The Treasury

Reserve Bank of New Zealand Bill Information Release

November 2021

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RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

TE TAI ŌHANGA
THE TREASURY

Joint Report: Proposed RBNZ Bill governance amendments

Date:	18 February 2021	**Report No:**	T2021/255
		File Number:	MC-1-7-3-1-3-1

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	Agree to the recommendations. Refer a copy of the report to Hon David Parker.	

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
James Campbell	Principal Advisor	[39]	N/A (mob)	✓
Tamiko Bayliss	Director, RBNZ Act Review		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury. Refer a copy of the report to Hon David Parker.

Enclosure: Yes (attached)

Executive Summary

The Reserve Bank of New Zealand Bill (the Bill) creates new governance arrangements for the Reserve Bank, including establishing a board that will be responsible for corporate governance, balance sheet management and financial policy matters. A separate monetary policy committee (MPC), chaired by the Governor, will continue to make decisions on monetary policy. The Bill is currently being considered by the Finance and Expenditure Committee (FEC), who will report back to Parliament by 8 June.

Recent engagement on the Bill and work relating to the financial arrangements of monetary policy (as outlined in our joint briefing of 11 December 2020 [T2020/3302 refers]) has highlighted some challenges for the current governance model in the Bill. In particular:

- the use of the Bank's balance sheet for monetary policy purposes (particularly in relation to alternative monetary policy instruments) creates a tension between the MPC's responsibility for formulating monetary policy and the board's responsibility for managing the Bank's balance sheet and financial responsibility duties.

- Ministerial appointment of the Governor creates risks in terms of blurred accountability for the Governor and the potential for tensions between the Governor and the board

- recent engagement with the International Monetary Fund has also highlighted that the lack of cross-membership between the MPC and the board poses risks to the effective coordination of the monetary and financial policy.

In response to these concerns, the Treasury and the Reserve Bank recommend making amendments to the Bill, including:

- making the Governor a member of the board. This would reduce the risk of conflict between the MPC and the board, better promote coordinated financial and monetary policy, and provide for a clearer role and accountabilities for the Governor. This approach would better serve the board's responsibility in terms of balancing both oversight and decision making. This would also resolve the Governor's status, both in terms of employment law and in terms of the visible role that central bank governors are expected to have in formulating and communicating policy.

- clarifying that the MPC will be constrained in monetary policy making by the board's assessment of balance sheet and operational risks. Doing so would clarify responsibilities and accountabilities, and minimise the risk of conflict between the board and the MPC on balance sheet issues.

While we considered alternative models, such as creating a statutory Financial Policy Committee or making the Governor the chair of the board, these changes would require more significant amendments to the overall governance model in the Bill and necessitate an extension to the Select Committee process. The Treasury and the Reserve Bank also disagree on the relative merits of these options. Given the undesirability of making significant changes to the overall governance structure at this stage in the legislative process, both agencies support the proposed approach.

[33]

This would reduce potential

conflict between the board and MPC, ensure you have clearer grounds to hold the board to account. We are separately considering possible changes to the process for updating an MPC remit. Both these sets of changes, if made, could be progressed via the same process as the changes discussed in this report.

Subject to your agreement we will draft a Cabinet paper and regulatory impact statement seeking agreement to these changes. The Treasury could then recommend these changes to FEC via the departmental report process in early April.

Recommended Action

We recommend that you:

a **note** that further analysis on the RBNZ Bill has highlighted governance issues relating to monetary policy decision making and implementation, the effectiveness of monetary and financial policy coordination, and the status of the Governor.

b **agree** to seek Cabinet approval to amend the governance provisions in the Bill to provide that:

a. the Governor will be a member of the board

Agree/disagree.

b. the MPC will be constrained in monetary policy making by the board's assessment of balance sheet and operational risks

Agree/disagree.

c **note** that, subject to your agreement, we will further develop the above proposals and provide a draft Cabinet paper and regulatory impact statement for ministerial consultation in early March 2021 ahead of Cabinet decisions in late March 2021.

d [33]

e **note** that any changes to the RBNZ Bill would be progressed via the select committee process, with the Treasury recommending them to the committee as part of the departmental report process.

f **refer** this report to Hon David Parker for his information.

Tamiko Bayliss
Director, RBNZ Act Review

Hon Grant Robertson
Minister of Finance

Purpose of Report

1. To seek your agreement to amendments to the Reserve Bank of New Zealand Bill (RBNZ Bill), to be progressed via the select committee process for the Bill.

Analysis

Context

2. The RBNZ Bill, one of two pieces of legislation resulting from Phase 2 of the Review of the Reserve Bank Act, is currently being considered by the Finance and Expenditure Committee (FEC). The RBNZ Bill reforms the institutional arrangements of the Reserve Bank, including providing for:

   - a governance board responsible for corporate matters and financial policy, and for implementing the monetary policy formulated by the MPC
   - alignment with the Crown entity governance model in many (but not all) respects
   - a new financial stability objective and financial policy remit for the Reserve Bank
   - strengthened accountability and reporting mechanisms
   - measures to promote regulatory coordination, including a statutory mandate for the Council of Financial Regulators.

3. The governance model in the Bill centres on the introduction of a non-executive board, which will be responsible for all of the Reserve Bank's functions, other than monetary policy decisions which will continue to be made by the monetary policy committee (MPC). However, the Board is responsible for ensuring the monetary policy is implemented. The Governor will be the chief executive of the Reserve Bank, subject to and under the direction of the board with the exception of their role on the MPC. The Governor will continue to be appointed by the Minister, reflecting their role as the chair of the MPC.

4. Submissions recently closed on the Bill – these are summarised at a high-level in **Annex 1**. The Treasury presented its initial briefing to FEC on 15 February and will be presenting its departmental report, responding to submissions and FEC questions, on 7 April 2021.

Potential issues with the model

5. In the time since the introduction of the RBNZ Bill in July 2020, potential issues with the governance model in the Bill have been identified. These issues have been highlighted by the recent work on the financial consequences of alternative monetary policy (AMP), alongside further testing of the governance model as part of preparation for the select committee process.

Monetary policy decision making and implementation

6. The current Bill presents a risk of conflict between the MPC and the board over the implementation of monetary policy decisions. In particular, the use of the Bank's balance sheet for monetary policy purposes (particularly in relation to AMP) creates a tension between the MPC's responsibility for formulating monetary policy and the board's responsibility for both implementing monetary policy and managing the Bank's balance sheet and financial responsibility duties, and the board's accountability for all the Bank's other operational and financial policy responsibilities.

7. [33]

8. [33]

Policy coordination

9. The current Bill does not provide for an explicit mechanism for the coordination of monetary and financial policy making, on the presumption that this coordination would occur at an executive level and be reflected in the advice being provided to the MPC and the board.

10. Recent engagement with International Monetary Fund (IMF) staff has highlighted concerns that this model may not be sufficiently robust, with IMF staff recommending we reconsider executive membership on the board. The IMF has noted a fully non-executive board with policy making responsibilities is atypical from an international central bank perspective, with these boards typically having at least some executive membership. IMF staff have recommended reconsidering the current governance model to provide for "a robust substantive and procedural role for the Bank's executive management in public policy formulation".

Status of the Governor

11. The Governor is appointed by the Minister but has no independent statutory authority or powers, other than as chair of the MPC. In this role they have one of seven votes, the casting vote when votes are tied and certain functions under the charter. In all other respects the Governor is under the direction of the board, who decides the extent it wishes to delegate further powers to the Governor. The board is responsible for the performance of the Bank and while it is responsible for recommending the appointment and removal of the Governor, these decisions ultimately lie with the Minister (remuneration is set by the Remuneration Authority).

12. This model creates risks in terms of blurred accountabilities for the Governor and the potential for tensions between the Governor and the board, and in particular the Chair. It is unclear whether the Chair or the Governor would be seen as the head of the Bank, responsible for communicating and 'fronting' financial policy decisions. In addition, the Governor and board lack employment duties to each other (such as good faith and trust

and confidence) and nor does the Governor have any relevant statutory duties (except as an MPC member).

Proposed approach

13. While the above issues are important, we do not consider that they require a fundamental reworking of the Bill. Some issues, such as the effectiveness of policy coordination and the status of the Governor, were explicitly considered as trade-offs in the design of the model. There are, however, changes to the Bill that both the Treasury and the Reserve Bank agree would mitigate these concerns and strengthen the overall governance model.

Making the Governor a board member

14. Appointing the Governor to the board would mitigate the concerns raised about the governance model in the Bill. It would allow the Governor to act as the conduit between the board and the MPC on the coordination of monetary policy with both financial policy and balance sheet management. While it would not eliminate the risk of a disagreement between the Governor and the rest of the board, it would mean that the Governor is explicitly involved in board decision-making and is better placed to act as the spokesperson for the Bank on both financial and monetary policy matters. It would also clarify the Governor's accountabilities, giving them substantially the same duties and obligations as board members. Having the Governor as a member of the board would also be more internationally conventional.

15. In some ways this change would simply reflect the role that we would expect the Governor to play in practice under the current Bill – being involved in board discussions as the chief executive of the organisation. Appointing the Governor (who would continue to be the chief executive) to the board would embed this expectation and give the Governor a 'voice' at the table, ensuring that the Governor plays a leading role in policy formulation. The Governor would not be involved in the board's role of monitoring the performance of the MPC (given their role as chair of that committee).

16. There are trade-offs involved in this decision. Our previous advice in favour of a fully non-executive board was primarily on the basis that this model tends to promote stronger and more independent oversight of management. Having a CEO on the board of a Crown entity would ordinarily also create potential conflicts between their duties to the Minister and their duties to the board. However, these conflicts already exist under the current Bill, given that the Minister already appoints the Governor.

17. Overall, we consider that the benefits of this change, in terms of facilitating coordination and promoting role clarity, outweigh the costs. Importantly, it would also resolve the employment status of the Governor by making it clear they are a member and bound by the same statutory duties as other members of the Bill. Their relationship with other members would be clear.

Providing that monetary policy making will be constrained by the board's assessment of balance sheet risks

18. We consider that the best response to the risk of conflict between the MPC and the board would be to make it clear that the board will determine how much exposure it is prepared to take onto its balance sheet to support monetary policy. While we are still considering the legislative mechanisms to give effect to this change, it could involve providing that the board's obligation to implement monetary policy is subordinate to its financial responsibility duties and its tolerance for additional operational risk. The new

statement of financial risk management may also be a useful tool for articulating the board's risk appetite.

19. In practice, we expect that this would mean that the board would provide guidance to the MPC on how much balance sheet exposure it is prepared to take on in implementing monetary policy. The MPC would then seek to make decisions within this framework, with the Governor acting as the conduit between the MPC and the board. [33]

Alternative approaches

20. The Treasury and the Reserve Bank have considered a range of alternative approaches to resolving these governance issues.

21. In particular, the Treasury continues to see merit in the establishment of a statutory Financial Policy Committee (FPC), chaired by the Governor with internal and external members. This approach would have benefits in terms of clarifying the role of the Governor in leading policy development while providing for external perspectives. It would also create a similar structure for the Bank's two primary policy functions, providing a clear and stable basis for policy coordination. The board's role under this model would be to oversee the corporate and central banking functions of the RB to ensure that the organisation is well placed to deliver on the policy decisions made by the two policy committees. Two submissions were made on the Bill in favour of an FPC (see **Annex 1**).

22. The Treasury acknowledges that there would be trade-offs in terms of governance complexity with this model and that it would involve significant changes to the Bill that would require an extension to the select committee process. For these reasons, the Treasury prefers the approach proposed in this paper.

23. The Reserve Bank did not support the establishment of an FPC when this was first considered and consulted on in 2018, due to concerns about governance complexity and the statutory commitment to external members that may be difficult to implement in practice (mainly due to conflicts, and the availability of expertise required). The Reserve Bank shares the Treasury's concerns about the level of change that would be required to the Bill to introduce an FPC structure at this stage in the process. Detailed policy work would be required before the Reserve Bank could support this change.

24. The Reserve Bank notes that some of the benefits of an FPC (with the Governor as Chair and the option of external members to provide expertise and challenge) can be delivered under the proposed model by a delegation to the Reserve Bank's existing (non-statutory) Financial Stability Committee. External members can be appointed to the Reserve Bank's Financial Stability Committee as and when needed, and available. We note that the board would need to determine the nature and scope of any such delegation, and that it would remain accountable for financial policy decisions taken under the delegation.

Independent Expert Advisory Panel view

25. We have sought the Independent Expert Advisory Panel's feedback on the proposals in this report.

26. The Panel supports the recommendation to have the RBNZ Governor on the board and has made further suggestions to you on changes to the membership and responsibilities of the board and MPC (and potentially a statutory FPC). The Panel's full comment is attached as **Annex 2**.

[33]

27. [33]

Strengthening the board's financial responsibilities

28. The board's current responsibilities are not clearly defined as to the level of balance sheet risk that it can take on. Section 45 states "the board must ensure that the Bank operates in a financially responsible manner and, for this purpose, that it prudently manages its assets and liabilities".

29. Strengthening the board's financial responsibilities could involve clarifying the minimum level of capital with which the Reserve Bank should operate. While the Reserve Bank has historically been reluctant to operate in negative equity (that is, liabilities exceeding assets) due to reputational risks, the legislation is currently silent on its ability to do so. Other central banks internationally have been prepared to operate in negative equity (e.g., Chile, Czech Republic, Israel).

30. Clarity around the level of balance sheet risk the board can take on would reduce potential conflict between the board and MPC as it places a clear constraint on the board's ability to implement AMP, and ensures you have clearer grounds to hold the board to account, [33]

31. [33]

MPC remit process

32. Following recent advice on a replacement MPC remit [T2021/155 refers], the Treasury, in consultation with the Reserve Bank, are considering whether changes to the process for updating a remit would be beneficial. We will provide further advice on this issue in the near future, with policy approval for any changes being sought alongside the Cabinet paper.

Next steps

33. Subject to your agreement, we will prepare a Cabinet paper seeking approval for these changes. The follow high-level timeline would allow for these changes to be recommended to FEC as part of the departmental report on the Bill, and subsequently adopted as part of FEC's report back to Parliament.

Milestone	Date
Draft Cabinet paper and RIS to Minister of Finance for ministerial consultation	W/c 1 March
Final Cab paper and RIS to Minister	15 March
Lodgement	18 March
DEV decisions	24 March
Cabinet decisions	29 March
Departmental report to FEC	7 April
FEC report back	8 June

34. As noted, we expect to seek your agreement on other, less significant, changes to the Bill to support a capital-based approach to managing the financial implications of AMP, at the time that we provide you with a draft Cabinet paper and RIS for ministerial consultation.

Risks

35. We note that that there are relatively tight time constraints involved in making changes to the Bill via the select committee process under its current timeframes. It is therefore important to seek a decision on whether to proceed with these changes now, so that Cabinet approval can be sought in advance of advising FEC.

Annex 1: Preliminary summary of RBNZ Bill submissions

The Finance and Expenditure Select Committee has received 21 submissions on the Reserve Bank of New Zealand Bill (submitters listed below). These submissions cover a range of topics. The Treasury has summarised the key themes below.

Objectives

The removal of 'efficiency' from the Reserve Bank's objectives drew comment. One submitter, Andrew Body, told the committee that the substantial increases in our house prices, which exacerbate poverty, inequality and social and economic disruption in New Zealand, are an example of what happens when the Reserve Bank does not adequately consider efficiency. This submitter argued that by removing the efficiency objective the Reserve Bank would not be able to be held accountable for the broader impacts of its actions.

The Child Poverty Action Group (CPAG) also objected to the removal of the efficiency objective, which it thought could tilt bank lending towards residential property and way from more productive parts of the economy. CPAG also argued that the economic objective should reference asset prices due to the negative impacts of rising house prices. Dr Alma Wilson put forward that the CPI measure ignored differences in the actual level of inflation across economic and ethnic groups.

BNZ supported the removal of efficiency, and considered efficiency would be integral to the new financial stability objective. Other submitters proposed that inequality should be built into the Reserve Bank's objectives.

A financial policy committee

Simon Jensen and Helen Dervan spoke to the Committee on the lack of a financial policy committee. They also provided the Committee with a paper they have published on this particular issue. In short, they argue that a Financial Policy Committee with external membership is required to avoid cognitive biases arising from group think, and allow proper focus on both the Reserve Bank's commercial operations and its financial policy decision making. Michael Reddell drew attention to the difference in governance models between financial policy and monetary policy decision making, and especially the lack of a role for the Governor in financial policy matters.

Appointments

BNZ argued that there should be a higher bar for appointment of board members, with a statutory requirement of 'significant' expertise. Michael Reddell submitted that the board should have less of a role in the appointment of the Governor, arguing they will emphasise governance rather than monetary policy capability. Michael Reddell also put forward that the board members and Governor be required to front up to FEC before appointment.

Independence

Martin Taylor submitted that the level of Reserve Bank independence should be scaled back. This is because the assumptions underpinning central bank independence are untested and outdated, it makes it difficult to coordinate monetary and fiscal policy, and requires narrow objectives that do not take into account other important issues such as housing and wealth inequality. Martin Taylor argued that New Zealand's robust democracy and public institutions militate against concerns of undue influence over the Reserve Bank. Dr Alma Wilson also argued that Reserve Bank independence has led to it being captured by the private interests of the banks.

Currency

NZTech put forward that the Bill should explicitly address and allow for a central bank digital currency. NZTech supports this by stating it would ensure the Reserve Bank is a potential first mover, and that there is the risk that developments may result in rapid legislative solutions domestically which may be harmful to New Zealand. NZTech puts forward that Reserve Bank should have a function of issuing a central bank digital currency, and that such currencies be treated similar to notes and coins. Some other submissions also dealt with digital currencies. Roger Bray asked that the Reserve Bank ensure that physical currency remain a viable medium of exchange.

Coordination and information sharing

Industry submissions strongly supported a greater focus on regulatory coordination:

- The Financial Services Council strongly encourage regulators to take a coordinated approach in developing, supervising, and enforcing regulation. They noted the cost to industry of providing the same information to multiple regulators. The FSC also submitted that there should be clear functions for the Council of Financial Regulators.

- The Insurance Council of New Zealand supported statutory recognition of CoFR. The ICNZ sees a significant opportunity to reduce confusion, duplication, unnecessary regulatory burden and added costs. The ICNZ had concerns around the broad framing of the information sharing power and believes additional safeguards should be considered.

- BNZ submitted that enhanced coordination arrangements are critical given the broad scope of regulation applying to banks and the costs that arise from having distinct regimes that are not aligned to achieve the best results for customers and other stakeholders

The Office of the Privacy Commissioner noted the incorporation of the privacy principles, the recognition of personal privacy in the information sharing power, and supported the Bill.

Levies

Industry submitted on the new levy regulation:

- The Financial Services Council submitted that any levies would be on top of those paid to the FMA, and that industry consultation should be done before new levies are introduced.

- The Insurance Council of New Zealand was concerned about the new levy setting provisions. It disagreed that the industry is the primary beneficiary of the regulatory regime and argued that levy costs would be passed onto consumers. If levies were to be charged, the ICNZ would appreciate consultation with industry. The ICNZ also had issues with the drafting of the levy provisions.

- BNZ supported the changes to the RBNZ's funding model, including the ability to set levies. BNZ noted that the Reserve Bank's resourcing has not kept pace with the size and importance of its regulatory functions.

Other matters

Other submissions dealt with matters including deposit insurance, the viability of OBR, whether debt should be illegalised, negative interest rates, and a capital gains tax.

List of submitters

Alma Wilson
Andrew Body
Bank of New Zealand
Child Poverty Action Group (Inc)
David Scott
Financial Services Council of New Zealand
Insurance Council of New Zealand (ICNZ)
John Tax
John Wills
Kay Robertson
Martin Taylor
Michael Preece
Michael Reddell
NZTech (New Zealand Technology Industry Association Incorporated)
Office of the Privacy Commissioner
Phillip Coghini
Reginald Callaway
Roger Bray
Sean Kirton
Shayal Prakash
Simon Jensen and Helen Dervan

Annex 2: Feedback from the Independent Expert Advisory Panel

The Panel's view is that this is a once-in-thirty-year opportunity to get governance arrangements for the RBNZ fundamentally right.

Ultimate Purpose:

The Panel notes that the ultimate purposes of the governance arrangements being recommended for the RBNZ are to achieve effective and efficient:

1. fit for purpose, corporate governance
2. balance sheet management
3. monetary policy governance
4. financial stability governance
5. strategic coordination of monetary and financial-stability policies.

Proposed Governance Arrangements

The Panel supports the recommendation to have the RBNZ Governor on the board.

It suggests that the following indicative structure be considered for the board and associated policy committees.

- A 7-member governance board Chaired by an independent member of the board.
- 1 of the 7 board members having monetary policy backgrounds – and being members of a statutory Monetary Policy Committee (MPC) Chaired by the Governor of the RBNZ (the MPC also having an additional 3 external members).
- 1 of the 7 board members having financial policy backgrounds being a member of a Financial Policy Committee (FPC) Chaired by the Governor of the RBNZ (the FPC potentially having additional external members).
- The Governor of the RBNZ is a member of the Board and a member of the MPC and responsible for the FPC. The Financial Policy committee could be established under legislation or established by the RBNZ Board under delegation. The important point is to ensure that there is appropriate skill and expertise and strategic cohesion, with respect to which the RBNZ board has ultimate oversight.
- The remaining 4 members of the Board (including the Chair) bring governance expertise to the board.

Under this structure, the Board would serve as an effective governance board with the combination of skills to provide strategic leadership and there will be strategic cohesion across monetary and financial policy decisions.