment – and usually that does not require one to have a lot of technical detail. Too much technical detail tends to cloud rather than clarify the picture. What is needed, rather, is the ability to see past/through the complexity to the underlying risks and weaknesses. That calls as much for experience as it does for technical skill.[14]

This is consistent with what often is referred to as 'risk-based' supervision although, in my experience, much so-called risk-based supervision is still much more compliance-based than risk-based. While I am not close to how the RBNZ currently performs its supervisory role, I get the impression that the approach to determining where the greatest risks lie is more 'technical' than 'judgmental'.

It also seems to me that the Reserve Bank may over-emphasise bank size, per se, in its risk-based approach to bank supervision. In the case of small local banks, the Reserve Bank alone is pretty much 'the goalie' – if something gets past the Reserve Bank, there is no other 'line of defence'. Whereas in the case of a bank with an international parent bank, there are additional 'defenders' – both in front (parental governance and control) and behind (a source of capital if needed).

How much weight one attaches to these factors is a matter for judgment. But experience suggests that generally parents are (much) more of a 'source of strength' than a source of risk. There have been very few instances where a parent bank with the capacity to do so has not supported a wholly-owned bank subsidiary in need of support; but many more cases of a (significant) subsidiary having seriously impaired its parent.[15] These considerations suggest that if arrangements can be made for more effective supervision by APRA and the RBNZ of the banks in New Zealand that are part of an Australasian banking group, that could free up supervisory resources for the RBNZ and enable it to shift some of its focus to supervision of the locally-owned NZ banks. That would be consistent with wanting to see that part of the New Zealand banking system grow in strength and increasingly as a source of competition for the four 'big' Australian-owned incumbents.

Some shift in supervisory focus will also be necessary once deposit insurance is introduced. Once that is implemented, the incentive facing depositors will be to place their deposits (up to the insured limit) with whichever bank(s) are paying the highest rate of interest. And, almost by definition, those will be the banks taking the greatest risk (more risky lending enables charging the higher lending rates needed to pay the higher deposit rates). The possibilities for this kind of risk-escalation probably are greater in the case of those banks which are not subject to the constraining effect of 'second lines of defence'.[16]

[14] The Panel that reviewed APRA's capability, if anything, goes further in saying that effective supervision needs "highly skilled staff with good judgment and **courage**" (my emphasis).

[15] This corresponds with my experience in commercial banking, where the largest exposures are not necessarily always the ones that require closest oversight. Many a (sizeable but not especially large) exposures to locally-owned firms warrant at least as much, if not more, attention as those to the local subsidiary of a multinational, including because in the case of the former, there is no parental/head-office oversight and possible 'backstop'.

[16] Another source of possible constraint on risk-escalation is providers of wholesale funding, although experience suggests that this can be even more variable in its effectiveness than parental oversight.

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

Some history

Historically, the central bank-commercial bank supervisory relationship was founded on the reliance of commercial banks on the central bank as 'lender-of-last resort'. There was always the potential for a commercial bank to experience a loss of public/market confidence and to have to 'go cap in hand' to the central bank for funding support. This put the central bank in the position of being able to see to it that banks maintained appropriate prudential standards. Absent that, the central bank could withhold such support, particularly if it could not satisfy itself as to a troubled bank's solvency (recognising that when the market loses confidence in a bank, a central bank needs quite strong grounds to take the contrary view – it has to know more than the market knows).

This, at least, was the British tradition. Up until 1979 the Bank of England conducted banking supervision entirely on the basis of the (central) banker-to-bank relationship. It is often said that the primary enforcement instrument was 'the Governor's eyebrows'.

The US tradition is somewhat different with banks having been state or federally 'chartered' and 'regulated' long before the establishment of the Federal Reserve System in 1913. Thus, supervision in the US has always been more 'regulatory' in character. But as in the UK, supervision has often been said to be the 'quid pro quo' for access to the 'safety net' (the discount window, and since 1933 deposit insurance).

The global trend in recent decades has been toward more of a 'regulatory' approach to supervision. The prudential standards developed by the Basel Committee, which started out as being prescribed only in general terms (the 'Basel Concordat', the Basel 1 capital standard, and the initial 'core principle's), have become increasingly more detailed and prescriptive. And in most countries, this has been augmented with supervisory authorities having been given 'regulatory' powers of enforcement. These nowadays generally include powers to direct, and to apply financial sanctions/fines, either under their own authority or on prosecution before the court.

The Reserve Bank has had powers to give directions since the inception of the prudential supervision under the 1986 Reserve Bank Amendment Act, although those powers were very narrowly confined, for application only when a bank was in a very serious situation. Under the 1986 Act, for the Reserve Bank to give directions, the bank had to have been made subject to a 'Declaration at Risk', this being a step only one short of appointing a statutory manager. It was in that context that the power to give directions made was subject to the approval of the Minister, i.e., they were 'reserve powers' for application only in an (approaching) 'failure management' situation. The need for Ministerial approval was considered an appropriate check on the exercise of what potentially were strong powers e.g., as I recall, a direction could include a requirement to sell part of (or all) the banking business, including with override of the Commerce Act, or to remove directors.

These powers were substantially modified in 2003, to extend their scope such as to enable the Bank to 'enforce' regular prudential standards (those being applied by way of condition of registration), with it being made an offence (punishable by fine) for a bank not to comply with a direction. However, the requirement for the giving of a direction to be subject to the approval of the Minister appears not to have been adjusted or removed.

With, by 2003, the scope of the Reserve Bank's prudential 'standards' having considerably expanded, there clearly was a need for the Bank to have corresponding ability to 'give force' to those standards.

And the 'Governor's eyebrows' will not have had nearly the force they will have had in a former era, not even in the UK. Internationalisation of banking will have seen to that (subsidiaries will look to their parents for support long before they look to the central bank). Although in the wake of the GFC, banks now probably will have greater awareness of the dependency they have on their local central bank for local currency than was the case previously.

An approach going forward

With prudential 'standards' now an established part of the supervision regime, there is a need for means by which adherence to those standards can be 'enforced' – other than (threatened) resort to the 'nuclear' weapon, i.e., cancelling a bank's registration. There are few, if any, situations where that enforcement mechanism will be credible. At the same time, the enforcement regime must still incorporate proper safeguards and due process.

An approach that I think could be appropriate would be for powers of enforcement to include the ability to apply (civil) financial penalties, but for these powers to be vested in the Reserve Bank's Board/the Prudential Policy Committee, and with only limited delegation of such powers to Bank management (that only for relatively minor infractions). With committee decision-making, banks would have a level of assurance that the powers are being exercised appropriately. It would provide the Bank with credible means of enforcement, but also would provide banks with some degree of safeguard against disproportionate actions by the Reserve Bank. (There remains a question whether, constitutionally, it is appropriate that a Board should be able to apply fines – and, if it is, whether the penalised party should have a right of appeal and, if so who to – the Courts?)

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

See above for the background to the minister being required to approve the giving of directions and the cancellation of registration.

I see a case for retaining a role for the Minister in situations where there 'the public' would be affected, e.g., where the public would be exposed to loss, and where broader public policy considerations are in play (e.g., override of the Commerce Act, although it appears that provision already has already been removed from the Act?)

Otherwise, it would seem appropriate for the 'enforcement powers' to be vested in the Reserve Bank Board/the Prudential Policy Committee, as above.

However, the current checks in the process for appointing a statutory manager – recommendation by the Reserve Bank to the Minister and, in turn, recommendation by the Minister to the Governor General in Council, should be retained.

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

General comment

Early in Chapter 4 is the following:

> *The Reserve Bank has the 'sole right' (see section 25 of the Reserve Bank Act) to create New Zealand dollars and supply them to the financial system. This is arguably the key function of a central bank.*
>
> *As well as generating income, the Reserve Bank's ability to create New Zealand dollars (which can be electronic as well as physical notes and coins) enables it to undertake a variety of other useful activities, including:*
>
> - ***acting as the lender of last resort (LoLR)*** *(section 31) – providing financial institutions with New Zealand-dollar funding when market panic has made that funding hard to obtain elsewhere*
> - ***implementing monetary policy*** *– this usually involves intervening in the financial market to keep short-term interest rates near the OCR. In very weak economic circumstances, when interest rates are around zero, it may also include purchasing additional assets for the Reserve Bank balance sheet (this is known as 'quantitative easing')*
> - ***dealing in foreign exchange*** *(sections 16-24) – involves exchanging local currency for foreign exchange and vice versa*
> - ***providing banking services and other activities*** *(section 39) – these include settlement account services for financial institutions and certain trading in financial markets.67*
>
> *There are strong synergies between these activities and the Reserve Bank's role in managing the creation of New Zealand currency, so it seems appropriate to keep these functions within the Reserve Bank. However, it is worth considering issues related to their scope, objectives and governance. Chapter 7 discusses transparency and accountability arrangements in relation to the Reserve Bank's balance sheet (which are relevant to these activities).*

In my view, this description does not sufficiently capture the essence of the balance sheet to the business of being a central bank.

I agree with the statement that:

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

But would go on to make the point that this entails the Reserve Bank in issuing New Zealand dollars, whether evidenced in physical form (notes and coin) or in book-entry form, on the liability side of its balance sheet. It issues those liabilities in exchange for the value it accepts (government bonds, foreign currency, etc) as recorded on the asset side of its balance sheet. And the terms of that exchange define the central bank's monetary policy. This includes whether the transactions in question are described as:

- 'intervening in the financial market to keep short-term interest rates near the OCR' (often referred to as open market operations) or as 'quantitative easing';

- 'dealing in foreign exchange' – transactions in which the central bank accepts foreign claims in exchange for the issuance of its own liabilities;

- 'acting as lender of last resort' – transactions in which the central bank accepts a claim on a bank collateralised by 'good collateral, or through outright acquisition of the collateral itself.

It is not as though a central bank can implement monetary policy unless it has a balance sheet on which it can undertake these kinds of transaction. To be sure, central banks can influence market interest and exchange rates merely by announcing, or releasing information that provides guidance on, likely upcoming changes to its monetary policy. But the effect of those announcements flows from the central bank's ability to use its balance sheet to implement what it has announced. If one takes the balance sheet away, the central bank has no more capacity to influence financial market prices (interest rates or exchange rates) than any other 'market commentator'.

In sum, therefore, I see it as neither necessary, nor appropriate, to identify in the new Reserve Bank Act a list of 'balance sheet functions' separate from its 'monetary policy' function. It is through its balance sheet that the central bank gives effect to its monetary policy or, putting it the other way round, monetary policy is the policy followed by the central bank in setting the terms on which it transacts. 'Balance sheet functions' and 'monetary policy' are not separate functions, they inseparable, if not one and the same thing.

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

The lender of last resort role of central banks seems to be little understood. But I am not sure that legislation is the place to give better articulation of the role. Nor, in fact, whether it need be separately specified in the Reserve Bank Act at all. Acting as lender of last resort is the monetary policy that a central bank follows in a particular set of circumstances – that is, when there is a collapse of confidence in the commercial banking (or monetary) system. In those circumstances, to maintain monetary stability, the central bank needs to, in effect, step forward to refinance (solvent) commercial banks – so as to avoid the implosion in money and credit, and macroeconomic consequences, that otherwise would occur.

But if it is thought that there is a need for the Act to include instruction to the Reserve Bank on the monetary policy it is required to adopt in this kind of circumstance, perhaps once could find a way of crafting that into the high-level statement of purpose (see responses above to the questions in Chapter 2 of Consultation Paper 2A).) In this connection, I note that the Federal Reserve Act includes as its 'Official Title' :

> An Act To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.
>
> (The words most relevant to the lender of last resort function being 'to furnish an elastic currency' and 'to afford means of rediscounting commercial paper'.)

This US formulation goes back to the origins of the Federal Reserve – those having been to avert recurring crises of confidence in, and collapses of, US banks, and resultant serious instability in money and credit and in the macro-economy. The 'solution' was to have a central bank that could help to keep the, hitherto entirely commercial, monetary system on a more 'even keel', through supervision and the ability to step forward with re-financing (last resort financing) in a banking panic.

Despite the role of the central bank as 'lender-of-last-resort' being foundational to central banking – it is essentially why central banks were 'invented' – it is a role that in the second half of the 20th century fell very much into the background, and came to be relegated mostly to the history books. Post World War II banking was so regulated that crises of confidence/bank runs came to be regarded as a 'thing of the past'. (The run on Northern Rock was the first run on a bank in the UK for more than a century.) [17]

But the GFC brought the role very much back to the fore, especially in the immediate wake of the Lehman's bankruptcy when collapse of confidence within wholesale markets resulted in banks almost everywhere facing severe difficulty in retaining/raising funding (in effect there was a global wholesale 'run'). If central banks had not then stepped in to provide the (re)financing needed, banking systems in a number of countries would have imploded, similar to what had happened nearly a century earlier in the 1930s, when the Federal Reserve refrained from acting as lender of last resort.[18] It was, in the circumstances, the appropriate response – at one and the same time, both the appropriate monetary policy response and the appropriate 'financial stability' response.

But whether it is necessary to prescribe in law that response as being the appropriate response in those circumstances I am less sure. Is there any more need for the Act to state the monetary policy to be followed in that kind of situation than there is to specify the monetary policy to be followed in a period of sustained high inflation, or what the policy should be in the current period of sustained low inflation and, it seems, near full-employment (if we knew what the statutory prescription for that should be!)

It perhaps also bears repeating how the central bank in its role as lender of last resort not only gives effect to 'monetary policy', but also how bank supervision is an inextricable to the role. A central bank cannot act as lender of last resort, without risking debasement of its own liabilities, unless it can be satisfied that the banks to which it is lending are solvent. That requires either that the central bank undertakes sufficient supervision itself to be satisfied that banks in whose solvency the public/market has lost confidence can be judged actually to be solvent, or can rely on a separate supervisory agency for that assurance (as the RBA relies on APRA).[19] In the latter case, the central

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[17] Although less so in New Zealand, give the runs that occurred in the 1980s on the Countrywide building Society (1985) and the United Building Society (1988).

[18] As Chairman of the Federal Reserve Bernanke famously said on the occasion of Friedman's 90th birthday:

> Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again.

[19] It seems sometimes to be thought that it is not necessary for a central bank to be able to judge the solvency of the banks because loans of last resort can be – and generally should be made – made against collateral. That, however, is to miss the point that if the market/public have lost confidence in a bank, and are 'running', refinancing by the central bank on a collateralised (preferred) basis is more likely to finance continuation, rather than to stop, the run. Providing funding on such a basis does nothing to lessen the public's (depositors') exposure to loss and hence nothing to restore confidence. (That was very much the experience with Northern Rock – the queues got longer, not shorter, once it became known that the Bank of England was providing emergency funding.) And absent curtailment of a run, the central bank may, at least in the limit, end up as the bank's sole financier. At which point the central bank itself is as much exposed to loss as if it had lent unsecured. Hence, the importance of a central bank, at the outset, being satisfied as to the solvency of banks

bank can be thought of as having 'out-sourced' the supervision needed in order for it to be 'lender of last resort'. In this regard, it might be said that 'you can take bank supervision out of the central bank but you cannot take the central bank out of bank supervision.'

These points underscore the connection of between monetary policy and bank supervision – functions that I consider to be 'joined at the (lender of last resort) hip'. As above, I think it would be helpful if the new Reserve Bank Act were to reflect that integration, in contrast to what in the current Act is a listing of mostly separate (and dis-connected) functions.

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

I think the Reserve Bank Board (and/or the Monetary Policy Committee) should have full discretion in setting the policy by which it issues its liabilities in exchange for value (i.e., monetary policy) provided that the claims acquired in that process are confined to:

- claims on the NZ government – subject to these being acquired on, or on terms equivalent to, those prevailing for corresponding claims in the secondary market;
- claims on NZ banks;
- claims on foreign counterparties (in the context of the Bank managing foreign exchange reserves).

Operating within those constraints would respect the principle that the Reserve Bank generally should avoid acquiring claims on the New Zealand private sector and, in that way, become involved with credit and resource allocation within the market economy. For the Rserve Bank to become a participant in those processes would take it into what are commercial banking and/or quasi-fiscal functions.[20]

That said, perhaps one cannot rule out the possibility of situations arising that call for the Reserve Bank to operate outside of the usual bounds for a central bank. This might include needing to become a 'market maker of last resort', say for commercial paper, as in the case of the Federal Reserve during the GFC.[21] It would be appropriate for extensions of the Reserve Bank's role into

to which it lends in its role as 'lender of last resort' role. This reflected in Bagehot's dictum that in a crisis, central banks should lend freely to solvent banks, against good collateral, at a penalty rate – solvency being the first, and I'd say foremost, consideration.

[20] Historically many central banks have undertaken some commercial banking functions and, indeed, some central banks e.g., the Bank of England and the Reserve Bank of Australia, started out as commercial banks (the Reserve Bank of Australia was split off from the Commonwealth Bank only as recently as 1959). The Reserve Bank of New Zealand for much of the post WWII period up until the mid-980s was commercial banker to the primary producer boards (the Dairy Board, the Apple and Pear Board, the Wool Board, the Tobacco Marketing Board, etc. This both 'complicated' the conduct of monetary policy and entailed provision of non-transparent and sizeable fiscal subsidies to those primary sector agencies.

[21] The other possibility is that there is insufficient 'qualifying' collateral available for the Reserve Bank to acquire and thereby issue its own liabilities in the amounts it considers necessary. Although, for that constraint to be binding, the circumstances would need to be such that it would not be appropriate to acquire (eligible) foreign claims, and the supply of those is next to limitless.

such commercial banking and/or quasi-fiscal functions to require the approval of the Minister of Finance.

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

The current specification of the roles of the Bank and the Minister in the Reserve Bank Act largely reflects the state of policy understanding in the late 1980s. This was toward the end of a long period during which exchange rate policy had been seen as squarely a matter for the government, and relatively early in the process of exchange rate policy coming to be seen actually as also inseparable from monetary policy. It was simply too soon for it to be considered appropriate for the Minister's/government's role in determining exchange rate policy to be relinquished. This state of affairs was not unique to New Zealand – in many countries, including, for example, the US, exchange rate policy still rested (and still rests) with the Treasury, not the central bank.

The way in which these competing considerations was reconciled in 1989 was to adopt for exchange rate policy a version of the 'over-ride' model. This provided for the Minister to be able to give the Bank directions on (including to fix) the exchange rate and, in that event, for the Bank to be able to require renegotiation of the Policy Targets Agreement or, if the Bank considered the direction inconsistent with the section 8 'price stability' primary objective of the Act, to invoke the full over-ride provisions of the Act.

To the best of my knowledge, in the 30 years since, the Minister has never given a direction on the exchange rate (though I am sure it sometimes will have been a subject of discussion when the Governor has briefed the Minister following OCR decisions). The main development regarding exchange rate policy since 1989, rather, was initiated by the Bank. In 2003 the Reserve Bank sought 'approval' from the Minister for a change from the 'policy' that had been followed since the float in 1986, that having been to maintain an entirely free float, with intervention to be confined to where necessary to support the <u>functioning of the market</u>, not to influence the rate (something that again, to the best of my knowledge has never happened).

The 2003 policy change was to introduce provision whereby the Bank could/would intervene in the foreign exchange market where it considered that would help to 'knock the peaks and troughs' off 'the exchange rate cycle', subject to the Bank considering that to be achievable without jeopardising the price stability objective. Whilst, under the Act, there was no need for the Bank to obtain the Minister's formal approval for this change of policy, the Bank considered that it gave rise to a need for the Bank to have a larger amount of foreign exchange reserves, and also a larger amount of capital, both of which <u>did</u> need to the Minister's approval. The Bank undertook some interventions in the fx market soon after the new policy framework was adopted, but I understand that there has been little, if any, intervention in the 15 or so years since.

Where to from here? Given the history since enactment of the 1989 Reserve Bank Act, one might take the view that there is no longer any need for the provisions in the Act to enable the Minister to have specific ability to direct the Reserve Bank with respect to the exchange rate. Arguably, things have evolved to the point where it is now reasonably fully understood that exchange rate policy cannot be separated from monetary policy or, in other words, that exchange rate policy is monetary policy.[22] That suggests that:

- the Remit for the MPC may now be the more appropriate vehicle by which the Minister can provide 'nuance' on the government's views on 'how the exchange rate fits in' with the overriding objective of maintaining price stability and maximising sustainable employment; and that

- the full 'override' provision is the vehicle by which the government can exercise its 'sovereign right' to set exchange rate policy (where the government's desired policy cannot be reconciled with the overriding objectives of the Act).

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

An issue that was debated around the time of the design of the 1989 Reserve Bank Act is whether the Act should mandate the Reserve Bank as the (or one of) the Government's banker(s). I have addressed that issue in response to question 2 in Consultation Paper 2A (above). To summarise, I think a case can be made for that, mainly on the grounds that it helps to lessen the conflict of interest that the government would face if 'its banker' was, or was at risk of becoming, insolvent. It is easy to see how in that circumstance, the government would face strong incentives to 'bail out' 'it's bank' – to avoid loss on its deposit balances and to avoid possibly serious disruption to the government's transactional banking (e.g., ability to pay welfare benefits). For these reasons, many central banks act as banker to the government, including, for example, the RBA.

Under current arrangements in New Zealand, the government's core transactional banking services are provided by Westpac, with each of ASB, BNZ, ANZ and Citibank providing sub-sets of banking services. However, balances are kept to a low level, by virtue of a daily end-of-day 'sweep' of balances in the core Westpac transactional account(s) to the government's account at the Reserve Bank.

Nonetheless, the government's dependency on commercial banks, particularly Westpac, for transactional capability remains. It is probably fair to say that the government's transactional banker is 'too important to close'; which underscores the need for a credible and effective capability to resolve such a bank without any cessation of transactional banking services. Without that, a government may have little option other than to 'bail out' a bank on which it has a significant dependency for transactional banking services (or may prefer to retain the central bank as its core transactional banker, as remains substantially the case in Australia).

Some also consider that it is necessary that the government bank with the central bank so as to underpin a demand for the central bank's money (liabilities); that being achieved through banks having to settle payments to the government in central bank money, and therefore commercial banks having to hold some level of central bank 'reserves'. I have never found that argument intellectually compelling. It has always seemed to me that if people wish to use something other than Reserve Bank liabilities as money, they should be able to do so. I am not convinced that institutional arrangements should be designed to enforce use of the central bank's money. Which is

[22] Indeed, some countries define and implement their monetary policy by way of their exchange rate e.g., Hong Kong and, to some extent, Singapore.

not to overlook that, if use of the Reserve Bank's money were to fall substantially out of favour, the Reserve Bank's ability to implement monetary policy also would diminish.

But this issue, to date, has been of little more than academic interest. No country with reasonably effective 'institutions' has seen domestic use of the currency issued by its central bank fall out of favour to such an extent that it has lost the ability to conduct 'monetary policy'.[23] The more material matter, I think, concerns management of the 'conflict of interest' that can arise where the government depends on commercial banks for its own banking services.

Another issue concerns the need for the government to finance the central bank with capital.

In balance sheet terms a central bank can resource itself – a central bank, and only a central bank, can pay its obligations by issuing its own liabilities. In that sense a central bank is bankruptcy proof. A central bank always is able to pay its obligations, at least those contracted in its own currency[24]. Correspondingly, it does not need a buffer of 'capital' to remain solvent.

Which is not to say that maintaining a sound balance sheet is not vital for a central bank. As for any organisation, the liabilities issued by a central bank can be only as good as the (net) assets on the other side of the balance sheet. Hence why central banks generally confine those to very low risk assets – government bonds and (collateralised) claims on (solvent) banks. If a central bank takes losses that result in it having negative net assets, that amounts to debasement of its currency. It is sometimes said that central banks need capital not to avoid bankruptcy, but to avoid policy bankruptcy.

To see that, consider a commercial bank with negative net assets, ie, with negative capital. If it is not recapitalised, it is closed and, in the wind-up, its liabilities are converted to 'good money' at a written down rate (say, 80 cents in the dollar, in the case of a bank with 20% negative net assets). Whereas in the case of a central bank, the central banks liabilities continue on issue and to circulate – but they will come to buy less than previously. In other words, there is a depreciation of the currency, internally relative to the goods and services it can buy, and externally relative to the value of the currencies issued by other central banks. It is in this sense that central banks can become 'policy bankrupt' even though they cannot become financially bankrupt.

How much capital – how investment of real resources by the government – needs to be made in the central bank?

In theory the answer might be 'none', if:

- the central bank issues its liabilities only against 'safe' assets; and/or

- the government is bound to cover with a capital injection sufficient to cover any losses that are subsequently incurred (and with the government doing that by way of the command it

[23] Though who knows what the future may hold. It is not impossible to see something like a 'Google money' coming into sufficiently common usage that the demand for, and use of central bank-issued money does start to fall away and, with that the ability of central banks to implement monetary policy.

[24] Theoretically a central bank can also always meet its foreign currency obligations, in that, in theory, there will always been some price in local currency at which someone will sell the central bank the foreign currency it needs. But in practice, there is a point at which the local currency become so debased that no one holding 'good money' is willing to exchange it for the local currency - the hyper-inflation situation.

has over real resources (through its power to tax), rather than itself merely borrowing from the central bank. In other words, provided that the government is bound promptly to recapitalise the central bank ex post.

Moreover, central banks have a virtually guaranteed source of income – that being the seignorage earned from issuing notes and coin. Those liabilities bear no interest income, whereas the proceeds can be and are invested in interest earning assets. That source of income, however, currently is diminished owing to the exceptionally low prevailing level of interest rates. It may also diminish further in the future if the amount of notes and coin on issue falls away, upon electronic means of payment using commercial bank (deposit) liabilities making further inroads into the role currently played by central bank-issued notes and coin.

Yet it is widely thought, at least amongst central banks, that central banks do need to be 'adequately capitalised'. That reflects a number of considerations:

- optics/credibility. Public understanding of (the mysteries) of fiat money and central banking is limited – such that if a central bank with little or no capital would likely be (reported) and widely perceived to be 'unsound'. Credibility is important and reporting a balance sheet that looks sound by conventional (commercial banking) metrics assists with that.

- central banks can and sometimes do incur losses (e.g., in foreign exchange intervention activity).[25] Also, most central banks maintain a structural exchange rate exposure within their balance sheet . Most central banks, including the Reserve Bank maintain a 'long' foreign exchange position, resulting in holding gains when the NZD is depreciating and losses when it is appreciating. Again that carries some advantage in terms of 'optics', but it also means that there will be foreign exchange gains and losses over the cycle.

- relying on ex post capitalisation could undermine the central bank's independence – if for instance, it required budgetary appropriation (rather than being covered by permanent appropriation)

These considerations might point to the actual amount of capital required being determined taking account of:

- the credit risks inherent in the central bank's assets – generally these should be very small, given that a central bank's assets should normally comprise only claims on the government and on (solvent) banks; and in the case of assets held as foreign reserves, similarly rated assets;

- the extent to which there is seen to be a need for intervention activity in the foreign exchange market, and of the structural fx position embedded in the balance sheet;

- the extent of the Reserve Bank's seignorage income, relative to the losses it could incur (and its operational expenses).

[25] And not only from buying the local currency in an (unsuccessful) attempt to prevent its depreciation. Buying foreign currency in an (unsuccessful) attempt to curtail appreciation of the local currency also results in loss to the central bank (including often a carrying loss if the foreign interest rate is less than the local interest rate).

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

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

Under the current Act, in exercising their powers a statutory manager of a registered bank is required to have regard to—

(a) the need to maintain public confidence in the operation and soundness of the financial system:

(b) the need to avoid significant damage to the financial system:

(c) to the extent not inconsistent with the considerations referred to in paragraphs (a) and (b), the need to resolve as quickly as possible the difficulties of that registered bank:

(d) to the extent not inconsistent with the considerations referred to in paragraphs (a), (b) and (c), preserving the position of creditors and maintaining the ranking of claims of creditors:

(e) the advice of the Bank.

The introduction of a deposit protection/insurance regime will have important implications for the resolution regime. For instance, under the current hierarchy of 'considerations', deposits, and therefore the deposit 'insurance fund' could be used to 'bail out' the financial system; and if the government is to be guarantor of the fund, that could result in possibly even greater 'government bail-out' of the banking system than would occur under existing arrangements. Under the current statutory regime, the extent to which a statutory manager can impose losses on depositors is at least constrained by the first ranked "need to maintain public confidence in the operation and soundness of the financial system".

I make this observation mainly to illustrate that introduction of deposit insurance will necessitate a thorough-going review of the existing statutory management regime; something which, in the light of the considerable progress made on resolution regimes internationally since the GFC, is needed in any event. Without going into detail, a few specific issues that occur to me include:

- where does the 'protection of depositors'/the insurer now fit in? There is a spectrum, from there being a primary focus on protecting the deposit insurer (a statutory preference for insured deposits?) to the current prescription, where depositors' interests are ranked down the list;

- where does OBR fit in, in particular:
    - does the pre-positioning of bank's systems for OBR become the operational vehicle for enabling depositors to have rapid access to insured deposits; i.e., what was to be the de minimus amount becomes the insured amount?

    - is there a need for additional/alternative resolution options, say, if it considered necessary to avoid closing/haircutting a bank's wholesale operations (including fx trading/derivatives book/trade finance etc). One alternative would be to enable the insurer fund a 'purchase and assumption' or a 'bridge bank' structure – or should deposit insurance funds be capable of being applied only to the paying out of retail deposits?

- whether to introduce a 'no creditor worse off' (than under a standard liquidation) test?

A further critical matter, in the case of banks owned by foreign banks, is the matter of co-ordination with the foreign authorities. If, as seems most likely (almost certain?), the need to resolve a foreign bank-owned New Zealand bank will arise only if the foreign parent also has 'failed' (and hence is unable to recapitalise its New Zealand subsidiary), there is the critical question of cross-border co-ordination.

It seems vital that this question be capable of being determined rapidly at the time with the foreign authorities. Delay and/or uncoordinated resolution interventions would be almost bound to result in considerable uncertainty (even chaos) and, in the case of a bank with substantial franchise/brand value, most likely would result in serious damage to the value of that asset – which for some banks probably is their most valuable asset. The less the damage that can be done to that asset, the wider are the resolution options available. This aspect is obviously of critical importance in the case of the four Australian bank-owned banks in New Zealand (given the systemic importance of those banks, in both countries).

The history, or at least the experience in the late 1980s/early 1990s crisis, has been adoption of a 'single point of entry' approach to resolution.[26] However, in recent years the Reserve Bank has taken a series of steps that would better enable a 'multiple points of entry' approach, under which the Reserve Bank could (or would?) resolve the New Zealand subsidiary of an Australian bank on a national, stand-alone basis. To what extent this is have in place a 'back-stop' should a proposed resolution by the Australian authorities be considered inadequate, and to what extent it reflects a preferred modus operandi by the Reserve Bank is not clear. The existing Memorandum of Cooperation on Trans-Tasman Bank Distress Management is helpful in so far as it goes, but leaves a large degree of uncertainty about how things might work in practice. It leaves most of the key matters to be resolved at the time. Perhaps this is unavoidable – there are limits in this space on the extent to which governments can commit in advance.

But it is also a matter where leaving things 'constructively ambiguous' is far from ideal. From the GFC we learned that in a crisis ambiguity is more likely to be destructive than constructive. I don't have a ready-made 'solution' for this 'problem'. Perhaps the best that can be done is for the RBNZ to build with APRA the more integrated approach to supervision of the Australian-owned banks in New Zealand discussed above. With that, stronger working understandings might develop, with those providing a platform from which the chances of achieving good outcomes (for both countries), or at least avoid unnecessarily bad outcomes, would be improved. This is an area where solid but less than entirely formal cross-border relationships may provide the best chance of success. Going for too much certainty may, perversely, leave one with less, not more certainty.

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[26] All the trans-Taman banks that failed or near failed in the late 1980s/early 1990s were all 'resolved' on the basis of a 'single-point of entry' – by the home country authority. The BNZ's recapitalisations to stave off failure in 1989 and in 1990) were handled entirely by NZ, including the 1990 recapitalisation notwithstanding that Australia was the source of much of the loss that gave rise to the need for that second recapitalisation. And the difficulties of Westpac (1992) and failure of the State Bank of South Australia (1991), both of which had branches in New Zealand, were resolved by the Australian authorities.

An additional, important, point is that, these being matters that involve another country's authorities, means that, ultimately, they are for determination at a government-to-government level. They do not fall within the proper scope of 'central bank independence'.

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

I favour the Reserve Bank remaining the 'resolution authority', mainly because effective resolution of a bank requires the resolution authority to have a good understanding of banking and of the bank in question. That is also needed to be an effective bank supervisor. New Zealand is too small to be able to 'afford' a doubling up on that capability.

But I think the Consultation Paper also correctly raises relevant issues concerning the allocation of resolution powers and roles as between the Minister, the Reserve Bank (Board) and a statutory manager. These are details to be clarified/refined as part of the thorough-going review of the existing statutory management regime.

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

As above, I consider it appropriate to remove the requirement for the Reserve Bank to obtain ministerial approval before exercising what, under the new regime, would be powers of direction relating to enforcement of prudential standards.

However, I consider it remains appropriate that the appointment of a statutory manager should be subject to a process with stronger checks and balances; and the current process – recommendation by the Governor (in future the Board) to the Minister and, in turn, by the Minister to the Governor General-in-Council – seems appropriate. Statutory management entails powers to override contracts and property rights and therefore calls for significant safeguards. And, arguably, it should be for the Government- of-the-day to determine whether to follow the statutory management course, or alternatives, e.g., government bail-out. There seems to be no more case for removing these decision-making rights from the democratically elected government than there is for removing them in respect of the government 'bailing out' any other enterprise (Air New Zealand, KiwiRail, other commercial enterprises that may fail in the future).

In any event, in any bank failure, public funds potentially are at risk. Once 'the balloon goes up' , there is no telling what one will find – potentially a much larger, or different kind of, 'hole' than was first thought to exist and the potential need for use of public money when none had been envisaged.[27] Moreover, once deposit insurance arrangements are in place, if the government is to

[27] As in the case of the DFC, where public funds were used to enable a more favourable outcome for a category of creditors who may otherwise have frustrated the resolution process/initiated Court proceedings (in this case, against the backdrop of a government agency being a significant shareholder in the DFC).

provide underwriting for those, any bank failure (potentially) will exposure the government to at least some residual level of risk.

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

This is an aspect of the current prescription in the Act that is not as 'tidy' as it could be. Some clarification probably is in order, to make it clear that ultimate decision-making rights rest with the government authorities. That said, experience suggests that its important that the appointed statutory manager has the capabilities needed for the role, and those kinds of people may well be reluctant to take on such a role if they think they are going to be 'micro-managed' every step of the way. The desirable balance is one that gives a statutory manager a fair bit of scope to 'run the statutory management' within a framework agreed with the authorities, but with effective reporting and requirements to consult on material matters, and with the authorities having final decision-making rights.

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

I support having a 'bail in' capacity – <u>provided that</u> it is clear in the contractual terms of the issue. Deposits, by contrast, should not be capable of being issued on bail-in-able terms.

The Australian authorities in November 2018 proposed that banks in Australia be required to fund an additional proportion of their risk-weight assets by way of liabilities issued on 'bail-in-able' terms. The proposal was to increase 'total loss absorbing capacity' (TLAC) by the equivalent of 4-5 percentage points of risk weighted assets, to a level (including a level of 'surplus' capital above the regulatory requirement) of 18.5-19.5 per cent of risk-weighted assets. In July this year APRA advised that, following consultation, the requirement would be to increase TLAC by 3% points by 2024, with a view to the balance of the proposed increase being applied over a period after 2024.

There would be merit in the Reserve Bank considering a parallel approach for New Zealand – consistent with establishing an appropriate allocation of group capital as between Australia and New Zealand.

Also notable is the application in Australia of a levy on 'big banks' (those with total liabilities exceeding A$100 billion). This levy is charged at the rate of 0.015 per cent of total liabilities (with a number of deductions including for: deposits covered by deposit insurance, high-quality prudential capital, and balances in exchange settlement accounts held with the RBA.) This levy is intended to cover the 'subsidy' implicit in 'too big to fail' – in effect, an 'insurance premium' in respect of 'implied insurance' for wholesale funding not covered by deposit insurance. There could be merit in New Zealand considering something similar. Even though increasing TLAC to something similar to the level being phased in in Australia should take the safety of reasonably well supervised banks, including the big banks, to a (very) high level, there is always a residual risk of failure (tail events) and it is appropriate to price that risk.

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

This has been a vexed issue – all the more so in New Zealand given the emphasis given to disclosure in the 'New Zealand' approach to banking 'supervision' policy (albeit less than once was the case). Again there is some history behind what is in the current Act.

Disclosure obligations for banks in respect of issuing deposits to the public commenced under the 1986 Reserve Bank Amendment Act. The policy intent of that legislation was to put the issuing of deposits on the same basis as issuing debt securities to the public – to lessen, and possibly eventually to eliminate, the 'special status' of banks and bank 'deposits'. Consistent with this, an exemption for banks from having to raise deposits by way of a registered prospectus was removed. This made banks' deposit-taking subject to the continuous disclosure and strict liability provisions of the then Securities Act.

However, in the late 1980s, some difficult issues arose. It was becoming evident to the directors of some banks that their bank's financial position no longer corresponded with what was disclosed in its registered prospectus; but they were not in a position to disclose that. Nor was suspending the prospectus (taking the Bank 'off the market') a feasible option. The difficulty facing bank directors in that situation will be evident.

It was for this reason, amongst others, that the 1989 Reserve Bank Act re-instated the exemption from the Securities Act prospectus requirement, and substituted the new 'Reserve Bank Act' disclosure regime for registered banks. This retained the statutory strict (criminal) liability provisions of the Securities Act, but shifted from a continuous disclosure obligation to one based on disclosure at discrete (quarterly) intervals. Directors remained exposed to potential civil liability on a continuous basis.[28] This was something of an uneasy compromise – not a regime that was ideal in any respect, but one that substantially lessened the possibility of being faced with the kind of impossible situation that can arise for a bank under a strict liability continuous disclosure regime.

It was also a less than complete solution in that it did not address the continuous disclosure obligations of any bank that has securities listed on the NZX and therefore is subject to its continuous disclosure obligations. But that ceased to be such an issue in New Zealand once BNZ ceased to be listed on NZX (once acquired by NAB in 1992).

Since then, Heartland Bank's parent company (Heartland Group Holdings) has listed, each of BNZ, ANZ and ASB has debt securities listed on NZX, as are the Westpac and ANZ parent banks. Moreover, significant issues in any of the subsidiaries of the 'big four' Australian banks in New Zealand probably would require disclosure by the parents in terms of the ASX listing rules. So the issue has not gone away; in some respects it is at least as acute now as it was in the late 1980s/early 1990s. It proved to be an issue even in the case of CBL insurance whose business was not so totally reliant on maintenance of public confidence as is the case with a bank. The introduction of deposit insurance may help to address the problem, but only at the margin (given that the issue will remain for uninsured depositors and other investors). In any event, given that the large banks are all parts of

[28] Only 'potentially' in that to establish liability a depositor would need to establish that they had relied on the information in the most recent disclosure statement when making their deposit – not something that would be all that easy to establish.

an ASX listed group, it is something that sensibly can be addressed probably only on a trans-Tasman basis.

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

I support in principle the requirement that any alteration to creditors' rights and rankings in a resolution being subject to the 'no creditor worse off' principle. However, I can see that could be a difficult test to apply in practice. Its application will require a clear and meaningful benchmark against which to test whether a creditor is 'worse off'; that is, to establish the counterfactual, which almost by definition can only ever be a hypothetical. Who will ever know what the outcome might have been if instead of being 'resolved' the bank simply had been liquidated? I do not know how other jurisdictions go about making such assessments.

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

I have reservations about establishing a funded fund, whether that is in the context of (retail) deposit insurance, or of an 'industry-funded resolution fund'.

The need for (pre-) funded deposit insurance in particular probably would be slight if deposit insurance was to be combined with a preference for deposits. In that case, if, as one would expect, the preference for deposits were to flow through to the insurer, it would only be in the case of the failure of a bank without significant wholesale funding that a claim on deposit insurance would arise – most likely a small bank. Establishing the full apparatus of a pre-funded deposit insurance scheme to cover such an eventuality might be considered an 'administratively top-heavy' approach (with that appearing to be the view that has been taken in Australia).

Without a preference for depositors, the position would be somewhat different. But even then it is not obvious that (ex ante) funding of an investment vehicle is the best approach. It would be a (very) long time before the fund was sufficient to provide the resources needed to provide compensation to depositors, at least in a resolution of anything other than a small bank. A levy at the rate of 0.015% p.a.[29]applied to NZ banks' total liabilities of $520bn (based on banks' total assets net of equity as at June 2019) would generate $78m p.a. At that rate it would take nearly 40 years to build a fund of $3bn, and over 60 years to build a fund of $5bn (assuming no claims on the fund in the meantime), although if investment returns exceeded the cost of running the fund, the timeframes would be shorter. As a point of reference, the cost (net of recoveries) to the government of the 'bail out' of retail depositors with South Canterbury Finance, an institution that had total liabilities of only about $2bn, has been reported as having been about $600m.

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[29] This is the levy rate applied in Australia to 'large banks' liabilities (excluding insured deposits, capital and net of the amount of liquid balances held with the RBA). It is in effect a tax that is applied to large banks in recognition of 'too big to fail'. The proceeds are not used to build an investment fund but rather (presumably) go towards the government's general revenues. All else equal, they result in slightly less government borrowing each year than otherwise and, over the years, increased capacity to borrow to fund the resolution of a bank that is 'too big to fail'.

That suggests that, even if it is decided that there should be a 'funded fund', the sensible course could be to defer the passing of the levy proceeds to the fund for investment for at least a decade or two, pending the proceeds accumulating to a meaningful amount (say, at least $1bn-$2bn) that could be efficiently invested (and not be 'chewed up' by the cost of administration). And/or that, rather than establish another government investment fund, the investment function be carried out by an existing government fund, say the New Zealand Superannuation Fund.

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

See comments above regarding the cross-border – particularly trans-Tasman –aspect of resolution.

<u>Chapter 6: How should the Reserve Bank coordinate with other agencies?</u>

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

The increasing role of the Council of Financial Regulators has been a positive development. It provides an effective means by which individual agencies with clearly assigned (lead) responsibilities can support each other in discharging their respective responsibilities; and, correspondingly, avoid both unnecessary duplication (overlaps) and inadvertent gaps (underlaps) in policy and 'regulatory' coverage.

Two matters that I do think warrant consideration, nonetheless, are:

- the chairing of the CoFR. Currently the Reserve Bank and the Financial Markets Authority alternate in that role. I see advantage in:
  - having one agency <u>permanently</u> as chair. This would help to further lift the effectiveness of the CoFR by providing continuity in the co-ordination required. To be effective, the chair needs to do more than just chair the individual meeting discussions, it needs to adopt something of a 'stewardship' role and in that capacity chart the forward agenda so as to bring continuity and direction to a forward-looking process.
  - the chair of the CoFR <u>not</u> being a front-line agency. The agency chairing the CoFR should take an 'agency-neutral' view, across the mandates/remits of the various front-line agencies.

  The natural agency amongst the current members of the CoFR to play these roles is the Treasury. That would be consistent with the Treasury's role as co-Chair (with the Australian Treasury) of the trans-Tasman Council on Banking Supervision.

- whether the number of agencies involved in financial regulation is excessive and unwieldly. Current membership of the CoFR comprises:
  - the FMA, with responsibility for financial market conduct and co-responsibility for securities market infrastructure (securities clearing/settlement/depository systems, and the NZX);
  - the Reserve Bank, with responsibility for prudential supervision and co-responsibility for payments and securities clearing/settlement/depository systems;

- the Commerce Commission, with responsibility for regulation of consumer credit and competition policy – including with respect to the payments system (e.g., the rules on surcharging and interchange fees etc);
- Ministry of Business, Innovation and Employment, with policy responsibility for the FMA and the Commerce Commission (which has seen it undertaking policy work on 'open-banking);
- The Treasury (the adviser to the Minister of Finance with respect to the Reserve Bank, with that role possibly to be extended to include a strengthened monitoring role).

This seems more like a 'large country' than a 'small country' set of institutional arrangements – the kind of multi-agency 'institutional architecture' that one associates with the US more than with NZ? In Australia, the membership of the Australian Council of Financial Regulators comprises just four agencies (RBA, Treasury, APRA and ASIC), despite Australia having a much larger financial system and having established a separate prudential supervision authority.

Opportunities for consolidation and simplification might be to:

- transfer regulation of consumer credit from the Commerce Commission to the FMA (giving the FMA overall responsibility for matters of 'conduct' in the financial sector?) and

- combine the financial sector regulation policy role into one policy agency, perhaps the Treasury.

- consolidate responsibility for supervision of financial sector infrastructure (payments, settlement and depository systems) into the Reserve Bank, rather than across all of the Reserve Bank, the FMA and the Commerce Commission.

The latter is an area that calls for particular specialist expertise, and that may be catered for better by concentrating the available expertise in one agency. Since the late 1990s, responsibility for policy and supervision of payment and settlement systems in Australia has resided in the RBA (under the governance of a separate Payments System Board).[30] This included transfer to the RBA of responsibility for most aspects of competition [and consumer protection?] policy with respect to payments and settlement systems. Under these arrangements, payments and settlement systems in Australia have advanced to now be at the international frontier; those in New Zealand, if anything, have slipped well off that frontier (having, 30-40 years ago, been world leading). Concentrating responsibility for oversight of financial system infrastructure within the Reserve Bank would line up with the role played in Australia by the RBA and provide a basis for more effective trans-Tasman engagement on payments system development than currently will be possible.

[30] These arrangements, to consolidate policy and supervisory responsibility for the payments system in Australia, were recommended by, and implemented following, the Wallis Inquiry, in conjunction with moving responsibility for bank supervision from the RBA to the newly formed (consolidated) prudential authority, APRA.

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

See response to question 6 A.

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

See above.

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

See above.

Also, as suggested in response to the first consultation paper issued for the Phase II review, I see merit in including in the Reserve Bank Act a duty to support other government agencies in the discharge of their responsibilities, for example, the FMA in relation to culture and conduct, and the Commerce Commission in relation to competition (in the financial sector). This would be both to foster a 'whole of government' approach, and also to help make clear what the Reserve Bank does, and does not, have lead responsibility for. In other words, to help make clear that the Reserve Bank is responsible for maintaining 'monetary stability', and with its role in promoting 'culture and conduct' and competition within the financial sector being a support, rather than lead, role.

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

See response to question 6.A above.

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

No further comments to offer.

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

No further comments to offer.

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

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

My general sense is that:

- the current resourcing of the Reserve Bank's financial sector supervisory role is stretched, if not inadequate; but that
- the current funding model (five year funding agreements) is not itself fundamentally broken.

The strains on the existing level of resourcing appear to have come about as the result of:

- change in policy (a step-up from very 'light touch' approach of the 1990s); and
- expansion of the scope of the role (to include non-bank deposit-takers and, more particularly, insurers).

without commensurate adjustment to resourcing. But it is not obvious that 'fault' lies with the funding model, but rather with how it has been applied. This could be because:

- the Bank has not made a sufficiently good case for the additional funding needed to be able fully to carry out its expanded responsibilities (perhaps out of concern not to be seen as letting go of its distinctly 'New Zealand approach'); and/or
- the Treasury (and Minister) insufficiently understood the need for the resources required; and/or
- the Bank's own internal prioritisations; and
- some combination of all of these.

But I see nothing fundamentally wrong with a funding model under which a balance is struck between the Bank:

- having to justify the claims it makes on resources, rather than being, in effect, free from any budget constraint, as would be the case if (and used to be the case when) the Bank had unconstrained access to seignorage income; and
- having the security of resourcing for the medium-long-term (five years); rather than having to seek an annual appropriation.

It seems now to be reasonably well-established that the Bank may need additional resources to perform its supervisory responsibilities, but also that decisions on future resourcing levels need to take account of:

- the scope for better leveraging the relationship with APRA in undertaking home-host (joint) supervision of the four big banks, and the gains in efficiency and effectiveness that could be achieved from that;
- the shift in the focus of supervision (particularly with respect to the small local banks) that will be necessitated by the introduction of deposit insurance;
- the nature (experience and capability) of the management and staff needed to perform the supervisory role;
- how the Bank sees the priorities, both within the supervision function (which currently seems weighted toward 'policy overhead' compared with 'front-line' supervision(see pages 73-74 of Consultation paper 2b); and across its different 'functions'. Is it possible that efficiencies will achievable from the "Future of cash" review currently in train?

It seems important that these matters be given careful consideration ahead of determination of the next five-year level of funding for the Bank. As above, I think that usefully would include a 'capability review' of the Bank's supervisory role; with conclusions from that to feed into the next funding agreement.

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

My general impression is that the information available on the Bank's funding and spending is not all that 'accessible'. This will stem at least in part from the uniqueness of a central bank, for example, how seignorage is a substantial source of income. Nor is the nature of the expenditure on 'domestic operations' or on 'settlement services' self-evident. It could help if the Bank's expenditures (and funding agreements) were reported and explained in a way that was more accessible to those who do not have expert knowledge of the intricacies of central banking.

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

I am broadly comfortable with the current role of the Minister in determining the Reserve Bank's resourcing. The scope for improvement I see more in terms of:

- improving the accessibility of the information upon which funding decisions are based (and reported);
- whether the Minister should have a (greater) role in establishing the balance of the Bank's priorities, by, for example, the funding agreement being broken down by broad function. Should the Minister be able to determine, for example, that "I want the Bank to give greater emphasis to front-line supervision and less to macro-economic 'research'" than during the past 5 years? Or vice versa. At what point would that begin to compromise the Bank's 'operational independence'?

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

I am comfortable in principle with the Reserve Bank being part-funded by fees charged for supervision to supervised institutions. Modest fees were charged for a short period in the early 1990s, but those were terminated when the Bank shifted to what was a 'public disclosure' approach to supervision (to counter any suggestion that the fee was a 'fee for service').

There may also is scope for the Reserve Bank to recover more of the cost it bears from providing notes and coin (a quite heavily subsidised means of payment) and from providing settlement services. I don't know how much of the $27m of expenditure in 2017/18 attributed to these two categories of expenditure was recovered by fees, but perhaps not much? Together they accounted for over 35% of the Bank's operational expenditure.

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

No particular comments – the broad framework for considering the issues seems appropriate.