

# The Treasury

## Reserve Bank Act Review Phase 2 Review Update Proactive Release

March 2020

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**Report:** RBNZ Act Review, policy decisions relating to the proposed Institutional Act

<b>Date:</b>	4 October 2019	<b>Report No:</b>	T2019/2764
		<b>File Number:</b>	MC-1-7-3-1-3

### Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	<b>Agree</b> to the recommendations <b>Discuss</b> outstanding matters with Officials on 10 October	Thursday, 10 October 2019

### Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Felicity Barker	Principal Advisor, Reserve Bank Act Review Phase 2	[39]  (mob)	✓
Bernard Hodgetts	Director, Reserve Bank Act Review Phase 2	[39]  (wk)	N/A  (mob)

### Minister's Office actions (if required)

Return the signed report to Treasury.  
Refer a copy of this report, to the Associate Ministers of Finance and Hon Twyford.

**Enclosure:** No

## **Report:** RBNZ Act Review, policy decisions relating to the proposed Institutional Act

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### Executive Summary

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This report on the Review of the Reserve Bank Act 1989 (the Review) is seeking your decisions on policy issues relating to the new 'Institutional Act' for the Reserve Bank (the Bank). Policy decisions relate to:

- the purpose statement for the Act, and the Bank's objectives, decision-making principles for financial policy, and functions
- a Financial Policy Remit
- governance arrangements
- accountability and transparency
- funding
- coordination with other financial sector regulators, and
- other minor issues.

No substantive change is proposed to the provisions that were enacted in Phase 1 of the Review, which related to monetary policy.

Both agencies support the proposals in this report in relation to objectives, the features of the Board and accountability requirements. There are several areas where the Bank and the Treasury take a different view and have provided separate recommendations. The points of difference are as follows:

- the appointment of the Governor
- a Financial Policy Remit
- the funding agreement, and
- the ability of the Bank to levy regulated entities.

#### *Objectives and decision-making principles*

The key change in respect of the Bank's objectives is the proposal to replace the Bank's current objective to promote the maintenance of a sound and efficient financial system with the objective to: 'protect and promote the stability of New Zealand's financial system'. This objective recognises the role of the Bank in ensuring financial stability, including the Bank's role in mitigating risks to the financial system. A number of decision-making principles that the Bank must have regard to in exercising its financial regulatory powers are proposed to ensure financial stability is not pursued at all costs. The principles would include efficiency related considerations, such as the need for regulatory actions to have net benefits.

#### *Financial Policy Remit*

The Treasury recommends that the Minister be required to issue a Financial Policy Remit. The Financial Policy Remit would direct the Board to have regard to matters the Minister considers relevant to the Board's pursuit of the financial stability objective. The Financial

Policy Remit would allow for dialogue between the Minister and the Bank on matters relevant to the pursuit of the financial stability objective, providing flexibility over time. As a legislative requirement, it would become a standardised part of the regime. The Financial Policy Remit would also be a mechanism for including expectations in terms of how the Bank has regard to climate change risks when pursuing the financial stability objective. This is in addition to the decision-making principle relating to long term risks to financial stability. The Bank prefers to maintain the status quo, where the Minister has a power to direct the Bank to have regard to Government policy.

### *Governance*

The Bank undertakes a range of complex functions including monetary policy, prudential regulation and supervision, and currency operations. It also operates a number of commercial operations (such as settlement systems). Due to this complexity, the Bank's governance arrangements will necessarily be unique. In this context, the Review has strived to ensure the proposed governance arrangements are as simple as possible and protect operational independence. It is proposed that many of the features of the Crown entity model be adopted. The Bank would not, however, be designated as a Crown entity due to several features that differ significantly from the Crown entity framework.

It is proposed that a governance board (the Board) be established with statutory responsibility for all matters, except those relating to the Monetary Policy Committee (MPC). It is recommended that the Board have similar features to an independent Crown entity board, such as collective and individual duties and accountability to the Minister. The Board would have a number of unique features relating to:

- the board size
- limitations on Board service
- experience and expertise requirements
- additional disqualification provisions, and
- the process for appointment, which would include a nominations committee.

It is recommended that the Treasury, in its capacity as the Government's lead economic and financial advisor, be the Bank's monitoring agency, and administer the Institutional Act.

In relation to the Governor, the Treasury recommends that the current processes for the Minister of Finance to appoint and remove the Governor be retained. While this limits the Board's authority in terms of the ability to directly appoint and remove the Governor, the Treasury considers that the requirement for the Board to recommend candidates to the Minister and manage delegations ensures that the Board retains a sufficient level of authority. The Governor is also a statutory position as a member and chair of the MPC. The Bank recommends that the Board appoint the Chief Executive, consistent with the process provided for in the Crown Entities Act. The Bank's view, is that to do otherwise undermines the authority and role of the new governance board – a central plank of the Phase 2 reforms.

It is recommended that the statutory position of Deputy Governor and associated provisions are removed. This statutory position is unnecessary given the move away from the single decision-maker model.

### *Accountability and transparency*

The new Institutional Act would enhance the accountability and transparency arrangements for the Bank. For example, legislative changes would end the current exemptions for the Bank from the Public Audit Act 2001 and the Ombudsmen Act 1975. The Treasury also recommends greater standardisation of the Bank's reporting requirements. In particular, changes are proposed that would require the Bank to publish an annual Statement of Performance Expectations, in addition to a triennial Statement of Intent.

### *Funding*

Two options for the Bank's funding arrangements are provided. The Treasury recommends the retention of a funding agreement, with some modifications. The Bank prefers that the Board sets the Bank's budget in consultation with the Minister. The Treasury also recommends that the Bank be able to recover a portion of the cost of its regulatory functions via fees and levies. The Bank is not in favour of introducing levies, on the grounds that levies introduce complexity and potentially change the Bank's relationship with industry from supervisor to service provider.

### *Coordination*

It is recommended that coordination is supported via a new function to cooperate with other public sector agencies. This recognises that multiple agencies have roles in the regulation of the financial sector, and that cooperation between these agencies delivers better outcomes. Members of the Council of Financial Regulators (CoFR) have not identified a need for a legislative mandate for the CoFR. It is recommended that you discuss a legislative requirement for a coordination committee with the Minister of Commerce and Consumer Affairs, and indicate if this option is to be included in the Cabinet paper.

### *Minor issues*

Recommendations relating to minor issues include the application of Part 3 of the Crown Entities Act to the Bank.

The Review will provide you with a second report addressing a number of supplementary matters in mid-October. Following your feedback on these reports, a Cabinet paper will be prepared in time for consideration by the Cabinet Economic Development Committee on 20 November.

## Independent Panel views

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The Independent Panel (the Panel) are supportive of the majority of the Institutional Act recommendations. The Panel recommends that the Institutional legislation be written in the context of being permissive and enabling, as opposed to being prescriptive. The Panel expressed differences of views on the appointment of the Governor, the Financial Policy Remit, and the funding model.

### *Governor appointment process*

The Panel noted the importance of strong governance, including clarity about the reasoning behind the Minister's role in appointing the Governor, and consideration of the relationship between an enabled board and its CEO. The Panel have mixed views on the appointment process for the Governor. Some Panel members are supportive of the Ministerial appointment (on the recommendation of the board), noting international practice and that the Governor is a statutory decision-maker and chair of the Monetary Policy Committee. Other

Panel members believe the Board should appoint and remove the Governor (no role for the Minister), as this would be in line with the Crown Entities Act.

### *Financial Policy Remit*

On balance the Panel are supportive of the Financial Policy Remit. Some Panel members noted that a Remit could replace the Letter of Expectations. Some Panel members were concerned that a Remit would constrain the Board.

### *Funding model*

The Panel support a funding framework that enables the Bank to be strategic and responsive to future conditions. In this context, the Panel have mixed views on the optimal funding model. Some Panel members noted an agreement model provides democratic oversight of spending and is flexible enough to enable appropriate budgetary independence across different functions (support the Treasury's recommendation). Other Panel members noted that a funding agreement would constrain the Board and believe full budgetary independence is more appropriate (support the Bank's recommendation).

## Recommended Action

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We recommend that you:

### **General matters**

- a **agree** that the Reserve Bank Act 1989 be replaced by two new pieces of legislation: a new Reserve Bank 'Institutional Act'; and a 'Deposit Takers Act', consistent with your previous 'in-principle' decision.

#### *Agree/disagree*

- b **confirm** your previous in-principle decision that the Bank retain its central bank and prudential regulation functions.

#### *Confirm/do not confirm*

- c **note** that the 'Institutional Act' will include policy decisions relating to the Bank's objectives, governance, accountability and transparency, funding, and coordination.
- d **note** that the 'Institutional Act' will also include provisions relating to the Bank's current non-regulatory functions, including monetary policy, currency, and foreign exchange.
- e **note** officials are aiming for introduction of a Bill for the Institutional Act around July 2020.
- f **note** that the Bank's monetary policy functions, including provisions relating to the MPC, will be enacted in the Institutional Act unchanged, except to the extent necessary to fit into the new legislative scheme and subject to recommendation (aa).
- g **note** that duties performed by the current Board in respect of the Bank's monetary policy functions, will be performed by the new Board (including approval of the code of conduct, and recommending members of the MPC).

- h **note** that the Bank is currently reviewing the policy relating to the provision and management of bank notes and coins, and that advice resulting from this review may be provided at a later stage.

*Noted*

### **Purpose, objectives, decision-making principles and functions of the Bank**

- i **agree** that the purpose of the Institutional Act, in providing for the continuation of the Reserve Bank, remains: “to promote the prosperity and wellbeing of New Zealanders and contribute to a sustainable and productive economy”.

*Agree/disagree*

- j **agree** to the Bank’s main objectives being included in the Institutional Act and that these objectives are:
- (a) the economic objectives (unchanged from Phase 1):
    - i. achieving and maintaining stability in the general level of prices over the medium term; and
    - ii. supporting maximum sustainable employment.
  - (b) the financial stability objective: protecting and promoting the stability of New Zealand’s financial system.

*Agree/disagree*

- k **agree** that the Bank also be required to act in a way that furthers any other relevant objectives or purposes in legislation under which the Bank has functions, including objectives and purposes that relate to its central banking functions.

*Agree/disagree*

- l **agree** that the Institutional Act contain the decision-making principles set out in paragraph 19 that the Bank must have regard to in exercising its powers.

*Agree/disagree*

- m **agree** that the functions of the Bank be included in the Institutional Act (see example in Appendix II).

*Agree/disagree*

- n **agree** that the Minister of Finance may direct the Bank to perform additional functions consistent with the Bank’s objectives, as provided for in section 112 of the Crown Entities Act.

*Agree/disagree*

- o **note** the Review’s initial view is that the powers in the Deposit Takers Act should be directed at the overarching purpose of protecting and promoting the stability of New Zealand’s financial system. This overarching purpose will be achieved by the Bank exercising its powers primarily to:
  - (a) promote the safety and soundness of deposit takers;
  - (b) promote public confidence in the financial system; and
  - (c) mitigate risks that arise from the financial system.

*Noted*

- p **agree** either

that the Minister of Finance will be required to issue a Financial Policy Remit which sets out matters the Board should have regard to when pursuing the financial stability objective (the Treasury’s recommendation).

*Agree/disagree*

OR

to retain the current Ministerial direction powers which allow the Minister to direct the Bank to have regard to a government policy that relates to the Bank’s functions (the Bank’s recommendation).

*Agree/disagree*

- q **agree** that if a decision is made to adopt a Financial Policy Remit, that the current powers of the Minister to direct the Bank to have regard to Government policy in the Reserve Bank Act 1989, Insurance (Prudential Supervision) Act 2010 and the Non-Bank Deposit Takers Act 2013 be removed.

*Agree/disagree*

- r **agree** that if a decision is made to adopt a Financial Policy Remit, that the provisions in sections 113(1)(b), 114, 115 and 115A of the Crown Entities Act apply to the Remit. These provisions would require the Minister to consult the Bank on the Remit, publish the Remit, and would provide that the Remit cannot require the performance of an act in respect of a particular person or persons.

*Agree/disagree*

## **Governance**

- s **agree** that the Bank will not be designated a Crown entity, but the Crown entity framework will be used as a basis for the institutional design of the Bank, adapted to reflect the policy decisions in this paper and as otherwise appropriate.

*Agree/disagree*



t **agree** to the establishment of a Board with statutory responsibility for all Bank decisions, except those reserved for the Monetary Policy Committee (MPC), with the following features:

- (a) the Board will be fully non-executive
- (b) it will be comprised of between five and nine members
- (c) Board members can be appointed for a term of up to five years, but will be limited to serving for no more than 10 years or three terms in total
- (d) Board members must have proven skills and experience relevant to the position
- (e) individuals will be disqualified from serving on the Board if they are employed by, or are a director of, a regulated entity
- (f) individuals will be disqualified from serving on the Board if they are a member of the MPC, and
- (g) the disqualification provisions for Board members in the Crown Entities Act will also apply.

*Agree/disagree*

u **agree** that the current Board will be disestablished at the close of the day before the new Board takes office.

*Agree/disagree*

v **agree** to the establishment of an independent nominating committee to nominate Board candidates to the Minister for appointment by the Governor-General, and that the nominating committee will:

- (a) be appointed by the Minister
- (b) have the proven skills or relevant work experience that will enable them to identify candidates
- (c) be required to consult with the Minister, in relation to nominations, and
- (d) be required to identify candidates with appropriate skills and experience.

*Agree/disagree*

w **agree** that the Minister will be required to consult with other political parties in Parliament prior to recommending the appointment of a Board member.

*Agree/disagree*

x **agree** that Board members will only be able to be removed by the Governor-General for 'just cause' on the advice of the Minister, after consultation with the Attorney-General.

*Agree/disagree*

y **note** that 'just cause' has the meaning set out in Section 40 of the Crown Entities Act, and includes misconduct, inability to perform the functions of office, neglect of duty, and breach of duty.

*Noted*

z **agree** that the provisions in the Crown Entities Act providing that the remuneration of members of independent Crown entities is at a rate and of a kind determined by the Remuneration Authority apply to members of the Board.

*Agree/disagree*

aa **agree** to retain the current process for appointing and removing MPC members, but the number of terms that internal members can serve will be increased to three terms (from a previous limit of two terms), of up to five years per term.

*Agree/disagree*

bb **agree** that the Treasury will administer the Institutional Act.

*Agree/disagree*

cc **confirm** your previous in-principle decision that the Treasury be the monitoring agency for the Reserve Bank.

Confirm/do not confirm

dd **agree** to introduce a legislative requirement for the Minister to issue a Letter of Expectations to the Treasury setting out the role of the monitor and the Minister's expectations.

*Agree/disagree*

ee **agree** either

that the current process for appointing the Governor and Governor's term length be retained (the Treasury's recommendation).

*Agree/disagree*

OR

that the Board appoints the Governor (the Bank's recommendation).

*Agree/disagree*

ff **agree** to amend the provisions relating to when the Governor can be removed from office to reflect the shift of the Governor's functions and responsibilities to the Board.

*Agree/disagree*

- gg **agree** to remove the legislative requirement for a Deputy Governor, and that if the office of Governor is vacant or the Governor is absent, then the Board may nominate a person to act as Governor for a specified period.

*Agree/disagree*

- hh **agree** to replace the *ex officio* Deputy Governor position on the MPC with an internal position, to ensure the same number of internal members.

*Agree/disagree*

- ii **agree** that the Board retains the duty to monitor the MPC, members of the MPC, and the Governor. This includes advising the Minister if the Board considers an individual member meets any grounds for removal.

*Agree/disagree*

### **Accountability and transparency**

- jj **agree** to amendments to the Public Audit Act 2001 to enable the Auditor-General to conduct performance audits of, and inquiries into the Bank.

*Agree/disagree*

- kk **agree** that the current power of the Minister to initiate an audit be replaced with section 132 of the Crown Entities Act which enables the Minister to review the operations and performance of an entity.

*Agree/disagree*

- ll **agree** to add the Reserve Bank to the list of organisations in Schedule 1 of the Ombudsmen Act 1975.

*Agree/disagree*

- mm **agree** to require the Bank to comply with reporting requirements in Part 4 of the Crown Entities Act that relate to Statements of Intent, Annual Reports, Statements of Performance Expectations and accounting records, except as provided in in the next recommendation.

*Agree/disagree*

- nn **agree** that if a decision is made to adopt a Remit, that the Minister not be able to direct the Bank to make amendments to the Statement of Intent or Statement of Performance Expectations.

*Agree/disagree*

- oo **agree** that the Reserve Bank will be required to publish Statements of Approach that set out its approach to its regulatory functions.

*Agree/disagree*

pp **agree** that the requirements relating to the Financial Stability Report be included in the Institutional Act and updated to reflect consequential amendments.

*Agree/disagree*

qq **agree** that the requirement for the Reserve Bank to undertake regulatory impact assessments be included in the Institutional Act, and be updated to align with state sector practice.

*Agree/disagree*

### **Funding**

rr **agree** either

That the Bank's expenditure be subject to a funding agreement with the features set out in option 1 (paragraph 79) (the Treasury's recommendation).

*Agree/disagree*

OR

That the Bank's Board should set the Bank's budget, with the Minister having a review role (refer to paragraph 82) (the Bank's recommendation).

*Agree/disagree*

ss **agree** that if there is to be a funding agreement, that it would be tabled in Parliament, but no longer be ratified by Parliament.

*Agree/disagree*

tt **agree** either

That some of the costs of undertaking the Bank's financial regulatory functions be able to be recovered through levies set by regulation (the Treasury's recommendation).

*Agree/disagree*

OR

As at present, that the Bank not be able to recover the costs of undertaking financial regulatory functions through levies (the Bank's recommendation).

*Agree/disagree*

uu **agree** to a general fee setting regulation power, to replace the current fee making provisions.

*Agree/disagree*

- vv **agree** that if there is a funding agreement, the existing process to ascertain annual dividends remain, except that dividend principles be included in the funding agreement rather than the Statement of Intent.

*Agree/disagree*

### **Coordination**

- ww **agree** that the Bank will have a function to cooperate with other relevant public sector agencies, including overseas regulators.

*Agree/disagree*

- xx **note** that the members of the Council of Financial Regulators (CoFR) and the Review do not consider it necessary to legislate for a coordination committee.

*Noted*

- yy **indicate** if you would like the Cabinet paper to provide an option for a legislative mandate for the CoFR, subject to further discussion with the Minister of Commerce and Consumer Affairs.

*Yes/no*

### **Minor issues**

- zz **agree** that the Bank will be subject to the provisions of the Crown Entities Act, Part 3, as set out in paragraph 93.

*Agree/disagree*

- aaa **agree** that provisions in the Crown Entities Act discussed in paragraph 94 not apply to the Bank.

*Agree/disagree*

Bernard Hodgetts  
**Director, Reserve Bank Act Review Phase 2**

Hon Grant Robertson  
**Minister of Finance**

**Report:** RBNZ Act Review, policy decisions relating to the proposed Institutional Act

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**Purpose of Report**

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1. The purpose of this report is to seek your decisions on the policy issues arising out of Phase 2 of the Reserve Bank Act Review (the Review), as they relate to the new Reserve Bank Institutional Act. It is intended that these decisions will be taken to the Cabinet Economic Development Committee meeting on 20 November 2019 and to Cabinet on 25 November 2019. This will allow for drafting instructions to be issued in late 2019.
2. Recommendations in this report are joint recommendations unless stated to be the view of the Treasury or the Bank.
3. In-principle decisions relating to aspects of the proposed Deposit Takers Act (and depositor protection) are included in a second paper.

**Analysis**

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**Background**

4. You have made an in-principle decision that the Reserve Bank of New Zealand Act 1989 will be replaced by two pieces of legislation. The first piece of legislation will provide for the institutional form of the Reserve Bank ('Institutional Act'). The second piece of legislation will set out the Bank's prudential functions and powers in relation to deposit taking institutions and potentially establish the deposit insurance scheme ('Deposit Takers Act').
5. This report relates to the Institutional Act. It sets out recommendations regarding the purpose statement, the Bank's objectives and decision-making principles, governance, accountability and transparency arrangements, funding, and coordination. We will provide a second report to you in mid-October that will cover a number of supplementary matters, including balance sheet management, information sharing, and transitional provisions.
6. The Review has sought to align the institutional structure of the Bank with the Crown entity framework where appropriate. However, as discussed in paragraph [41], it is not recommended that the Bank be designated as a Crown entity, as there are a number of significant departures from the Crown entity framework.
7. You have previously made the in-principle decision that the Reserve Bank retain its central banking, monetary policy and prudential regulatory functions. This report proceeds on this basis.

8. The Review is aiming to develop the Institutional Act so that it could be introduced into the House around July next year. You have previously agreed that the Treasury will instruct the Parliamentary Counsel Office (PCO) on the Institutional Act [T2019/2242]. The Treasury intends to provide instructions to PCO in December of this year in order to meet the proposed introduction timeframe.

### ***Purpose, objectives, decision-making principles and functions***

9. Legislative purposes and objectives help to communicate the policy intent of the legislation. They provide statutory criteria on which to base the exercise of discretion and act as a guide to interpretation. Objectives also provide a basis against which to judge the performance of an entity and hold it to account. Objectives and purposes need to be drafted in such a way as to be enduring over time. They should provide a guide for the regulator's actions and not be too specific.
10. The Reserve Bank Act was amended in Phase 1 to provide that the purpose of the Act is to: "promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy". It is proposed that this continue to be the purpose of the Institutional Act in providing for the continuation of the Reserve Bank and its governance structure. This recognises that monetary and financial policy are not ends in themselves, but are means to improve wellbeing overall.
11. It is common for legislation to set out the objectives that the entity seeks to achieve. Under the Crown entity framework, the board of an entity must ensure the entity acts consistently with its objectives. The Review recommends that the Bank has the following main objectives, which recognise its roles in monetary policy and financial regulation:
  - (a) the economic objectives (unchanged from Phase 1):
    - i. achieving and maintaining stability in the general level of prices over the medium term, and
    - ii. supporting maximum sustainable employment.
  - (b) the financial stability objective: protecting and promoting the stability of New Zealand's financial system.
12. The financial stability objective is consistent with your previous in-principle decision [T2019/80]. It recognises the Bank's role in mitigating risks to the financial system and provides direction for sector specific regulation. It also recognises the role of functions, such as lender of last resort (LoLR), in stabilising the financial system during times of stress.
13. The Bank has a number of additional objectives and purposes. For example, the Bank also has functions in relation to anti-money laundering. Hence, the Bank should also be required to act in a way that furthers any other objectives or purposes that the Bank has in legislation. Such a provision is included, for example, in the WorkSafe New Zealand Act 2013.

14. There may be cases where these purposes and objectives could be further clarified in the Institutional Act. For example, the Bank is currently consulting on the inclusion of a specific objective in relation to its powers to issue bank notes and coins and oversee the 'cash system'. The Review will consider if there needs to be further objectives in relation to the Bank's central banking functions and will report back on this.
15. When the Institutional Act and Deposit Takers Act are in force, all sectoral Acts<sup>1</sup> would specify in more detail how the general objective of financial stability is supported. The initial recommendation for the Deposit Takers Act is that it direct the Bank to use its powers for the overarching purpose of protecting and promoting the stability of New Zealand's financial system. This overarching purpose will be achieved by the Bank exercising its powers primarily to:
  - promote the safety and soundness of deposit takers
  - promote public confidence in the financial system, and
  - mitigate risks that arise from the financial system.
16. The Deposit Takers Act would also provide objectives for the Bank's resolution activities and possibly the deposit insurance scheme. These objectives will be discussed in advice on the Deposit Takers Act.
17. The purpose statements in the sectoral Acts will not change during the transition period between enactment of the Institutional Act and the Deposit Takers Act. This will avoid the need for transitional purpose statements. Rather, a new purpose statement would be enacted in the Deposit Takers Act, and when other sectoral Acts are reviewed.
18. Stakeholders were generally supportive of the proposal for a financial stability objective. However, several stakeholders raised concerns that there would no longer be a reference to 'efficiency', as there is in the purpose statements that the Bank currently operates under. In order to address this concern, it is recommended that a number of decision-making principles are included in the Institutional Act. These principles would provide matters that the Bank must have regard to in exercising its financial regulatory powers. The principles would also set some boundaries around the extent to which financial stability is pursued. The proposed principle relating to long term risks would include consideration of long term risks associated with climate change.
19. It is recommended that the principles that the Bank is required to have regard to when exercising its financial regulatory powers are as follows:
  - the desirability of the benefits outweighing the costs imposed through regulatory actions, including compliance costs
  - the desirability of taking a proportionate approach to regulation and supervision, and ensuring consistency of treatment of similar institutions
  - the desirability that sectors regulated by the Bank are competitive
  - the desirability of taking into account long term risks to financial stability

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<sup>1</sup> The Deposit Takers Act, the Insurance (Prudential) Supervision Act and the Financial Markets Infrastructure Act (currently being drafted).



- the value of transparency and public understanding of the Bank’s objectives and how the Bank’s functions are exercised, and
  - practice by relevant international counterparts carrying out similar functions, as well as guidance and standards from international bodies.
20. Modern legislation tends to list the functions of the entity. We recommend that the Act provides a list of the Bank’s central banking, monetary policy and financial policy functions. Further details are set out in Appendix I of this report. Consistent with section 112 of the Crown Entities Act, the Minister would be able to add to this list of functions.

## ***Financial Policy Remit***

### *The Treasury’s recommendation*

21. Financial stability is a broad concept. Listing the matters that the Bank should have regard to when pursuing the financial stability objective in primary legislation would be inflexible over time. The broad scope of the objective, combined with the Bank’s standard making powers, means that the Bank would be making significant policy decisions when pursuing this objective. The Legislative Design Advisory Committee’s guidelines state that legislation should not delegate significant policy decisions.
22. For this reason, the Treasury recommends that the Minister of Finance should be required to issue a Financial Policy Remit that provides matters the Bank should have regard to when pursuing the financial stability objective. This would be issued at least five yearly. Unlike a standard Letter of Expectations, the Financial Policy Remit would have legislative backing and would be directly linked to the financial stability objective.
23. Matters that may be addressed in the Remit could include:
- expectations as to risk tolerance, for example, the Remit could provide an expectation that the prudential framework is broadly aligned with international standards
  - expectations as to long term risks, for example, the Remit could provide that the Bank should consider how climate risks impact on the financial sector and how to inform the public of those risks, and
  - information in relation to emerging risks to the financial sector that may be relevant to the Bank’s financial stability monitoring.
24. If the Financial Policy Remit is introduced, the Treasury recommends that the Minister’s current powers to direct the Bank to have regard to Government policy are repealed.<sup>2</sup> A direction has never been issued under these provisions. The Remit is preferred by the Treasury, as it would be a legislative requirement. The Remit would focus on the policy relating to the financial stability objective, rather than the Bank’s operations. For this reason, the Treasury considers that the Financial Policy Remit would continue to appropriately preserve the Bank’s operational independence.

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<sup>2</sup> Section 68B of the Reserve Bank Act, Section 13 of the Insurance (Prudential Supervision) Act 2010 and section 9 of the Non-Bank Deposit Takers Act 2013

25. A similar approach to the Remit is provided for in the Bank of England Act. This Act provides that HM Treasury<sup>3</sup> may at any time make recommendations to the Financial Policy Committee (FPC) on matters including the following:
- matters that the Committee should regard as relevant to the Committee's understanding of the Bank's Financial Stability Objective, and
  - matters relating to the responsibility of the Committee in regards to achievement of that objective.
26. The relevant provisions that were included in the October 2018 Remit to the FPC are provided in Appendix II. The Remit is provided to the FPC, rather than to the Bank of England.
27. In terms of the process for setting the Remit, the Treasury recommends that the provisions of sections 114-115A of the Crown Entities Act apply to the Remit. These provisions would:
- require the Minister to consult with the Bank before issuing the Remit
  - require that the Remit be published in the *Gazette* and tabled in the House
  - require that the Remit be reviewed at least every 5 years, and allow amendments prior to this, and
  - require that the Bank have regard to the Remit.
28. It is also recommended that, consistent with section 113 of the Crown Entities Act, the Remit would not be able to require the performance or non-performance of a particular act in respect of a person. This would ensure that the Remit does not impinge on the Bank's operational independence, particularly in regards to supervisory and enforcement activities. This is similar to section 68B(5) of the current Act.
29. An alternative to a Remit would be to apply the Statement of Intent (SOI) process as provided in the Crown Entities Act. The Bank is currently required to produce an annual SOI. However, under the current Reserve Bank Act the Minister's ability to participate in the Bank's SOI process is limited to commenting on the SOI.
30. In contrast, under the SOI process in the Crown Entities Act, a responsible Minister may also direct a Crown entity to amend any provision that is included in the entity's SOI which relates to: the entity's strategic intentions; the scope and management of the entity's functions and operations; and the assessment of its performance. Amendments to the SOI may not relate to statutorily independent functions. A statutorily independent function is one which the entity's Act provides: must be carried out independently; or in relation to which the Minister may not give a direction. The Bank does not presently have any functions which are statutorily independent as defined in the Crown Entities Act.
31. If the provisions allowing a Minister to amend an SOI were to apply, the Minister would have broader scope to amend an SOI than at present, including for monetary policy. While it would be possible to apply the Crown Entities Act framework for statutorily independent functions to some of the Bank's functions, this would not be straightforward as the level of independence differs across the Bank's functions. For this reason, the Treasury does not recommend extending the Minister's power

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<sup>3</sup> In practice the Chancellor.

to being able to make amendments to the SOI. In the Treasury's view, the Remit provides a better balance of protecting the Bank's operational independence, while providing an appropriate level of democratic influence over the very significant policy making functions that Parliament has delegated to the Reserve Bank in relation to financial stability. Other regulators with statutorily independent functions, such as the Financial Markets Authority (FMA), do not have comparable policy making powers.

#### *The Bank's recommendation*

32. The Bank does not support the proposal to have a remit letter. It is unusual and inconsistent with the intended approach, of establishing the Reserve Bank on the Crown entity model. The Bank's view is that the remit letter is redundant given a direction power, the Letter of Expectations, and the role of the new governance Board.
33. The bespoke and unprecedented nature of the proposed remit letter creates uncertainty about its status and effect. The Bank is concerned that the remit letter could be used to undermine the operational independence of the Bank – operational independence being one of the guiding principles of the Phase 2 review.
34. Consultation 1 highlighted the 'time inconsistency' problem – that short-term political imperatives may make long-term financial stability outcomes difficult to commit to. Operational independence is necessary for financial policy because:
  - decisions require a long-term approach that transcends electoral cycles
  - decisions involve weighing politically powerful private interests against a dispersed public interest
  - the regime requires a consistent approach over a long period of time to create a stable environment, and
  - public confidence that the regulator is impartial.
35. Delegating decisions to the Bank, as an independent agency, resolves this problem. The Bank fully acknowledges the need for mechanisms that support democratic accountability and public legitimacy as a result. The proposed institutional reforms have been designed with this in mind, in terms of both governance structure and greater transparency.
36. If a remit letter specifies short-term goals, it could undermine the Board's credibility, and the legitimacy of the Bank's actions, in fulfilling its long-term financial stability goals. Introducing a remit letter blurs responsibility for financial stability outcomes as between the Minister, the Board and the Governor. Further, a positive obligation to issue a remit letter (rather than the ability to issue a direction to have regard if desired) provides a focus for regular political debate.
37. The Bank recommends maintaining the well-understood model under the Crown Entities Act, ie a Ministerial direction power to require the Bank to have regard to certain matters, subject to appropriate safeguards, together with a Letter of Expectations.

## **Governance**

### *Institutional arrangements*

38. The Bank sits within its own category in the state sector and its governance structure is unique. Prior to the implementation of Phase 1 of the Review, the governance framework for the Bank deliberately placed all the powers of a board and Chief Executive in the Governor, who acted at arm's length from Ministers. This design was seen as instrumental in reducing New Zealand's high inflation rate as it ensured operational independence for monetary policy. At the time this governance structure was put in place, however, the Bank had limited prudential regulatory functions.
39. Phase 1 of the Review updated the Bank's governance of monetary policy. The Bank's prudential regulatory functions and powers have grown considerably over the years, and the Bank now plays a much more active role in prudential regulation than was previously the case. As a result, the governance structure for prudential regulation is out of date. In particular: the Bank's institutional framework does not align with the wider state sector; and standards otherwise applicable across the public sector do not apply to the Bank.
40. The Review considered designating the Bank as a Crown entity in order to ensure uniformity with other independent institutions, and the consistent application of standards that apply to independent entities. An alternative option is to retain the unique status of the Bank in the public sector, and deliver the outcomes sought by adopting many of the governance and accountability provisions in the Institutional Act that would otherwise apply to independent Crown entities.
41. There are three significant challenges associated with designating the Bank as a Crown entity. First, the independence of the Bank may be compromised, as a result of proposed changes to the State Sector Act. Second, a critical element of its institutional design, the appointment and removal of the Governor by the Minister (see below), is incompatible with the Crown entity model. Third, the creation of the MPC makes the Crown entity framework less appropriate because the MPC is a statutory decision maker, and this does not fit neatly with the Crown entity framework.
42. The State Services Commission has advised, that if the current appointment process for the Governor is retained, then the Reserve Bank should not be designated as a Crown entity. Rather, alignment with the Crown entity framework should be achieved by importing the relevant provisions of the Crown Entities Act into the Institutional Act, where appropriate.
43. For these reasons, it is not recommended that the Bank be designated as a Crown entity. Instead, it is recommended that the Institutional Act incorporate many of the features of an independent Crown entity, as well as other bespoke arrangements, such as the Financial Policy Remit and the MPC. In particular, the provisions in Part 2 of the Crown Entities Act (establishment and governance of Crown Entities) will generally apply, with amendments to reflect the policy decisions below.

### *Governance Board*

44. It is proposed that a governance board (the Board) is established with responsibility for all matters, except those reserved for the MPC. The Board will have the

collective and individual duties set out in Part 2 of the Crown Entities Act, except where amendments are necessary to support the policy decisions discussed here. Introducing the Board will support decision-making based on diverse perspectives and experiences. It will also protect against individual biases and preferences.

45. As the new Board will be significantly different from the current Board, it is recommended that the current Board be disestablished.
46. It is recommended that the Board be fully non-executive. This would reinforce the Board's governance role and ensure its separation from management. It would also be consistent with the structure that applies to the majority of Crown entities.
47. Two options have been identified for the nomination and appointment of Board members:
  - (a) adopting the process for nominating and appointing Board members currently used by the Guardians of New Zealand Superannuation, or
  - (b) adopting the model prescribed in the Crown Entities Act for independent Crown entities.
48. The first option (the preferred option) involves the establishment of an independent nominations committee appointed by the Minister. The nominations committee would undertake the search for and nominate candidates to the Minister. The Minister would then consult with other political parties in Parliament before making a recommendation for an appointment. The nominating committee would be legislatively required to consult with the Minister on appointments. The members would then be appointed by the Governor-General, on the recommendation of the Minister.
49. The first option is recommended over the second option, as it would protect the independence of the Bank, and provide strong political legitimacy to appointments through the cross-party consultation process. It would also ensure that appointments are focused on the specific skills and experience required by the Board.
50. Regardless of the appointment process selected, it is recommended that Board members be removed by the Governor-General. Removal would be for 'just cause' on the advice of the Minister and following consultation with the Attorney-General. This aligns with the process for the removal of members of independent Crown entity boards in the Crown Entities Act. 'Just cause' is defined in that Act to include "misconduct, inability to perform the functions of office, neglect of duty, and breach of any of the collective duties of the board or the individual duties of members".
51. It is recommended that the Board be comprised of a minimum of five and a maximum of nine members. The size of the Board would ensure a range of expertise. It would also provide sufficient flexibility to deal with conflicts of interest and variations in the availability of suitable candidates. This is the same size as the FMA board. It is expected that the Board will operate at the upper end of the size range.
52. It is recommended that Board member terms are for a period of up to five years. Five year terms will limit political influence over the Board, as longer terms will necessarily reduce the number of appointments an individual Minister of Finance will make. This will support the independent status of the Board. It is also consistent with board terms for independent Crown entities. Shorter terms would remain an

option and are likely to be utilised for the initial Board to ensure a staggered appointment process going forward.

53. Board members will be able to serve a maximum of 10 years, or three terms that total no more than 10 years. This will ensure that new perspectives and different types of experience are introduced with relative regularity.
54. The Crown Entities Act provides for two approaches to the remuneration of board members. Remuneration of members of independent Crown entities is set by the Remuneration Authority in accordance with the Remuneration Authority Act 1977. Otherwise, the remuneration for members of Crown agents or autonomous Crown entities is set by the Minister in accordance with the Fees Framework. The Review team recommends adopting the Remuneration Authority approach for the remuneration of Board members. This would be consistent with an independent Crown entity model.
55. In accordance with your previous in-principle decision, it is recommended that the Treasury is the Bank's monitor. The Treasury's role would be the same as the role of a monitor in section 27A of the Crown Entities Act. Consistent with the role of a monitor, it is proposed that the Treasury administer the Institutional Act. The Treasury, as the Government's lead economic and financial advisor, is the most appropriate organisation to perform the monitoring role and administer the Institutional Act.
56. It is proposed that a legislative requirement be introduced for the Minister of Finance to issue a Letter of Expectations to the Treasury as the Bank's monitoring agency. This would clarify the role of the monitor and the Minister's expectations.
57. The Board would have a broad range of functions. It would be expected, therefore, that the Bank would continue to operate a number of committees that provide advice to the Board. Further, the Board may form committees to deal with specific issues. This would be appropriate, for example, where the Bank has more than one responsibility in relation to a function (such as with payment systems).

#### *Provisions relating to the appointment and removal of the Governor*

58. The Governor is currently appointed by the Minister on the recommendation of the Board. Options considered as part of the Review included retaining the status quo, or enabling a Board appointment.
59. The Treasury recommends that the current ministerial appointment process remain, given the significance of the role of Governor. The Board would be empowered to make decisions regarding delegations. This would enable the Board to control which responsibilities are delegated and manage performance. Appointment of the Governor would be on the recommendation of the Board. This would give the Board the opportunity to select the candidate, effectively creating a "double veto". The Board would continue to have a duty to advise the Minister if the Governor is not performing. A ministerial appointment also recognises that the Governor has a statutory role as an *ex officio* member and chair of the MPC. Internationally, Governors are almost always appointed or approved by the Minister or the legislature.
60. The Bank's view is that the Board should appoint the Governor. The proposal for Ministerial appointment will result in unique institutional and governance arrangements that risk undermining the Board, the role of which is central to the

reforms. The boards of Crown entities select and appoint their own chief executives. For example, the board of the FMA appoints its chief executive. Ministerial appointment of an employee of the Board, in this case the Governor/CEO of the Bank, would be highly unusual.

61. The Bank's view is that appointment of the Governor by the Minister may be regarded as particularly anomalous given the intention for the Bank to move away from a single decision-maker model to a governance board model. The Board's inability to hire or dismiss the Governor (except in certain circumstances) means that the Board's authority is diminished. The Board will remain ultimately responsible for the Bank's performance against its objectives, and accountable to the Minister.
62. If the Minister continues to appoint the Governor, the current process for the removal of the Governor would be retained subject to several modifications. Under the existing process, the Governor can be removed by the Governor-General on the advice of the Minister, based on a specific set of criteria prescribed in the Act. The grounds on which the Minister could recommend removal would need to be limited to inadequate performance or incapacity of the Governor in their role as Chief Executive. The current removal provisions include the non-performance of the Bank; the responsibility for which would be shifted to the Board. The Board would continue to have a duty to advise the Minister if any of the grounds for removal are met.

#### *Provisions relating to the Deputy Governor*

63. The position of Deputy Governor was created in legislation to address risks associated with a single decision-maker structure. This 'key person' risk does not exist in the proposed group decision-making structure, except in relation to the Governor's statutory role as Chair of the MPC. The establishment of a new Board with full decision-making powers means that the legislative requirement for a Deputy Governor can be removed. As a consequence, the Deputy Governor would no longer be an *ex-officio* member of the MPC. The position would continue to be reserved for an internal member of the Bank to retain the current balance of internal and external members.
64. Removal of this position has minor implications for other parts of the Act. In particular, the Deputy Governor fills the role of Governor if the office of Governor is vacant. It is recommended that if the position of Governor is vacant, and the Minister has not made an interim appointment, then the Board would nominate an officer of the Bank to act as Governor pending that appointment. Further, the Board will be required to nominate an alternative Chair of the MPC if the Governor is absent.
65. Currently staff members can serve on the MPC for two terms in one capacity, and another two terms if that person is later appointed as Governor or Deputy Governor. The removal of this position effectively removes this possibility for a future Deputy Governor. As a result, it is recommended that the number of terms an internal member can serve on the MPC be increased to a maximum of 15 years or a maximum of three terms (of not more than 15 years).

## MPC

66. No change is proposed to the appointment and removal processes for the MPC (the new Board will assume the current Board's responsibilities), except as provided above.
67. The current Board has a number of duties with regard to monitoring the MPC. This includes advising the Minister if the MPC or members of the MPC have breached a statutory duty. The monitoring duties are necessary as only the Minister can recommend the removal of MPC members. It is recommended that the new Board assumes the role of monitoring the MPC.

## **Accountability and transparency**

68. It is recommended that the Auditor-General is legislatively enabled to conduct performance audits and inquiries into the Bank's activities. The Bank is explicitly excluded from sections 16(1)(a) and 18(2) of the Public Audit Act 2001. Section 16(1)(a) provides that the Auditor-General may examine the extent to which a public entity is carrying out its activities effectively and efficiently. Section 18(2) allows the Auditor-General to inquire into any matter concerning a public entity's use of its resources. The Auditor-General is also supportive of the Bank being brought within the Auditor-General's oversight. There was also general support for this change among stakeholders. The Minister will also have the power to review the operations and performance of the Bank as per section 132 of the Crown Entities Act. As a consequence, section 167 of the Reserve Bank Act is no longer required. Section 167 enables the Minister of Finance to initiate a performance audit.
69. It is recommended that the Bank be subject to the Ombudsmen Act. The Bank is one of the few agencies not currently subject to the Ombudsmen Act 1975. This provides the Office of the Ombudsman (an office of Parliament), with the ability to investigate administrative decisions by government agencies that affect a person or group of persons. An investigation can be the result of a complaint, or on the initiative of the Ombudsman. The Ombudsman may make recommendations to an agency, but cannot compel an agency to accept a recommendation. There is not a clear rationale for excluding the Bank from the scope of the legislation. Some of the Ombudsman's wider administrative investigations would be relevant to the Bank, such as the recent review of Official Information Act practices across government.
70. The SOI is the primary *ex-ante* reporting document. It is proposed the Bank's SOI process be aligned with the Crown Entities Act, except as provided in paragraph 71. The SOI outlines the entity's medium-term intentions and allows the Crown to participate in the setting of these intentions. The SOI also specifies measures which can be used to assess the entity's performance. The Bank is already required to issue an SOI. The main change is that the SOI would be required triennially. SOIs are currently an annual requirement for the Bank. Annual reporting would instead be via the Statement of Performance Expectations (SoPE).
71. A difference between the SOI provisions in the Crown Entities Act and the Reserve Bank Act is that under the Reserve Bank Act, the Minister cannot require amendments to an SOI (but can make comments). However, under the Crown Entities Act, a Minister may direct amendments to an SOI in relation to defined matters. This includes an entity's strategic intentions and explanations of the scope and management of its functions. It is recommended that the Minister's



involvement in the SOI (and SoPE) process remain restricted to commenting on the SOI, and not be extended to amendment. This recommendation is on the basis that the Minister will be able to issue a Financial Policy Remit. The Treasury prefers the Financial Policy Remit as it is limited to comments on the financial stability objective, thereby appropriately protecting the Bank's operational independence.

72. The Annual Report is the primary *ex-post* reporting document. The purpose of the Annual Report is to report on the activities of the Reserve Bank over the previous year, and assess these activities against the intentions set out in the SOI. The Annual Report also includes financial reporting. It is recommended that the requirements for Annual Reports in the Crown Entities Act will apply to the Bank. This will replace the current bespoke requirements for an annual report in the Reserve Bank Act.
73. It is recommended that the Bank be required to publish an annual SoPE. The purpose of the SoPE is to: enable the responsible Minister to participate in the process of setting annual performance expectations; enable the House of Representatives to be informed of those expectations; and provide a basis for assessing performance. The SoPE bridges the gap between triennial SOIs by providing updated forecasts of financial statements and performance measures on an annual basis. The Bank's activities would be defined as 'reportable classes of output' as per the funding agreement to ensure that the Crown Entities Act applies. The Crown Entities Act defines 'reportable classes of output' as those that are directly funded by appropriations, grants, levies, fees or charges.
74. It is recommended that the Bank be required to publish Statements of Approach (SoAs) outlining the approach to fulfilling its regulatory functions. While the Bank currently produces high level statements of approach, making this a legislative requirement would enhance their status. The SoAs would be 'living' documents and would be updated by the Bank as necessary. They would provide guidance and certainty to stakeholders. They would also provide clarity with regard to the Bank's approach to the performance of its regulatory obligations. The Prudential Regulation Authority (UK) is statutorily required to provide statements of policy and procedure. In New Zealand, both Worksafe and the FMA have legislative functions requiring the agencies to provide information regarding their regulatory approach.
75. Assessing the regulatory impacts of policy proposals is standard practice for policy and legislative development in New Zealand. Section 162AB of the Reserve Bank Act requires the Bank to undertake regulatory impact assessments. It is recommended that a regulatory impact analysis requirement is included in the Institutional Act. This will update section 162AB by requiring the Bank in undertaking the assessment to: outline the policy problem; set out the objectives of the proposal; evaluate the costs and benefits of the proposal and the alternative means of achieving the objectives; and demonstrate that it has considered stakeholder views. An exception for minor and technical matters will continue to apply.
76. It is recommended that the Financial Stability Report requirements be updated to reflect the change in the wording of the financial objectives, but will otherwise remain the same. Content could also be expanded to include reporting on matters specified in the Financial Policy Remit.

## **Funding**

77. The Bank's funding has a direct bearing on its ability to achieve its statutory objectives. The Bank receives its funding from a combination of self-generated revenue and fees for providing certain services. The vast majority of the Bank's funding comes from revenue generated via its balance sheet and currency operations. The amount of this income that the Bank can use to cover operating expenditure is currently set out in a five-year agreement between the Minister of Finance and the Governor. This agreement can be amended at any time, upon agreement between the Minister and the Governor. The funding agreement, and any amendment, must be ratified by Parliament. The agreement aims to achieve a balance between budgetary independence and value for money.
78. Two options are proposed for consideration for the Bank's funding model:
- Option 1: the Bank and the Minister would agree a six-year funding agreement that would prima facie cover all expenditure (the Treasury's preferred option); or
  - Option 2: the Board would set the Bank's Budget, with the Minister having a review role through the SOI process (the Bank's preferred option).
79. The Treasury considers Option 1 provides the best balance of operational independence and accountability (refer to Appendix III for further details). Option 1 provides:
- funding certainty through a six-year agreement (the increase from five years aligns with the SOI process)
  - significant operational independence over how the funding is allocated across the six years
  - democratic legitimacy and oversight of the Bank's spending;
  - accountability and assurance of value for money by outlining a budget from which performance can be assessed
  - improved transparency of the agreement process and realised spending, and
  - significant flexibility as certain expenditure can be excluded (such as commercial operations) and the agreement can be amended or replaced at any time if funding pressures arise.
80. Under the funding agreement option (Option 1):
- (a) the funding agreement would prima facie cover all expenditure (operating and capital) regardless of the funding source (i.e. expenditure of both income and reductions in equity would be prima facie covered)
  - (b) the Minister and the Bank would be able to agree to exclude particular items/activities from the funding agreement (as is the case at present), and could agree on certain items extending over a timeframe that exceeds the term of the agreement
  - (c) the Minister and the Bank would also agree the sources of funding for particular functions, including the extent of any cost recovery via new fees or levies

- (d) the funding agreement would specify the reportable classes of output for the purposes of the SoPE
- (e) the funding agreement would outline dividend principles, from which the annual dividend is calculated
- (f) the funding agreement period would be six years, and signed at the same time as an SOI (which are triennial)
- (g) the funding agreement could be amended or renegotiated at any time, and
- (h) the proposed and final versions of the budget used to determine the funding agreement and the SOI (along with any comments from the Minister) would be published (see below).

81. The Treasury considers Parliamentary ratification of the funding agreement is unnecessary. Rather it is proposed that the funding agreement is tabled in Parliament. Tabled the funding agreement in Parliament will ensure that Parliament will continue to have oversight of the Bank's expenditure. Parliament also has a number of other channels to oversee the Bank's operations and expenditure, including through the Annual Review and presentation of the SOI to the House. Parliamentary ratification has potentially led to the funding agreement process being less flexible than intended.
82. Option 2 (preferred by the Bank) would see the Board set an annual budget for revenue and expenses based on the Board approved strategy and proposals by the Governor and Bank management. The budget would replace the existing statutory arrangements for a five-year funding agreement. There would continue to be many opportunities for the Minister and the Treasury to review the SOI, the budget and related performance criteria. The Bank is of the view that Option 2 would optimise:
- *Accountability* – the Board would be accountable to the Minister and Parliament for the expenditure incurred each year, and for its proposal on the amount of the annual dividend (determined by the Minister). This would be consistent with the Crown entity model and the proposed role for the Board – expectations would be set in advance (via the SOI and, if agreed in the case of the Bank, the Financial Policy Remit) and the Bank (though its board) would govern the resources required to deliver on objectives and would be accountable for performance against them;
  - *Adequate resources* – it would allow timely and disciplined investment of the Bank's resources to deliver functions and objectives and expectations and to ensure the Bank is fit for purpose over time;
  - *Operational independence* – the Bank would not be as constrained by financing arrangements. In line with best practice set out by the Basel Committee and monitored by the International Monetary Fund through the Financial Sector Assessment Program, the Bank's ability to achieve its agreed outcomes should not be impeded by political pressure or third-party influence;
  - *Transparency* – high-levels of transparency on strategies, activities, delegations and resource usage would be expected, including through the SOI, the Annual Report and Finance and Expenditure Committee (FEC) hearings, and the proposed review role for the Auditor-General;

- *Focus* – it would allow stakeholders, the Board and management to focus on how the Bank is delivering on its objectives and how it is managing income, expenditures and balance sheet in support of the objectives;
- *Simplicity* – it would provide a straightforward method of funding the Bank, without the need for complex cost allocation arrangements, either within the Bank or between different categories of regulated entities.

83. Under Option 2:

- (a) the Board would set an annual budget (the first year of a 3-year rolling forecast, set out in the SOI)
- (b) the Bank would continue to use its income from seigniorage and investment returns to support its operational activities and charge for commercial activities as well as fees for services that confer private benefits
- (c) the Bank could provide additional detail in its SOI about the proposed allocations of resources to different functions within the Bank as well as anticipated income from activities, and
- (d) as now, the Minister would make the final determination of the amount of the annual dividend.

84. Regardless of the funding model chosen, the Treasury recommends that the costs of undertaking the Bank's financial regulatory functions, and certain prescribed services, be able to be recovered through fees and levies. Internationally and domestically, it is common for independent regulators to be funded, at least in part, by industry levies. Only Parliament can approve the levying of money by the Crown or an agency of the Crown. Therefore, to allow cost recovery (via levies or fees), empowering provisions must be added to the Bank's primary legislation. The levies and fees would be set by regulations, issued by the Governor-General on the advice of the Minister, following consultation with the Bank. The Act would prescribe the procedural requirements that must be followed in determining a levy.

85. The Bank is not in favour of the levies proposal because it introduces complexity and potentially changes the Bank's dynamic with industry, from supervisor to service provider. In particular, the Bank does not see a role for levies under Option 2, as it would cut across simplicity – an important attribute of the Bank's funding proposal.

86. Fees would be required to be related to specified expenditure. There are currently a number of fee provisions relating to specific functions in the Acts. Both agencies support replacing these provisions with a general regulation making power for fees.

87. It is worth noting that even if cost recovery powers were broadened in the Act, it may be a number of years before they are fully operationalised. Levy and fee calibrations require significant consultation with industry. In addition, with the other Phase 2 reforms (such as the establishment of a depositor protection scheme and possible levy), the nature of the Bank's operations is changing.

88. The Treasury recommends that the Bank be required to publish the proposed and final six-year budgets that inform the funding agreement. The budget should provide sufficient detail to enable understanding of the expected level of service for each of the Bank's key functions and outputs. In addition, scenario analysis should be included in the proposed budget to communicate how different levels of funding could provide different levels of outputs. Publishing the proposed budget supports

the Bank's budgetary independence, by making it clear where changes are the result of ministerial consultation.

89. To date, the Bank has generated revenue in excess of its expenses. A portion of this surplus income is paid to the Crown annually through an annual dividend, with the remainder retained as capital. The Minister determines the annual dividend, following a recommendation from the Bank, in accordance with 'dividend principles' set out in the SOI. It is recommended that the existing process to ascertain dividends remain under either option. Under Option 1, the dividend principles would be included in the funding agreement rather than the SOI. The rationale for the change is that the funding agreement is a more appropriate place for these principles as they should be agreed between the Minister and the Bank (rather than the Minister's limited powers through the SOI process).

### **Coordination**

90. Regulatory coordination in the financial sector is particularly critical. Multiple agencies have roles in the system. The roles frequently interact and overlap. Coordination helps to deliver better policy outcomes by providing a forum for agencies to: identify synergies; consider policy trade-offs; and manage regulatory gaps and overlaps.
91. It is recommended that the Bank have a function to cooperate with other relevant public sector regulatory agencies (including overseas regulators). This has a number of benefits:
- it reinforces the expectation that the Bank actively participates in forums such as the Council of Financial Regulators (CoFR)
  - it will enable the Bank to assist other agencies in performing their functions
  - the proposed function would also align with the FMA's cooperation function, clearly signalling that it is a reciprocal relationship
  - introducing a cooperation function would reinforce the desirability of a culture of coordination, and
  - it would encourage consideration of whether this function is appropriately resourced.
92. The possibility of creating a legislative mandate for the CoFR has been considered. The view of the CoFR members and the Review is that a legislative mandate for the CoFR is unnecessary, as it may compromise its flexibility. If a decision is made to require the establishment of a committee in legislation, it is important that this is non-prescriptive and maintains the flexibility of the arrangement. For example, a high level obligation could require the establishment of a committee.

## **Minor issues**

93. Part 3 of the Crown Entities Act provides for a number of matters relating to the operation of Crown entities. The Review recommends that the following provisions in Part 3 apply:
- provisions relating to whole of government directions (which currently relate to procurement, ICT and property)
  - requirements for the process for issuing ministerial directions (sections 113 – 115A)
  - the ability of the Minister to add functions to the Bank (section 112)
  - requirements to be a good employer (the Crown Entities Act provisions would replace current provisions in the Reserve Bank Act: section 168 and section 169), and
  - provisions relating to corruption of members and appointment of attorneys.
94. There are a number of provisions of the Crown Entities Act that would not be applicable to the Bank, given its role as a central bank. This includes provisions relating to banking and financial market activities, the ability to liquidate the Bank, requirements relating to ongoing financial viability, the requirement to operate as a successful going concern, certain provisions relating to subsidiaries and provisions relating to payment of surplus income, and the capital charge.
95. Replacing the current Act with two pieces of legislation as recommended will require the remaining provisions in the 1989 Act to continue in parallel with the Institutional Act, pending the enactment of the Deposit Takers Act. A number of changes will be needed to the sectoral acts to recognise the establishment of the Board.

## **Risks**

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96. Policy advice on the Institutional Act is being developed in a short time frame meaning certain other matters will not be considered (such as evaluating the provisions relating to the MPC).
97. The Bank is concerned that the outcome of the proposals is to create an entity that is highly unusual, relative to the Crown entity framework, and anomalous given the intention to move away from a single decision-maker model and to empower a new governance board, with responsibility for financial policy. The Bank's view is that the proposal for a remit letter risks undermining the operational independence of the Bank, contrary to the original agreed principles of the review.

## **Appendix I Recommended Functions**

Recommended functions are:

- a) To act as the central bank of New Zealand including by:
  - I. issuing bank notes and coins to meet the needs of the public
  - II. providing settlement accounts for qualifying entities
  - III. managing foreign reserves
  - IV. providing liquidity to the financial system
  - V. acting as lender of last resort
  - VI. carrying out any foreign exchange direction issued by the Minister of Finance
  - VII. carrying out any other central banking activities consistent with the objectives and purposes of this Act, and
  - VIII. liaising and cooperating with other central banks and related international institutions.
- b) To formulate and implement monetary policy directed to the economic objectives, while recognising the Crown's right to determine economic policy
- c) To act as prudential regulator and resolution authority by performing and exercising the functions, powers, and duties conferred or imposed on it under prudential legislation
- d) To act as prudential supervisor, including by monitoring compliance with and investigating conduct that constitutes or may constitute a contravention of, and enforce, any requirements imposed on entities under or pursuant to prudential legislation
- e) To keep under review the laws and practices relevant to prudential regulation
- f) To cooperate with other relevant public sector agencies, including relevant overseas regulators
- g) To provide information about its functions, powers, and duties under this Act and other enactments and provide, or facilitate the provision of, public information relevant to its financial stability objective, and
- h) To carry out other functions, and exercise powers, specified in this Act or any other Act.

## **Appendix II**

### **Remit for the FPC UK, as at 29 October 2018**

#### **B. Matters that the Financial Policy Committee should regard as relevant to the Bank's Financial Stability Objective, and the responsibility of the Committee in relation to the achievement of that objective**

The FPC is charged with contributing to the Bank's Financial Stability Objective primarily by identifying, monitoring and addressing risks to the resilience of the UK financial system as a whole. It should ensure that it considers all parts of the financial system, prioritising as appropriate. The purpose of preserving stability is to contribute to avoiding serious interruptions in the vital functions which the financial system as a whole performs in our economy: notably, the provision of payment and settlement services, intermediating between savers and borrowers, and insuring against risk (for individuals, businesses and financial market participants).

The Committee originally focused its energies on rebuilding the resilience of the banking sector. With the current programme of reform in this area now firmly in the implementation phase, the Committee has broadened its focus to include systemic risks to, or stemming from, other sectors such as financial markets, institutional investors, or insurance. It has also broadened the range of risks it considers: in addition to the risks stemming from financial institutions' balance sheets, the FPC has taken on responsibility for identifying, monitoring and addressing market issues and systemic non-financial risks, such as cyber risks, that could have material implications for the resilience of the financial system. The Committee should continue with this broader range of focus, and should continue

its work with the firm-level regulators and other bodies as appropriate to address the risks it identified in these areas.



## Appendix III

