

The Treasury

Reserve Bank Act Review Phase 2 Consultation 3 Submission Information Release

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MEMORANDUM

TO: Phase 2 of the Reserve Bank Act Review
New Zealand Treasury

FROM: Andrew Body
Principal
Andrew Body Limited

DATE: 30 September 2020

SUBJECT: Submission for the third consultation round of Phase 2 of the Reserve Bank Act Review

Summary

Chapter 2 of consultation document – Purposes of the Deposit Takers Act

1. The scheme of purpose and objectives in the proposed Deposit Takers Act has a number of problems that undermine the efficacy of the proposed act:
 - Absence of reference to the continuing overarching prosperity and well-being purpose of the RBNZ
 - Lack of clarity in the proposed purpose to protect and promote financial stability
 - Proposed decision making principles are unclear and poorly constructed
 - The decision making principles are not a substitute for an efficiency objective.
2. The scheme's focus on stability has a "double whammy" of problems. It does not have an overarching purpose of New Zealanders' prosperity and well-being and it does not have an efficiency objective. As a consequence, it will eliminate the requirement for the RBNZ to try to mitigate the costs its actions in the areas of financial stability and economic objectives.
3. For example, under the proposed scheme a mistake in the RBNZ's capital adequacy banking standards, BS2A and BS2B, relating to the treatment of lending to private housing cooperatives will not require correction and will continue to distort the housing market and unjustifiably enrich banks.
4. Under the proposed Deposit Takers Act the RBNZ can simply ignore mistakes in its standards like this on the basis that correcting the mistake does not improve financial stability.

Chapter 4 of consultation document – Standards and licensing

5. Consultation is a key part of the proposed approach to standard-making.

6. However, consultation on regulatory matters related to the finance sector is often very poor, being dominated by the banks and insurers. The public are effectively excluded from consultation by the overly technical presentation of material.
7. Mistakes in regulatory consultation undermine public confidence in the process and create the justifiable and correct position that the standard changes and their impacts are not widely publicly understood or considered and can be challenged and overturned by political process.
8. The RBNZ should adopt a consultation standard and in the process create a “front-door” for the public to have their concerns dealt with properly.
9. The RBNZ is extraordinarily powerful and if it chooses it can operate in a way that lacks transparency and accountability. Enabling Parliament to review the RBNZ’s standards and its supervisory adjustments is a great idea.

Scheme of the purpose and objectives of the proposed Deposit Takers Act (Chapter 2)

10. The overarching purpose of the RBNZ and the Reserve Bank of New Zealand Act is to “*promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy*”¹. This purpose is continuing in the proposed Institutional Act².
11. The proposed Institutional Act, in an overly nuanced and somewhat confusing distinction from “purpose”, also says³ the “main objectives” of the RBNZ are:

“Economic objectives

- (a) *the economic objectives of—*

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

(ii) supporting maximum sustainable employment; and

Financial stability objective

- (b) *the financial stability objective of protecting and promoting the stability of New Zealand’s financial system; and*

Central bank objective

- (c) *otherwise acting as New Zealand’s central bank in a way that furthers the purposes of this Act.”*

12. The proposed Deposit Takers Act, without reference to the prosperity and well-being purpose of proposed Institutional Act, is to then give effect to the proposed Institutional Act’s main objective (b)⁴:

¹ s1A(1) Reserve Bank Act of New Zealand Act 1989

² cl3 Reserve Bank of New Zealand, introduced to Parliament on 28 July 2020

³ *ibid.* cl9

⁴ Safeguarding the future of our financial system. Further consultation on the prudential framework for deposit takers and depositor protection Phase 2 of the Reserve Bank Act Review. March 2020. p21

“the purposes of the Deposit Takers Act are to

- promote the safety and soundness of deposit takers*
- promote public confidence in the financial system*
- mitigate the risks that arise from the financial system*

and, in doing so, contribute to protecting and promoting the stability of New Zealand’s financial system.”

13. The proposed Deposit Takers Act is to also contain decision making principles that guide the exercise of powers and duties under the Deposit Takers Act when pursuing the objective of protecting and promoting the stability of New Zealand’s financial system.
14. The proposed decision making principles are designed to address concerns raised in earlier consultations about the removal of efficiency as an objective of the Reserve Bank⁵.
15. The proposed decision making principles are⁶:
 - “the desirability of minimising unnecessary costs of regulatory actions, taking into account the benefits of the outcomes to be delivered*
 - the desirability of taking a proportionate approach to regulation and supervision, and ensuring that similar institutions are treated consistently*
 - the desirability of sectors regulated by the Reserve Bank being competitive, taking account of the size of the market*
 - the value of transparency and public understanding of the Reserve Bank’s objectives and how the Reserve Bank’s functions are exercised*
 - consideration of the practice by relevant international counterparts carrying out similar functions, as well as guidance and standards from international bodies*
 - the desirability of taking into account long-term risks to financial stability.”*

Comments on scheme of the purpose and objectives of the proposed Deposit Takers Act (Chapter 2)

16. This scheme of related purposes and objectives has a number of problems that undermine its efficacy.

Absence of reference to the overarching purpose of the RBNZ

17. First the proposed Deposit Takers Act does not reference the overarching purpose of the RBNZ - to promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy.
18. The absence of this reference limits the purpose of the proposed Deposit Takers Act to only protect and promote the stability of New Zealand’s financial system.

⁵ RBNZ Act Review, policy decisions relating to the proposed Institutional Act. 4 October 2019. Para 18

⁶ Safeguarding the future of our financial system. Further consultation on the prudential framework for deposit takers and depositor protection Phase 2 of the Reserve Bank Act Review. March 2020. p23

19. Given the absence of an efficiency objective, the financial stability objective on its own could well be in conflict with promoting the prosperity and well-being of New Zealanders and on the proposed scheme the proposed Deposit Takers Act would require the RBNZ to choose the financial stability objective over the prosperity and well-being purpose.
20. The absence of the prosperity and well-being overarching purpose and the removal of efficiency objective risks undermining the review that officials are undertaking.
21. This “double whammy” of problems and its likely result is counter-intuitive, surely not intended by officials and is not politically sustainable.

Lack of clarity in the purpose of the proposed Deposit Takers Act

22. Second what is the difference between “protect” and “promote”? Why have both words been used instead of just one?
23. The use of both words increases the risk of the RBNZ acting in a way that is not consistent with the prosperity and well-being purpose.

Proposed decision making principles are unclear and poorly constructed

24. Third the proposed decision making principles are unclear and poorly constructed.
25. The decision making principles are “grab-bag” of potentially competing and generally unclear principles. Some of which have only limited relationship to efficiency.
26. It is unclear how these principles are intended to be traded off against each other.
27. It is also unclear what “guiding” is meant to mean. For example, does it mean that any decision taken by the RBNZ must strictly satisfy the decision making principles or is it intended that the principles can be pragmatically abandoned on a case by case basis?

The decision making principles are not a substitute for an efficiency objective in the form

28. Fourth the proposed removal of efficiency as an objective is a serious mistake.
29. The decision making principles are not a substitute for an efficiency objective in the form of a net economic benefit test
30. As background I attach my submission for the second round of consultation of Phase 2 of the Reserve Bank Act Review, dated 14 August 2019.
31. Moreover, for such a significant proposed change it is appropriate that a detailed record is publicly available (that supports further consultation) of why officials recommended removal of efficiency from the main objectives of the RBNZ.

32. Removal of efficiency as an objective means that RBNZ can focus on stability at the cost of efficiency and to the detriment of New Zealanders' prosperity and well-being, all without transparency and accountability.
33. It is easy to provide examples of situations where the RBNZ's focus on stability (and its other objectives) could be to the detriment of New Zealanders' prosperity and well-being and I do so below.

Example of focus on stability to the detriment of New Zealanders' prosperity and well-being

34. Housing is a key contributor to New Zealanders' well-being and is acknowledged by the Government's lead economic and financial advisor, New Zealand Treasury, as such⁷.
35. In the process of satisfying its main objectives (price stability, maximum sustainable employment and financial stability) following COVID-19 the RBNZ is likely to materially exacerbate the difficulties of New Zealanders in housing themselves and to the detriment of their well-being.
36. This approach may well be justified on a "least regrets" basis. However, what is "least regrets" if it is not a net economic benefit test?
37. A transparent and accountable RBNZ, seeking to promote public confidence in its actions by demonstrating that its decisions do indeed involve the least regrets, should assess the net economic benefit of its actions compared to other options it faces. Consideration of the impact on New Zealander's access to housing should be an integral part of such an assessment.
38. The RBNZ has apparently not consistently assessed the impact of its prudential policies and standards on the prosperity and well-being of New Zealanders
39. RBNZ has resisted correcting mistakes in its prudential standards. Such corrections will facilitate and promote the development of alternative forms of housing tenure that will play a significant role in mitigating the costs of its pursuit of its main objectives.
40. For example RBNZ has not yet modified its capital adequacy standards (BS2A and BS2B⁸) to make clear that private housing cooperatives can be treated as residential property for lending purposes.
41. Lending to private housing cooperatives is no more (and probably less) risky than lending to individuals secured by mortgage over residential properties in freehold title.
42. However the RBNZ has resisted recognising and correcting this mistake. As a result of this mistake banks' lending policies prevent tenure innovation, distort the housing market and unjustifiably inflate their lending margins and profits.
43. This mistake by the RBNZ is likely to continue if the proposed Deposit Takers Act does not have reference to prosperity and well-being and does not contain an efficiency objective.

⁷ <https://lsfdashboard.treasury.govt.nz/wellbeing/>

⁸ <https://www.rbnz.govt.nz/regulation-and-supervision/banks/banking-supervision-handbook>

44. It is reasonable to conclude that there are other problems with BS2A and BS2B in respect to housing that are not well understood by the RBNZ and that if corrected would not affect financial stability but would improve New Zealander's prosperity and well-being.

Scheme of standards-making under the proposed Deposit Takers Act (Chapter 4)

45. The RBNZ's making of its standards is a critical part of operationalising its purpose.
46. The proposed Deposit Takers Act creates broad powers for the RBNZ and the Minister of Finance to create standards with subsequent "supervisory adjustment".
47. The proposed procedural requirements for making standards include:
- Preparation of a regulatory impact analysis
 - Consultation with government agencies
 - Consultation with the public
 - Parliamentary oversight under the Legislation Act
 - Judicial review

Comments on the standards-making scheme (Chapter 4)

Consultation related to the finance sector is often very poor, with it being dominated by the banks and insurers

48. The problem with standards-making in the finance sector is that the stakeholders most affected by the standards (depositors, borrowers and the insured) find the area highly technical. Moreover they don't understand how important the standards are to their every-day lives.
49. As a result, like a lot of other regulation-making in the finance sector policymakers and regulators make the mistake of thinking that the regulated (in this case the banks and insurers) is the primary stakeholder group.
50. The consultations for the Reserve Bank Act Review are an example of this mistake being made repeatedly. The consultations have been poorly promoted, the documents technically inaccessible and the limited number of responses enables officials the opportunity to believe that they have measured what stakeholders think.
51. The consultations on the Review of the Reserve Bank Act have practically excluded the public and it would be interesting for officials to answer the question as to whether the style of consultation is consistent with the Crown's Treaty of Waitangi obligations.
52. Another example in the finance sector is the recent conduct of financial institutions bill submissions at select committee. In that case the regulatory impact statement⁹ to support the submissions process was of very low quality, presenting numerous statements of opinion as fact and without much economic analysis (and certainly no quantitative analysis).

⁹ <https://www.treasury.govt.nz/sites/default/files/2019-12/ria-mbie-rrg-dec19.pdf>

53. These mistakes in consultation undermine public confidence in the process and create the justifiable and correct position that the changes and their impacts are not widely publicly understood or considered and can be challenged and overturned by political process.
54. The difficulty in consultation process for standards-making is exacerbated by the RBNZ not having a “front-door” for stakeholder groups to have evidence-based, considered, analytical and fast-result discussions with the RBNZ about problems with its standards.
55. In the case of its prudential treatment of lending to private housing cooperatives the RBNZ’s prudential team has resisted being drawn into evidence-based, considered and analytical discussions about problems with its standards and processes. The unfortunate consequence of this is that the RBNZ causes the issue to become unnecessarily politicised.
56. Wellington “insiders” sometimes refer to the RBNZ as the “fortress on the hill” or the “fortress on the corner”. They are labels that, unfortunately from the public’s perspective at least, may have some justification.
57. The RBNZ’s standard-making consultations need to be completely rethought by the RBNZ and it needs a “front door” where people can go to get a high-quality (considered and analytical) hearing with a fast result.
58. The RBNZ should adopt a consultation standard and in the process create a “front-door” for the public to have their concerns dealt with properly.

Parliamentary oversight under the Legislation Act is a great idea

59. The RBNZ is extraordinarily powerful. Enabling Parliament to review the RBNZ’s standards and its supervisory adjustments is a great idea.
60. These reviews should be at Parliament’s discretion and Parliament should be able to be petitioned by the public to undertake such reviews.

MEMORANDUM

TO: Phase 2 of the Reserve Bank Act Review
New Zealand Treasury

FROM: Andrew Body
Principal
Andrew Body Limited

DATE: 14 August 2019

SUBJECT: Submission to the Independent Expert Advisory Panel for the second consultation round of Phase 2 of the Reserve Bank Act Review

Summary

1. The Reserve Bank of New Zealand (RBNZ) should have as its sole purpose the maximisation of net economic benefit to New Zealanders. Further objectives are not required.
2. Section 1A of the Act should be amended to read:
 - (1) *The purpose of this Act is to promote the prosperity and well-being of New Zealanders by contributing to a sustainable and productive economy.*
 - (2) *This section does not limit the functions or powers given to the Bank by any other enactment.*
3. A new section 7A should be added to the Act to read:
 - (1) *The Bank must use its powers and functions to take action when such action would result in a net economic benefit to New Zealanders.*
 - (2) *The Bank must publish a net economic benefit analysis prior to it taking action under 7A(1).*
 - (3) *The consistency of the Bank's use of its powers and functions with its purpose of creating net economic benefit is subject to judicial review.*
4. The critical issue within this scheme, of what monetary and prudential powers the RBNZ has under the scheme described above, would need to be revisited.
5. There is a sense about the RBNZ's behaviour that it does not want to, or is simply unable, to engage in all-sector efficiency or net economic benefit analysis because it takes the organisation out of a familiar institutional and "macro" analytical environment into an unfamiliar and more complex "meso" analytical environment.

6. Our statutory scheme corrects this problem.

Explanation

7. This submission addresses the question of what policy objectives the Reserve Bank of New Zealand (RBNZ) should have (the objectives' question).
8. The context for consideration of the objectives' question is very important:
- a. RBNZ's macro and microeconomic impact on the New Zealand economy is far reaching - far beyond cost of capital and prudential supervision of the banking and insurance sectors
 - b. The RBNZ has a governance structure and level of independence that substantially limits its accountability - its regulatory hegemony in its field means it can simply ignore and fail to even acknowledge the negative consequences of its actions
 - c. Clarity and internal and temporal consistency of purpose is important to both its results and meeting the demands of its limited accountability – the purpose (including objectives) of the RBNZ is becoming unclear and internally and temporally inconsistent
 - d. As an organisation it does not bear the consequences of the mistakes it makes
 - e. There is a vast array of well-developed literature on the theory and practice of efficiency and its application to New Zealand, including New Zealand Treasury's cost benefit analysis
 - f. Regulation is now in the domain of political populism – the voters will decide on what regulation they like, so being too clever and stepping away from clarity, consistency and meaningfulness is not a politically sustainable position in regulatory policy development.
9. Consistent with the beginning of section 1A of the Reserve Bank of New Zealand Act 1989 (the Act) the RBNZ should be solely focussed on maximising the net economic benefit to New Zealanders of its actions. Any other focus will only maximise net economic benefit to New Zealanders by accident.
10. In cost benefit analysis terms this amounts to maximising the sum of:
- Benefit of an action
 - Less cost of an action
 - Less cost of administration
11. Maximising net economic benefit to the New Zealanders is an allocative, productive and dynamic economic efficiency task. It also incorporates the concept of the administrative cost of intervention.
12. Maximising net economic benefit to New Zealanders does not require a statutory objective. It is clear, internally and temporally consistent and amongst other things requires consideration of the stability of the financial system. Importantly voters can “get it”.

13. Practically, expressing and operationalising RBNZ's purpose can only be undertaken with reference to the powers the RBNZ has. The critical issue within this scheme, of what monetary and prudential powers the RBNZ has under the scheme described above, would need to be revisited.
14. Therefore section 1A of the Act should be amended to simply read:

(3) The purpose of this Act is to promote the prosperity and well-being of New Zealanders by contributing to a sustainable and productive economy.
(4) This section does not limit the functions or powers given to the Bank by any other enactment.
15. A new section 7A should be added to the Act to simply read:

(4) The Bank must use its powers and functions to take action when such action would result in a net economic benefit to New Zealanders.
(5) The Bank must publish a net economic benefit analysis prior to it taking action under 7A(1).
(6) The consistency of the Bank's use of its powers and functions with its purpose of creating net economic benefit analysis is subject to judicial review.
16. RBNZ's powers and functions largely relate to the operation of monetary policy and banking and insurance prudential supervision. Trade-offs between the cost and benefit of additional financial stability are simply subsumed within the net economic benefit analysis and proposed provisions of the Act described above.
17. Moreover the concept of multiple subsidiary objectives as suggested in the June 2019 Consultation Document 2A creates a dangerous lack of clarity of purpose and encourages internal and temporal inconsistency. There should not be any subsidiary purposes or objectives in the Act.
18. For example maintaining public confidence as a subsidiary objective can only be achieved using the powers the RBNZ has and the exercise of these powers to maximise net economic benefit to New Zealand is the only positive way the RBNZ can influence public confidence. So why make it a separate objective?

RBNZ avoiding the full implications of its actions

19. The critical question that both the November 2018 and June 2019 Consultation Documents missed is how far should the RBNZ's net economic benefit analysis of its actions extend beyond the financial system? For example should the RBNZ be required to take into account the impact of its actions in its cost benefit analysis on all sectors of the New Zealand economy?
20. There is a strong sense from RBNZ's behaviour that it that it does not want or is simply unable to engage in all-sector efficiency analysis because it takes the organisation out of a familiar institutional and "macro" analytical environment into an unfamiliar and more complex "meso" analytical environment.

21. Instead it simply relies on its regulatory hegemony to avoid consideration of the all-sector economic implications of its action or inaction.
22. The RBNZ's current narrow consideration of efficiency is extremely expensive for the New Zealand economy and is at odds with the voters' trust and confidence in such an "independent" regulator.
23. Our proposed statutory scheme corrects this behaviour of the RBNZ.