

The Treasury

Reserve Bank Act Review Phase 2 Review Update Proactive Release

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MEMORANDUM FOR RBNZ Act Review Team
FROM RBNZ
DATE 24 July 2019
SUBJECT **Reserve Bank of New Zealand: institutional design**

This memorandum outlines the Reserve Bank's proposal for the constitution of the Reserve Bank and addresses the questions raised in chapter 3 of the 'C2A' consultation paper.

The purpose of the memorandum is to assist the review team to finalise its proposals and to assist the drafting process for a Reserve Bank institutional Act.

Key features are:

- Reserve Bank to be an independent Crown entity, with variations.
- Monetary Policy Committee (MPC) remains in place, but monitored by the board rather than the Treasury.
- Minister of Finance appoints members of a new nominating committee, members of the board, members of the MPC and the governor.
- Appointments of board members and members of the MPC must be based on nominations made by nominating committee.
- Appointment of governor must be based on nomination by the board.
- Other variations to CE Act suitable for central bank as noted below.

Institutional Act

Overall, the CE Act covers the same ground as the RBNZ Act relating to the constitution and the management of the Bank. The CE Act is considerably more detailed and prescriptive than the RBNZ Act.

The standardised provisions that would apply to the Bank are:

- Establishment of the Bank
- Validity of acts (essentially natural person powers)
- Role and accountability of board members (the CE Act refers to "members" rather than "directors").
- Role of minister and monitor
- Appointment, removal, and conditions of members.
- Remuneration and expenses
- Collective and individual duties, and effect of non-compliance by members with those duties (a variant on these applies to members of the MPC)
- Conflict of interest disclosure rules
- Delegation
- Government directions to Crown entities, including policy directions and whole of government directions
- Employment of employees, employment of CEO and good employer obligation
- Protections from liability of member, officer holder and employee
- Contracting, seals and attorney
- Reporting: SOI, statement of service performance and annual report
- Numerous miscellaneous provisions.

- Schedule 1: The Bank would be listed as a Crown entity and exempted from restrictions applying in the Act to acquisition of financial products, borrowing, guarantees and derivative rules as well as the restriction on paying its operating surplus to the Crown
- Schedule 5: procedures for appointment of board chair person and meetings procedure.

Modifications to CE Act

Apart from the CE Act, each CE has its own institutional Act. The institutional Act may override or modify provisions in the CE Act. Thus, there is plenty of scope for adaptability within the CE framework.

Clearly, much of the CE Act could apply to the Bank. However, the following standard provisions of the CE Act should be modified:

- Powers: sections 14-18 of the CE Act provide the basic powers of a CE. These appear to be slightly more narrowly drafted than similar provisions in the RBNZ Act, (notably section 39(f)). The Bank's current operations as a landlord and operator of NZClear could be subject to question if the statutory framework was narrowed.
- Subsidiaries: we consider the Bank should have less procedure and restriction should it choose to incorporate a subsidiary. Apart from the existing subsidiary relating to NZClear operations, the ability to form a subsidiary could be important for crisis management.
- Bank accounts: the restrictions on bank accounts are not appropriate for a central bank
- Liquidation procedures: we question whether section 177 of the CE Act, which provides for the application of the liquidation provisions of the Companies Act to Crown entities, should apply to a central bank.

Fundamental modifications/design issues

We have identified the standardised provisions of the CE Act that could apply to the Bank and some modifications that could be made without violating the basic CE Act framework or impacting the Bank's management and operation in a problematic way.

Beyond those provisions, three fundamental design issues require careful attention. These issues arise because of the "full-service" nature of the Bank. If the Bank were a "pure" central bank" or a "pure" financial regulator the issues would not arise. (That said, if the Bank were a pure central bank there would also be a stronger case not to apply the CE Act.)

The three issues are interlinked and are:

1. The appropriate independence for the Bank: should the Bank be an ICE?
2. The role of the MPC.
3. The role and appointment process for the Governor (and Deputy Governor)

Independence / ICE

Crown entities are divided into three categories:

1. Crown agents
2. Autonomous Crown entity (ACE)
3. Independent Crown entity (ICE)

Each is distinguished from the other by its degree of independence. This is manifested through the provisions relating to appointment and dismissal of members: Crown agent members can be dismissed virtually at will by ministers, whereas ICE members can only be appointed or dismissed by the Governor General (on the advice of the responsible Minister).

The other manifestation of independence is the extent to which the Minister can direct the Crown entity on a matter of policy. Crown Agents can be directed to follow government policy; ACEs can be directed to have regard to a statement of government policy relevant to their functions and objectives, while ICEs cannot be directed by a minister unless a power of direction is provided in the entity's own institutional Act.

We have surveyed each ICE and, of all 17, only two can be issued a policy direction by a minister:

- The Commerce Commission can be directed to have regard to the economic policies of the Government as transmitted in writing from time to time to the Commission by the Minister¹;
- The Electricity Authority can be directed to have regard to any statements of government policy concerning the electricity industry that are issued by the Minister².

The direction power relevant to the Commerce Commission is broad and indirectly focused. The direction power relevant to the Electricity Authority is similar to that applying to ACEs as well as the current ministerial direction applying to the Bank under section 68B. Otherwise, the point can be made that a distinguishing feature of ICEs is that they are truly at arms-length from ministerial input with the Electricity Authority representing the outermost limit of a ministerial direction power for an ICE.

The only power that the Minister has over the Financial Markets Authority is that the Minister may request that the FMA inquire into, and report on, any matter relating to financial markets, financial markets participants, or other persons engaged in conduct relating to those markets.³

The important implications are:

- Other decisions yet to be made for Phase 2 could determine whether the Bank is truly an ACE or an ICE. For example: the scope of a statement of government policy (as recommended by James Every-Palmer) or a financial policy remit (as described in the consultation paper) should not be more intrusive than that applying to the Electricity Authority, given that ICEs are generally not subject to such directions.
- Some of the options floated in respect of the Bank's role as resolution authority may be more appropriate to a Crown agent (e.g. the proposal that the Minister can direct the Bank how to carry out a resolution).
- If the institutional Act results in a more extensive role for Ministerial input than would apply to an ICE then logically the Bank should be classified as an ACE. This has implications for the appointment and dismissal of the Bank's members. As a matter of logic, if an entity has a greater duty to have regard to or carry out government policy, the government should have greater ability to dismiss its members.
- If the Bank ends up classified as an ACE (in name or substance) then the Minister's position at the outset of Phase 2 – that the Bank's operational independence is paramount and will be protected – will have been defied. On the other hand, acceptance that the Bank is an ICE provides a benchmark against which proposals for ministerial input can be assessed.

Despite the many variants to the typical CE model overall, on balance we think that the Bank should be categorised as an ICE and its relationship with its minister should be typical of an ICE (putting aside the MPC).

¹ Commerce Act 1986, section 26. However, section 26(3) says: "a statement of economic policy transmitted to the Commission under this section is not a direction for the purposes of Part 3 of the Crown Entities Act 2004."

² Electricity Industry Act 2010, section 17.

³ Financial Markets Authority Act 2011, section 20.

The role of the MPC

The MPC is a statutory committee and the apex structure within the Bank for the formulation of monetary policy. Several of its features are adapted from the CE Act (such as duties upon its members and their dismissal procedures), while others are inconsistent with the CE Act.

If the MPC is assessed against the CE Act, there are some ICE elements (e.g. procedure for dismissing members), while other elements would most closely align with a Crown agent model, or to an entity with even less independence. This applies most notably to the charter – for a Crown entity, decision making procedures are a matter of internal procedure – and the Treasury observer (unprecedented).

So the MPC is not consistent with the CE framework. The MPC could be treated as a bespoke organisational carve-out and not relevant to the overall characterisation of the Bank. This may be true, but that depends on how the role of the MPC is reconciled with the rest of the Bank under the new Act.

The role and appointment process for the Governor and Deputy Governor

The CE Act is explicit that a CE's board appoints the CEO. Under the RBNZ Act, both the Governor and the Deputy Governor (following phase 1 implementation) are appointed by the Minister, albeit on the recommendation of the RBNZ board (which is of a very different nature to a CE board).

For a regular CE (especially an ICE) which has a corporate board, appointment of the CE by the Minister would be an intrusion into the operation of the CE.

However, under the RBNZ Act the Governor is more than a mere CE, he or she is also *ex officio* chair of the MPC, which entails a number of duties in the Act and Charter, including being its sole spokesperson for the official announcement of each monetary policy decision. Given these roles, we therefore expect that the Minister will wish to appoint the Governor.

Consequently, despite the departure from the CE Act, we consider the Minister should appoint the Governor on the recommendation of the Board. Similarly, the Governor should only be dismissed by the Governor General on the advice of the Minister, whether according to statutory criteria or as recommended by the board.

The Governor should not be a member of the board. The board should be entirely non-executive.

We consider that there is no need for similar appointment processes to be in place for a Deputy Governor. The legislation should consequently remove any references to the role or function of Deputy Governor. The Deputy Governor would become a normal management position, employed by the Bank. The position of the Deputy Governor as an *ex officio* member of the MPC can be replaced by adding another internal member position to the MPC.

Nominating committee

The members of the board and the members of the MPC (apart from the Governor who is an *ex officio* member) should all be nominated by a nominating committee and appointed by the Minister of Finance. The nominating committee should be based on section 56 of the New Zealand Superannuation and Retirement Income Act 2001. As with the current RBNZ Act (Schedule 2, section 9), the nominating committee should be required to consult the Governor and the Board before making a recommendation in respect of an internal member of the MPC.

Responses to questions raised in 'C2A' consultation paper

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?

Coherence and consistency of the overall legislative design and how it provides for the board. New legislation should avoid unnecessary complexity and prescription. The Crown Entities Act is a tested model that provides for a board and is a better option than bespoke legislation.

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?

This should be based on the Crown Entities Act: sections 73-76.

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?

This Treasury's approach should be based on section 27A of the Crown Entities Act, supplemented by the State Services Commission's general guidance to monitoring departments. We support the suggestions in the SSC guidance that the Minister should consider sending a letter of expectations to the Treasury to confirm the expected monitoring arrangements, or that the Treasury should make an explicit agreement with the Minister about its monitoring responsibilities and approach.

The MPC should be monitored by the board rather than by the Treasury. However, if Treasury is to monitor the MPC, it would no longer be appropriate to have a Treasury observer at the MPC. Although the consultation paper suggests that the risks of conflict of interest could be mitigated by separation arrangements within the Treasury, we think there is a real danger of compromising the independence or effectiveness of monetary policy decision-making.

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

Yes. See above.

3.E For the new governance board:

- what should the split of executive and non-executive members be?
 - what skills and expertise should non-executive members have? Is there merit in having representation from the FMA and/or the Treasury?
 - how should members be appointed and removed? Should the board be able to appoint the Governor as CEO?
- *The new governance board should be fully non-executive.*
 - *Members should be appointed by the Minister on the recommendation of a nominating committee, who can determine the skills required of members based on a skills matrix. Members should be chosen on the basis of appropriate skills and manageable conflicts of interest. We are not aware of any other ICEs which have representatives from other agencies on their boards and note that the Council of Financial Regulators is intended to be a mechanism through which agencies can share information. However, we would be interested to review and consider any submissions on this point.*
 - *Board members appointed by the Minister on recommendation of nominating committee. Removal of members should be based on section 39 of the Crown Entities Act.*

- *The Governor should be appointed by the Minister on recommendation of the Board. Removal should be by Order in Council on the advice of the Minister, either according to statutory criteria (bankruptcy, etc) or on the recommendation of the board.*

3.F Are there any aspects of the board's operation would benefit from legislative clarity or guidance?

- *The Crown Entities Act is sufficient to determine the role of the board and how it should operate.*