

# Safeguarding the future of our financial system

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## Background paper 2: The case for and against separating prudential regulation and supervision from the Reserve Bank of New Zealand

Phase 2 of the Reserve Bank Act Review

November 2018

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# About this background paper

This background paper accompanies the consultation document, *Safeguarding the future of our financial system: The role of the Reserve Bank and how it should be governed*, which was released on 1 November 2018.<sup>1</sup> Chapter 5 of the consultation document asks, “Should prudential regulation and supervision be separated from the Reserve Bank?”

The paper looks at alternative options outside the status quo, and considers the merits of each one. These options were developed through an in-depth analysis of international models of financial sector regulation and supervision, and academic literature on the pros and cons of assigning a prudential mandate to a central bank.

## The wider context

Together, the consultation document and this background paper are part of a second phase of a broader review of the Reserve Bank of New Zealand Act 1989 (the ‘Reserve Bank Act’). The Review aims to ensure that the Reserve Bank’s monetary and financial policy frameworks are the most efficient and effective for New Zealand. Phase 1 focused on improving New Zealand’s **monetary policy framework**, and the resulting Cabinet decisions were announced on 26 March 2018.<sup>2</sup>

Phase 2 focuses mainly on the Reserve Bank Act’s **financial policy framework**, which provides the basis for prudential regulation and supervision. The Minister of Finance announced its [terms of reference](#) on 7 June 2018.

The Review includes a question about separating prudential regulation and supervision from the Reserve Bank because a number of stakeholders have suggested that its current location, alongside the Reserve Bank’s monetary policy and other functions, may no longer be appropriate.

Note the Government has expressed an initial preference for prudential regulation and supervision to stay within the Reserve Bank. However, the Minister of Finance has asked that the Review consider and explain the rationale for the current arrangements.<sup>3</sup>

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<sup>1</sup> This paper was prepared by members of the joint Treasury-Reserve Bank Phase 2 Review team. If you have any questions about this paper please send an email to [rbnzactreview@treasury.govt.nz](mailto:rbnzactreview@treasury.govt.nz).

<sup>2</sup> You can find more information about [Phase 1](#) on the Treasury website.

<sup>3</sup> See paragraph 22, [Cabinet Economic Development Committee](#) paper, 21 May 2018.

# Executive summary

Phase 2 of the review of the Reserve Bank of New Zealand Act 1989 considers the Reserve Bank's place in the 'institutional architecture' of financial sector regulation in New Zealand. This is because a number of stakeholders have suggested that locating prudential regulation and supervision within the Reserve Bank may no longer be appropriate.

A necessary condition for effective regulation is an institutional architecture that assigns clear functions and objectives to regulatory agencies, and covers the key institutions and participants in the financial system.

Jurisdictions around the world use a number of institutional 'models' to assign financial system functions and objectives. While these suggest that there is no one 'best' model for New Zealand, they all have the central bank (which in New Zealand is the Reserve Bank) as a key participant. This is because a central bank has a 'natural interest' in the performance and results of the financial system – for example, effective monetary policy and price stability depend on a stable financial system.

There has been much debate on the pros and cons of assigning additional financial system functions to a central bank, such as a responsibility for the prudential regulation and supervision of the banking sector and other financial institutions.

The arguments in favour of locating these functions in a central bank generally relate to the coordination benefits of having complementary functions in the one place, and the synergies that can result and be used to best advantage. Those against tend to focus on tensions or trade-offs between monetary policy and these other financial system functions. In the past 10 years though, largely owing to the experience of the global financial crisis (GFC), arguments have tended to favour assigning a prudential mandate to the central bank. Today, a majority of the world's central banks have a prudential mandate for the banking sector.

This paper examines the arguments for and against the central bank having a prudential mandate and, using international literature, evaluates three alternative models for New Zealand – an 'enhanced status quo', a separate 'New Zealand Prudential Regulation Authority', and a separate institution with both a prudential and financial market conduct mandate (a 'New Zealand Financial Services Authority').

# Part 1: Context and stakeholder feedback

## What is New Zealand's financial sector regulatory system?

New Zealand's financial system is relatively simple by advanced economy standards, with the banking sector accounting for a large share of total financial system assets. The banking sector itself is dominated by four Australian-owned banks who together make up around 87 percent of banking sector assets. Financial institutions who undertake lending, but are not banks, today comprise a very small share of intermediated lending. New Zealand's insurance sector is small by international standards, as are domestic capital markets (markets that involve the buying and selling of bonds (debts) and equity).

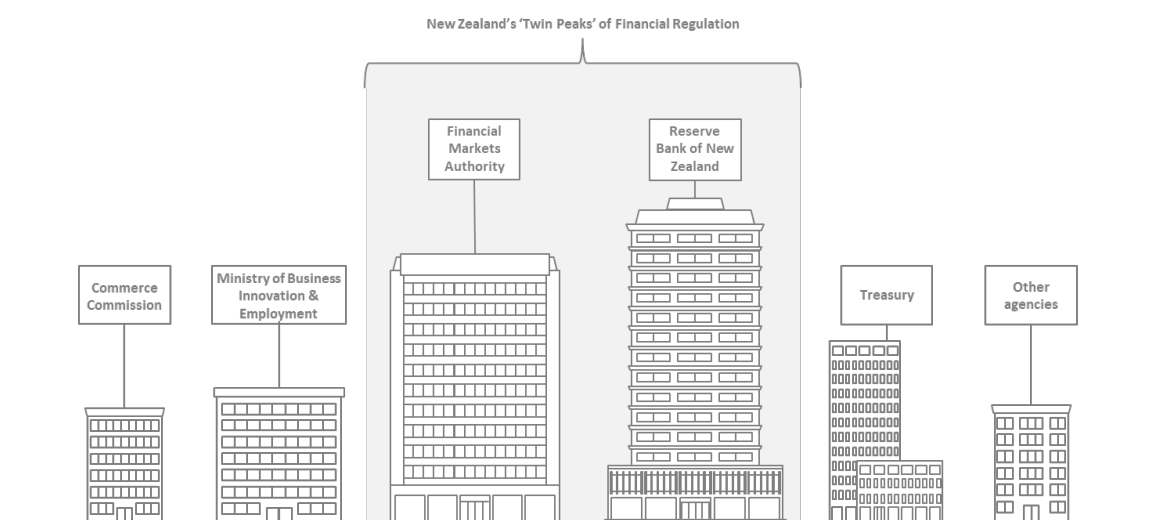
Two agencies have primary responsibility for financial regulation – the Reserve Bank (which is the focus of this Review) and the Financial Markets Authority (FMA). Both are independent of government, and together they represent the 'twin peaks' of New Zealand's regulatory system for the financial sector.

Under New Zealand's twin peaks model, regulation is split into two broad functions: **conduct regulation** and **prudential regulation**.

- Conduct regulation focuses on behaviours in financial markets. It aims to ensure that consumers are adequately informed and treated fairly, and that regulated entities act with integrity.
- Prudential regulation aims to ensure that institutions adequately manage both their own financial risks and the risks they collectively pose to the financial system.

In New Zealand, the Reserve Bank is responsible for prudential regulation and the FMA for financial market conduct regulation. These agencies are complemented by other government agencies and financial regulators (Figure 1).

Figure 1: Key agencies in New Zealand's financial regulatory system



## The Reserve Bank's role

The Reserve Bank has a high-level financial policy objective to **promote the maintenance of a sound and efficient financial system**. It does this by:

- identifying and managing the build-up of risks and vulnerabilities in the financial system through its role as the prudential authority for banks, non-bank deposit-takers (NBDTs), and insurers. Prudential regulations, such as capital and liquidity requirements, ensure that these institutions adequately manage their risks and the risks they collectively pose to the financial system
- supervising banks and insurers (but not NBDTs) to ensure that they abide by the regulations, and undertaking enforcement actions when necessary<sup>4</sup>
- managing the impact on the financial system when a regulated entity is in financial distress.

Specifically, the Reserve Bank's regulatory and supervisory functions include:

- bank registration, prudential regulation, supervision, and crisis management since 1986
- overseeing designated payment and settlement systems (a type of financial market infrastructure [FMI]) since 2003<sup>5</sup>
- NBDT licensing, prudential regulation, and crisis management since 2008
- supervising banks, life insurers and NBDTs in relation to its obligations under the Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) Act since 2009
- insurer licensing, prudential regulation, supervision, and crisis management since 2010
- formulating and implementing macro-prudential policy since 2013.<sup>6</sup>

The Reserve Bank also has a number of other functions, which include issuing New Zealand's banknotes and coins, and formulating and implementing monetary policy to ensure price stability. In addition, it acts as the 'banker to the banks' – lending to financial institutions as a normal part of monetary policy implementation and in situations of financial stress as the 'lender of last resort' (LoLR) for the financial system.

## The FMA's role

The FMA, established in 2011, has an overarching objective to promote and **facilitate the development of fair, efficient, and transparent financial markets**.

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<sup>4</sup> NBDTs are separately supervised by trustees, licensed by the FMA.

<sup>5</sup> A new regulatory framework for FMIs is currently before Parliament. The [proposed new regime](#) will include powers to set regulatory standards for designated FMIs, powers to oversee these rules, and investigative, enforcement, and crisis management powers.

<sup>6</sup> In New Zealand, the approach to prudential regulation and supervision has always been informed by a **systemic** focus – the soundness and efficiency of the financial system – rather than an objective aimed at ensuring outcomes for **individual** institutions per se, which is the more traditional definition of 'micro-prudential' policy in other countries. In practice, however, the concentrated nature of New Zealand's banking sector means that significant attention is directed at the big-four banks. Traditional prudential policy involves the use of various prudential instruments (such as minimum capital requirements) in a largely 'set and forget' way, although they are re-calibrated periodically. Macro-prudential policy is informed by the same systemic objective, but uses prudential instruments in a more active (time-varying) manner to address the build-up of risks over the financial cycle.

The FMA's financial system functions include:

- enforcing securities, financial reporting, and company law as they apply to financial services and securities markets
- regulating securities exchanges, financial advisers and brokers, auditors, trustees, and issuers (including issuers of KiwiSaver and superannuation schemes)
- jointly overseeing designated settlement systems with the Reserve Bank.

Chapter 1 of the consultation document explains the roles of other participants in New Zealand's regulatory system.

## Previous assessments of institutional arrangements

It is worth noting that the development of New Zealand's twin peaks model has included previous reviews of the costs and benefits of other models – so the question of where to locate the prudential mandate within the regulatory architecture is not new.

Today's twin peaks model resulted from the [Review of Financial Products and Providers \(RFPP\)](#) in the mid-2000s, which aimed to address gaps in the approach to regulating and supervising non-bank financial institutions (NBFIs) such as non-bank lenders, insurers, and managed investment schemes. At the time the regulatory framework for NBFIs was fragmented and insufficiently developed, and there were gaps in oversight.

One outcome of the RFPP was to make the Reserve Bank responsible for insurers and NBDTs, in addition to its longer-standing role of regulating and supervising registered banks. The Government had considered the pros and cons of making a single agency responsible for all three sectors, and whether this agency should be the Reserve Bank – and concluded that the benefits of co-locating these prudential functions alongside the Reserve Bank's responsibility for monetary policy outweighed any potential costs. The RFPP also considered, and dismissed, the merits of integrating a prudential and financial market conduct mandate into a single agency.

Co-locating a prudential mandate alongside monetary policy within the Reserve Bank was considered to have the following benefits (they also feature in the international literature; see Part 3):

- The mutually supporting objectives of prudential supervision and the central bank's traditional system oversight role.
- Cost savings (economies of scale) from consolidating a prudential mandate and system oversight functions.
- Synergies as a result of sharing information across the various functions (e.g. information from payment system activities providing early warnings of financial problems for banks, and information about individual banks being useful for a central bank's LoLR role).
- Synergies as a result of the interactions between different skill sets that benefit all policy functions (Cabinet Economic Development Committee, 2005, p. 7).

Against this, the main argument for separating the prudential functions from monetary policy rested on the potential reputational costs for monetary policy as a result of poor financial policy outcomes. Overall, officials considered that "the synergies from consolidating prudential regulation within the



[Reserve] Bank are sufficiently strong and the risks sufficiently manageable through governance and accountability arrangements that creation of a separate entity is not justified” (p. 8).

In 2008 a number of enhancements to the Reserve Bank’s governance and accountability arrangements were introduced with the Reserve Bank Amendment Act.

Similarly, the establishment of the FMA in 2011 consolidated under one roof a number of functions related to financial market conduct. The policy analysis at the time reaffirmed the Government’s decision to not create a ‘mega-regulator’ model for financial sector regulation – that is, combining prudential and market conduct functions into a single authority.

Appendix 1 describes in more detail the evolution of New Zealand’s twin peaks model.

## What does ‘institutional separation’ mean?

For the purpose of this background paper and consultation document, ‘institutional separation’ means:

- a change to the Reserve Bank’s functions and objectives that involves removing some prudential responsibilities from the Reserve Bank
- transferring these responsibilities to a new or an existing agency.

The potential reallocation of responsibilities would be expected to include the ‘micro-prudential’ and crisis management functions for registered banks, NBDTs, and insurers. It could also include a reallocation of responsibility for macro-prudential policy and FMI oversight, although the Reserve Bank could keep these functions even if other functions were carved out. The Reserve Bank would keep its emergency LoLR role (as an adjunct to the Reserve Bank’s ordinary lending facilities for implementing monetary policy).

This Review’s scope does not include a formal consideration of New Zealand’s overall arrangements for AML/CFT regulation and supervision; however, any form of separation would require decisions on where the Reserve Bank’s current responsibilities in this area should lie.<sup>7</sup> The Phase 2 terms of reference also note that the Review will not consider any fundamental change in institutional arrangements related to the home-host relationship with Australia, except where there may be opportunities to enhance cooperation and collaboration. This means it will not consider the possibility of the Australian Prudential Regulation Authority (APRA) taking sole responsibility for regulating and supervising the large Australian-owned banks operating in New Zealand.

Also out of scope is the possibility of separating the regulation of various financial institution types (or sectors) into individual specialist agencies.<sup>8</sup>

### Separation of prudential regulation from supervision

This paper does not consider the possibility of separating the general functions of prudential **regulation** and **supervision**: that is, separating the development of prudential policy and the calibration of regulatory requirements (‘regulation’) from the monitoring of regulated entities and the enforcement of prudential rules (‘supervision’).

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<sup>7</sup> The Reserve Bank currently supervises registered banks, NBDTs, and life insurers for AML purposes under the AML/CFT Act 2009. New Zealand’s AML/CFT framework will be reviewed by the Financial Action Task Force in 2020.

<sup>8</sup> Other legislation that the Reserve Bank administers (covering insurance and NBDTs) is out of scope of this Review, except where consequential changes would be desirable to encourage alignment with proposed changes to the Reserve Bank Act framework. Similarly, the proposed new regulatory framework for FMIs is out of scope.

A decision on the appropriate split between regulation and supervision should not be driven primarily by institutional form. The issue is equally applicable to all three of the institutional models considered in the options discussion in Part 5 of this background paper (and in Chapter 5 of the consultation document). Decisions in this area should instead be driven by views on the optimal design of the regulatory system for a prudential mandate, with reference to the following:

- the matters being regulated for, and how those regulations are being applied
- the need for the regulatory framework to develop and change over time
- the level of ‘operational independence’ the regulator should have from government.

Decisions relating to the split of regulation and supervision functions are also not binary. ‘Regulation’ has a number of constituent elements (primary legislation, secondary legislation, administrative instruments, guidance). Within each of these elements there are choices available about the appropriate level of regulator involvement and accountability.

There is a precedent for a functional split between regulation and supervision in the New Zealand financial system, in the form of the relationship between the Ministry of Business, Innovation and Employment (MBIE) and the FMA.<sup>9</sup> The higher level of regulatory independence held by the Reserve Bank relative to the FMA primarily reflects the different nature of prudential regulation (although there are some inconsistencies across different sectors the Reserve Bank regulates – banks, NBDTs, insurers). The Reserve Bank sets detailed requirements that apply to licensed or registered entities, a largely ‘administrative’ model.<sup>10</sup> In contrast there are many elements of conduct regulation that apply obligations to persons that are not registered or licensed (a more ‘legislative’ model).<sup>11</sup>

Chapter 7 of the consultation document considers the appropriate scope of the Reserve Bank’s operational independence. More detailed issues of regulatory design will be examined in the second phase of consultation. They are not considered in the options analysis in Part 5 of this paper, or in Chapter 5 of the consultation document.

## Why did some stakeholders favour institutional separation?

In developing the Phase 2 terms of reference, the Treasury and the Reserve Bank met with a number of stakeholders to understand the issues relating to the Reserve Bank’s financial system-related responsibilities. A number of stakeholders thought that the institutional arrangements for prudential regulation and supervision needed to change.<sup>12</sup> Among the variety of reasons, the most commonly raised included:

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<sup>9</sup> On the conduct side of the twin peaks model, the FMA has powers to determine requirements for specific regulated entities. However, the main requirements are set out in government regulations made by Order in Council (OIC), with the main responsibility for advising on these regulations resting with MBIE, as the policy agency, rather than the FMA. This differs from the Reserve Bank, which is generally able to determine regulatory requirements without requiring approval from Ministers or Cabinet.

<sup>10</sup> For a discussion of different types of regulatory instruments see MBIE’s 2017 [guide](#).

<sup>11</sup> Prudential regulation internationally is typically based around an administrative model. For that reason separating regulation and supervision is uncommon, and does not align well with operational independence. There is greater diversity in conduct regulation. Conduct regimes that require extensive licensing requirements tend to follow an administrative model and provide a higher level of regulatory independence.

<sup>12</sup> This section restates the main concerns of stakeholders, rather than providing any evaluation of the validity of these arguments. A [full summary](#) of stakeholder feedback from the scoping for Phase 2 can be found on the Treasury website.

- concerns around **governance**
- the perceived lack of **resourcing** of prudential policy and supervision
- the internal **culture** of the Reserve Bank and its **approach** to prudential regulation and supervision
- a perceived lack of focus from being tasked with two high-level **objectives** (soundness and efficiency), with both open to interpretation and the possible conflict between the two at times.

Many of the reasons echo arguments in the international literature relating to the institutional arrangements for financial sector regulation (see Part 3).

## Governance

Stakeholders commented on a number of potential conflicts of interest in the Reserve Bank's current policy functions, and how these may not be being managed adequately through the current governance arrangements. They included conflicts between:

- the Reserve Bank's prudential functions and monetary policy
- the Reserve Bank's prudential functions and LoLR role
- the development of prudential policy and rules and their implementation through supervision and enforcement.

Some stakeholders also suggested that separation would enable an enhanced role for government in influencing financial system outcomes through a redefinition of respective roles and responsibilities, or provide an opportunity for better oversight and accountability.

## Resourcing

A number of stakeholders considered that the Reserve Bank's prudential functions were under-resourced (see Box 1 below), and saw institutional separation as a way to fix this issue. Some also suggested that the Reserve Bank does not employ staff with the right mix of skills or industry experience for its prudential functions.

In addition, stakeholders commented on the interplay between the governance framework and the allocation of resources, noting, for example, that:

- a single-decision-maker model is used to allocate resources across the Reserve Bank
- the Reserve Bank Board (as the monitoring agent of the Minister of Finance) has no independent resources from the Reserve Bank.

## Box 1: Funding and resourcing for the Reserve Bank's prudential mandate

A number of stakeholders identified institutional separation as a solution to a perceived lack of focus on and funding for the Reserve Bank's financial system responsibilities.

To provide some context, the Reserve Bank receives no direct funding for its operations from the Parliamentary appropriation process, nor is it funded by levies on regulated entities. Its income comes from the returns on its investments, funded by the issuance of currency (seigniorage), deposits (held by banks and the Crown), and equity (held by the Crown). A five-year funding agreement between the Governor of the Reserve Bank and the Minister of Finance specifies the amount of income available to cover operating expenses.

The Governor is responsible for deciding how to allocate this specified amount to the various functions of the Reserve Bank. In the 2017/18 financial year, the Reserve Bank's operating expenses totalled \$76 million (including staff costs and other overheads).

Table 1: Expenditure by function, 2017/18 (\$m)

Function	2017/18	2016/17
Currency operations	20	21
Prudential supervision	15	12
Monetary policy formulation	10	9
Macro-financial stability	9	8
Foreign reserves management	8	6
Settlement services	7	7
Domestic market operations	7	5
	<b>76</b>	<b>68</b>

Source: Reserve Bank, [Annual Report 2017-18](#), p. 90.

The Reserve Bank's prudential functions account for just over 30 percent of total operating expenses, compared with just over 20 percent for its monetary policy function (formulation and implementation via domestic market operations).

That said, the resourcing for the Reserve Bank's prudential mandate is low compared to that in most other countries. This largely reflects New Zealand's relatively light-handed approach to supervision, which emphasises the primacy of self- and market discipline within the Reserve Bank's three-pillar prudential framework (see Hunt [2016] for further explanation). This means the Reserve Bank does not apply the intrusive and higher-cost model of supervision seen in most other countries (e.g. the number of full-time-equivalent staff per supervised entity is much lower than elsewhere). This approach to supervision, along with the Reserve Bank's funding model, will be examined in the second round of consultation planned for early 2019.

For the purpose of the separation question, a higher level of funding for prudential regulation and supervision is compatible with any alternative model proposed in this consultation, including an 'enhanced status quo' (see Part 5).

On the other hand, the separation of current functions into a stand-alone prudential agency does not guarantee more funding and resourcing. The funding level and model (Parliamentary appropriation or industry levies) will be additional considerations should the Government decide to change the current institutional model.

## Culture and approach

Some stakeholders raised the issue of 'culture' in terms of behaviours within the Reserve Bank itself, notably a general lack of focus on its prudential functions (reflected in the under-resourcing noted above). There was a sense that the Reserve Bank's responsibilities for financial stability had historically been a 'poor cousin' to monetary policy.

In addition, some stakeholders were concerned that:

- the Reserve Bank's general approach to prudential regulation and supervision was less intensive than in other jurisdictions
- there was a lack of transparency in prudential policy
- the Reserve Bank did not genuinely listen to relevant stakeholders when consulting on prudential policy.

They argued that separation would provide an opportunity to develop a new organisational culture appropriate for a modern prudential regulator, while resetting the relationship between the regulator and the regulated. A somewhat related comment was that a separate prudential regulator in New Zealand could allow for greater coordination with APRA.

## The Reserve Bank's objectives

Some stakeholders considered that the current soundness and efficiency objectives were vague and mis-specified, and that separating the prudential function from the Reserve Bank would allow for clearer objectives. These objectives would then provide a better focus for senior management, reducing the potential for distraction or a perceived lack of attention in relation to prudential policy.

# Part 2: Institutional models for financial sector regulation

## The role of institutional design in regulatory outcomes

The overall purpose of financial sector regulation is to support the financial system's contribution to sustainable economic growth and the welfare of New Zealanders.

Financial sector regulation is necessary because of the presence of 'market failures' which, if left alone, can result in undesirable outcomes for society, such as:

- monopoly or anti-competitive behaviour
- the information advantage that providers of financial products often have over consumers/investors which can lead to financial market participants making poorly informed decisions
- negative impacts on the financial system that could stem from the failure of a large and systemically important financial institution.

These market failures mean that some regulation will be "indispensable to the proper functioning of economies and societies" (New Zealand Productivity Commission, 2014, p. 1).

The first step in designing a regulatory system that is the most efficient and effective for New Zealand is to create an institutional architecture with the general characteristics described in Table 2 below.

The particular allocation of objectives and functions to various agencies defines the overall regulatory architecture (or institutional model). While all models of financial regulation aim for a robust regulatory architecture, there is no 'best' model that can guarantee effective regulation and supervision. Other countries' models are typically shaped by the structure of their financial systems, experiences with past financial crises, and a broad range of legal, historical, cultural, and political factors. As Llewellyn (2006) argues, "[i]t is an illusion to believe that there is a single, superior model of institutional structure that is applicable to all countries... Equally, it is an illusion to believe that any structure is perfect or guarantees effective regulation and supervision of the financial system. Changing the institutional structure of regulation should never be viewed as a panacea, or a substitute for effective and efficient conduct of regulation and supervision" (p. 7).

Nevertheless, institutional structure can certainly influence the effectiveness of financial sector regulation. As explained by Montanaro (2016), "[e]ven though models used to organise financial supervision are not sufficient to provide effective regulation, they are still important: on the one hand, they should ensure that no part of the financial system can escape regulation, and, on the other, they should avoid that overlapping or conflicting mandates of different agencies might compromise proper regulation because of poor coordination between the various policies implemented" (p. 6).

Table 2: Attributes of a robust regulatory structure for the financial system

Comprehensive coverage of the main <b>financial entities and sectors</b> operating in a jurisdiction	Examples include banks, non-bank lenders, insurance companies, FMIs, and securities firms.
<b>Clear objectives</b> for financial sector regulation that reflect desired public policy outcomes	<p>Examples internationally are:</p> <ul style="list-style-type: none"> <li>▪ financial stability, or the sound and orderly functioning of the financial system as a whole</li> <li>▪ sound individual financial institutions, particularly those that are large and important for any given sector or the financial system generally</li> <li>▪ consumer protection, where consumers and investors can make well-informed choices, while unfair behaviour by those providing financial services is minimised</li> <li>▪ a competitive and dynamic financial system</li> <li>▪ a reduction in financial crime.</li> </ul>
The assignment of <b>functions</b> (and appropriate powers) to an agency to achieve these objectives	<p>Examples internationally are:</p> <ul style="list-style-type: none"> <li>▪ systemic risk monitoring, oversight, and mitigation</li> <li>▪ prudential regulation and supervision</li> <li>▪ financial market conduct regulation and supervision</li> <li>▪ competition policy</li> <li>▪ AML/CFT.</li> </ul>
The regulatory agency tasked with a financial system-related role sits at <b>arm's length</b> from government	Responsibilities should be delegated to an independent agency to avoid the politicisation of financial sector regulation, while helping to promote a stable and consistent regulatory environment. This delegation should be supported by robust accountability arrangements.

## A typology of institutional models

The Bank for International Settlements (BIS) has recently released the results of a survey of financial sector regulatory models in 82 countries, including New Zealand (BIS, 2018a).<sup>13</sup>

The survey examined the allocation of four financial system functions to various agencies, and develops three types of institutional model across the sample.

The financial system functions considered are:

- micro and macro-prudential regulation and supervision
- financial system monitoring and oversight
- crisis management and resolution

<sup>13</sup> The BIS was unable to classify three of the 82 countries: Cyprus, Kyrgyz Republic, and Timor-Leste.

- financial market conduct regulation.<sup>14</sup>

The survey did not include other financial system-related functions, such as competition policy and responsibility for addressing financial crime.

The three institutional models (with various sub-models) are:

- **sectoral** – there are specialist agencies for each financial sector (e.g. banking, insurance, securities firms), combining both prudential and financial market conduct mandates. Bank regulation and supervision may sit in the central bank or with a separate agency
- **integrated** – a single agency combines both prudential and financial market conduct mandates for all sectors. The agency may or may not be the central bank
- **partially integrated** – a hybrid of the sectoral and integrated models. New Zealand’s twin peaks model is an example, as the prudential and financial market conduct mandates are allocated to separate agencies. The ‘solvency peak’ (the prudential mandate) may be situated in the central bank (as in New Zealand and the United Kingdom) or outside (as in Australia and Canada). Another hybrid model is the two-agency model, in which one agency is responsible for the prudential and financial market conduct mandates for banks and insurers, and the other for securities firms.

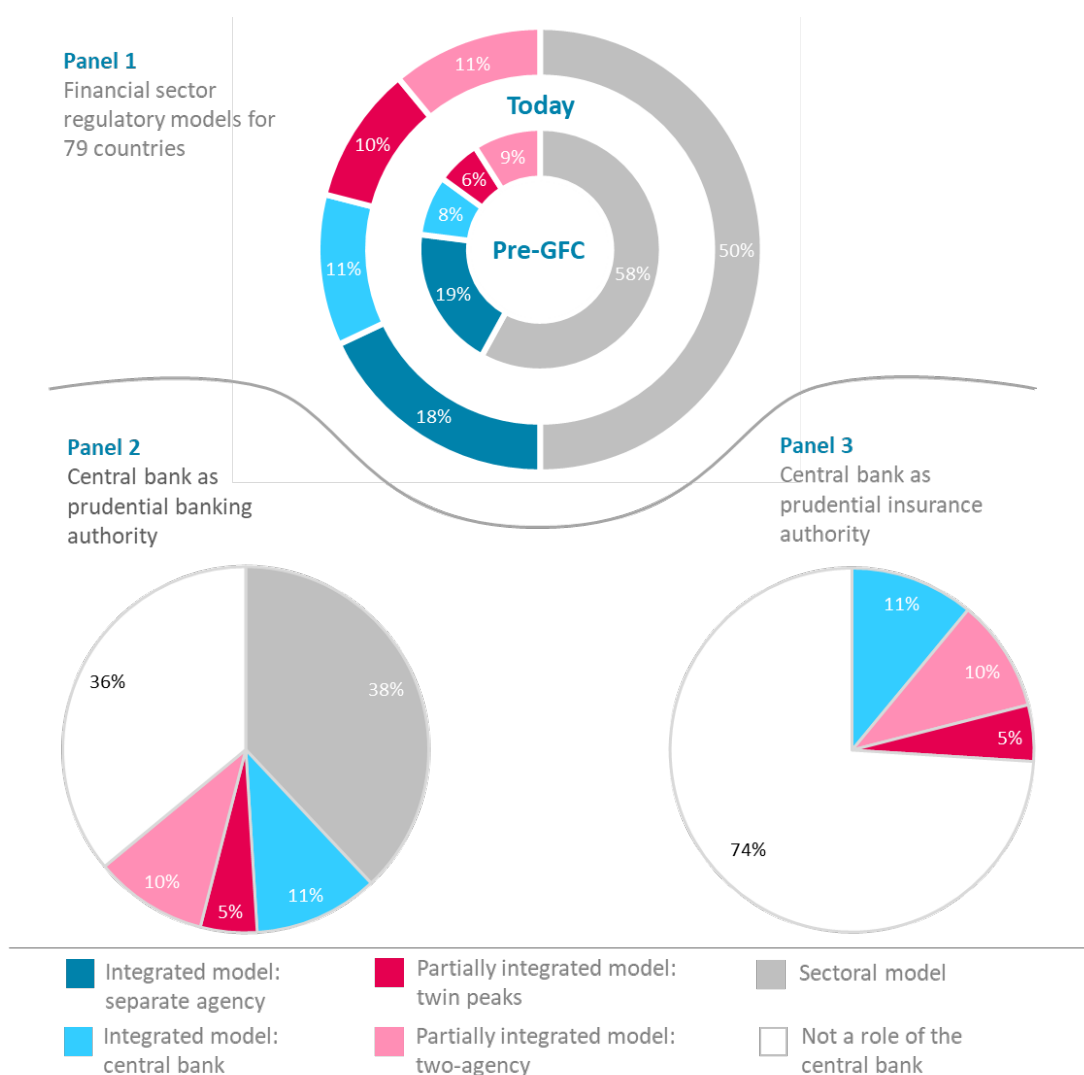
As shown in Figure 2, the sectoral model is the most common internationally, although this has lost some popularity since the GFC (see Figure 2, Panel 1, and Table 3). The central bank is now the prudential authority for the banking sector in close to two-thirds of jurisdictions (see Panel 2) and for the insurance sector in a quarter (see Panel 3).

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<sup>14</sup> Macro-prudential policy is a new policy area that emerged after the GFC in response to deficiencies in identifying and addressing system-wide risks and vulnerabilities. Resolution is also a relatively new function, with the GFC revealing the inadequacy of pre-existing arrangements in many jurisdictions.



Figure 2: Institutional models and the role of the central bank



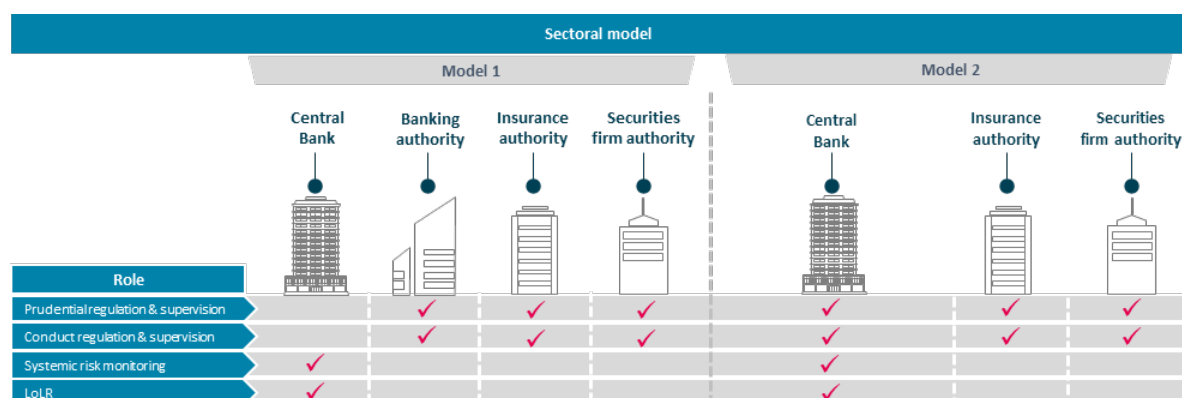
Source: BIS (2018a and b).

## The sectoral model

This model develops a regulatory architecture around specialist regulators for individual sectors (Figure 3).

In about three-quarters of the countries that have adopted the sectoral model, the central bank is also the specialist regulator for the banking sector (model 2). The use of the sectoral model is concentrated in Latin America, Asia, and Africa, and advanced country examples include Hong Kong SAR, Israel, and Spain.

Figure 3: Sectoral model



Source: BIS (2018a).

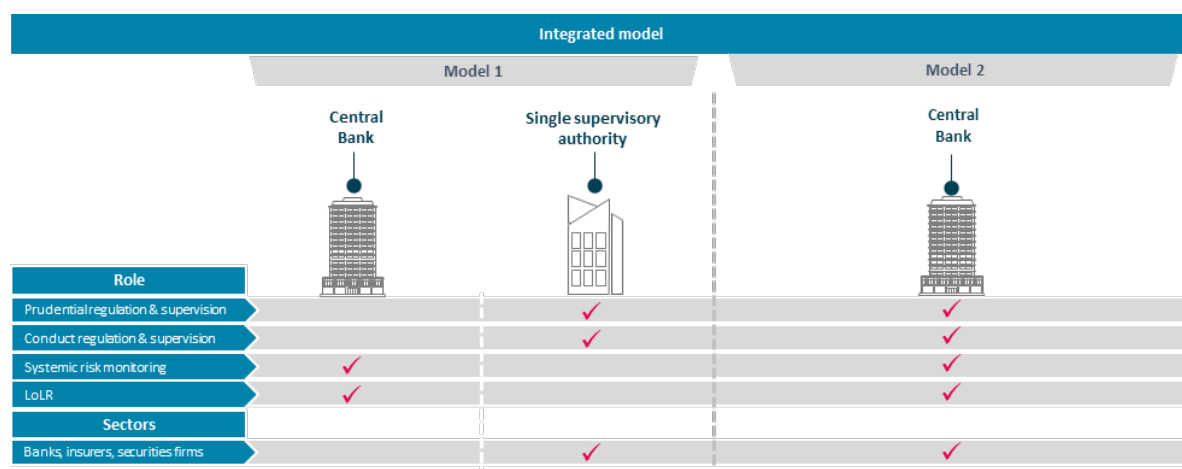
## The integrated models

The integrated model emerged in a wave of significant reforms in regulatory architecture during the 1980s. It was a shift away from the more traditional sectoral model to a cross-sectoral approach, which in many countries reflected the rise of financial ‘conglomerates’ – financial institutions undertaking banking, insurance, and securities business. The model’s rationale is that there are synergies in the supervision of banks, insurance and securities firms across both prudential and financial market conduct regulation and supervision.

This prudential and financial market conduct mandate sits in a separate agency in 60 percent of countries that have adopted an integrated model (model 1), and within the central bank in the remaining 40 percent (model 2). The central bank approach is used in the Czech Republic, Ireland, and Singapore, for example, while the separate agency model is found in Austria, Germany, Japan, Switzerland, and the Nordic countries. Iceland’s integrated model will change, following a recent [announcement](#) that the financial supervisory authority will be merged with the central bank.

All up, the integrated model accounts for close to 30 percent of all countries surveyed.

Figure 4: Integrated model



Source: BIS (2018a).

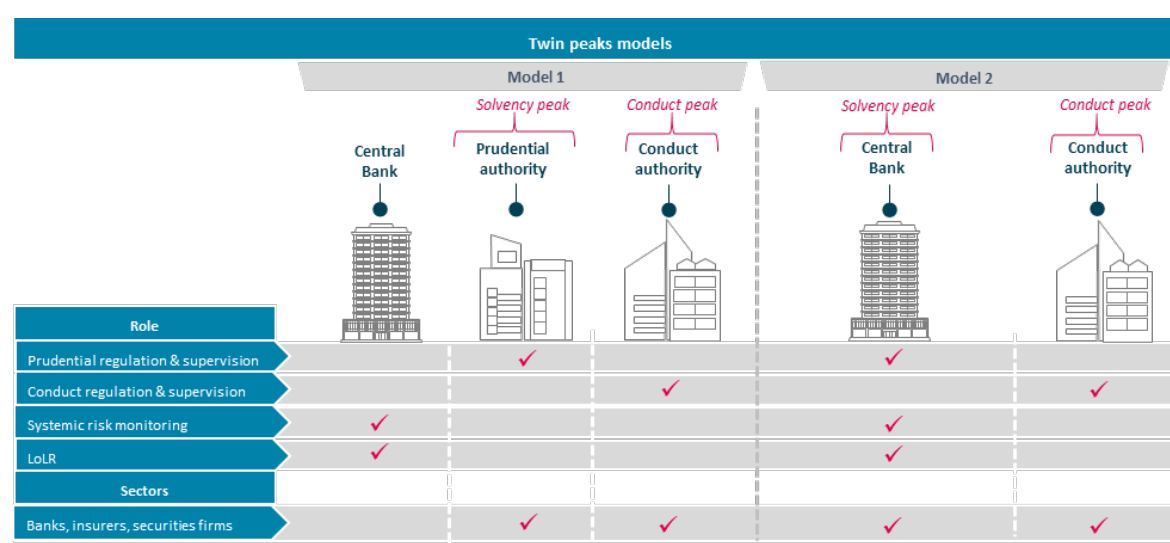
## The partially integrated models

### Twin peaks

In the twin peaks model, the prudential and financial market conduct mandates are assigned to separate agencies (Figure 5). In four of the eight countries that have adopted this model – Australia (see Appendix 3), Canada, Guatemala, and El Salvador – the solvency peak sits with a separate agency (model 1). In the other four the solvency peak sits within the central bank (model 2): Belgium, Netherlands, New Zealand, and the UK.

South Africa is currently changing its institutional architecture to a twin peak model from its previous sectoral approach, with the [central bank](#) assuming responsibility for the solvency peak.

Figure 5: Twin peaks model



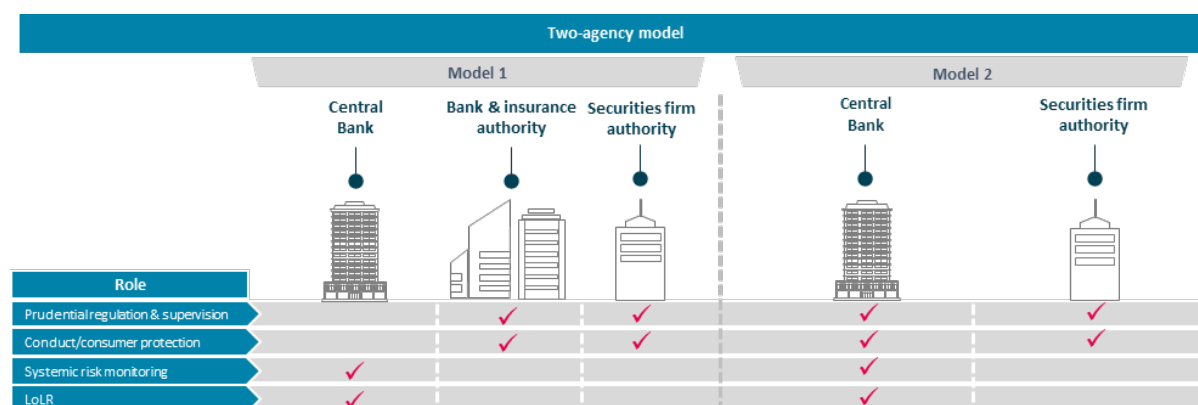
Source: BIS (2018a).

### Two-agency

In the two-agency partially integrated model, one agency is responsible for the prudential and financial market conduct mandates for banks and insurance companies, while another is responsible for securities firms (Figure 6). Examples include regulatory arrangements in France and Italy. China is also shifting to this model by [merging](#) separate agencies responsible for banking and insurance.

The central bank is the banking and insurance supervisory authority in eight of the nine countries that use this model (model 2).

Figure 6: Two-agency model



Source: BIS (2018a).

## Post-GFC trends and the role of the central bank

Of the 79 countries classified by the BIS, 11 have changed their institutional architecture since the GFC (Table 3), and a further three are doing so now.

Table 3: Post-GFC changes in institutional models

Changes in institutional models					
Model	Pre-GFC total	Changes			Current total
Sectoral model	46	To	Integrated model: separate agency	-3	39
		To	Integrated model: central bank	-1	
		To	Partially integrated: twin peaks	-1	
		To	Partially integrated: two-agency	-2	
Integrated model: separate agency	15	To	Integrated model: central bank	-2	14
		To	Partially integrated: twin peaks	-2	
		From	Sectoral model	+3	
Integrated model: central bank	6	From	Sectoral model	+1	9
		From	Integrated model: separate agency	+2	
Partially integrated: twin peaks	5	From	Sectoral model	+1	8
		From	Integrated model: separate agency	+2	
Partially integrated: two-agency	7	From	Sectoral model	+2	9
<b>Total (by number)</b>	<b>79</b>			<b>11</b>	<b>79</b>

Source: BIS (2018a).

In seven of the 11 countries that have changed post-GFC, this has involved moving from the sectoral model to other models. In the other four cases a separate agency integrated model has been replaced in equal measure by a central bank integrated model (e.g. Ireland) and a twin peaks model (e.g. UK). China and South Africa are shifting from a sectoral model to a two-agency and twin peaks model respectively.

In these model changes, central banks have generally assumed greater responsibilities. These include micro-prudential responsibility for banks and insurers alongside new macro-prudential and crisis management and resolution functions.

### **Micro-prudential mandate**

The BIS has identified seven cases where the micro-prudential responsibility for the banking sector has changed. Five have involved a shift of responsibilities from a separate agency to the central bank, one a shift from a government department to the central bank, and another a reallocation from a central bank to a separate agency.

The BIS cites 11 examples of changes in the location of insurance supervision. In eight the central bank has become the prudential authority, taking over from a separate independent agency in seven cases and a government department in the other. In the remaining three cases, a separate agency has taken responsibility for the sector from a government department.<sup>15</sup>

There is no example, post-GFC, of a consolidated (cross-sectoral) micro-prudential mandate like the Reserve Bank's (i.e. including banks, insurers, or other sectors) being separated from a central bank and allocated to a separate agency.

### **Macro-prudential policy**

Of the countries that the BIS has classified as having developed macro-prudential policy frameworks, the central bank is the lead agency in close to 60 percent. Other entities responsible for macro-prudential policy are dedicated inter-agency committees, separate micro-prudential authorities and government departments/ministries.

### **Crisis management and resolution**

The central bank is the primary crisis management and resolution authority in close to 60 percent of the countries surveyed by the BIS – a role closely aligned with being the main micro-prudential authority for the banking system.

As a general observation, post-GFC developments in institutional regulatory architecture have gone hand in hand with a reassessment of the costs and benefits of locating additional functions within the authority responsible for monetary policy – with increasing emphasis on the *benefits* from co-locating various financial system functions with monetary policy and a central bank's other traditional functions (see Part 3).

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<sup>15</sup> There are six country examples of the prudential authority for the insurance sector still being a government department. There are no examples in the BIS sample, where the prudential responsibility for the banking sector resides in a government department.

# Part 3: The pros and cons of a prudential role for the central bank

## The ‘natural interest’ of central banks in financial stability

Any institutional arrangements for financial system regulation will involve a country’s central bank. This stems from the traditional role that central banks have played in:

- extending liquidity on an everyday basis to the banking system as part of the monetary policy implementation process
- providing liquidity in emergency situations through the LoLR role
- promoting the stability of payment and settlement systems, often reflecting the central bank’s direct role in providing inter-bank overnight clearing and settlement services
- undertaking general macro-financial monitoring – identifying vulnerabilities in and risks to the financial system.

Price stability, which is one of the primary objectives of all modern central banks, is a relatively recent role. Many central banks were initially established with a financial stability role, as the ‘banker to the banks’.

That said, the concepts of monetary stability and financial stability are linked, as both seek to achieve broad economic stability. They are not ends in themselves – something that the changes to the Reserve Bank Act resulting from Phase 1 of this Review have sought to reflect - and it is an analytical simplification to suggest that their objectives are entirely separate (Restoy, 2018).

In the decade before the GFC, the central banks’ traditional financial stability focus was largely secondary to price stability. In part this was due to a focus on developing monetary policy frameworks to address high and volatile inflation, and their subsequent success in securing price stability. This coincided with the ‘great moderation’ (a globally benign period in inflation and output volatility that emerged in the early 2000s) and led to the somewhat misguided notion that policy-makers had ‘conquered the business cycle’. In this environment financial cycles became somewhat of an after-thought, and financial excesses were seen as amenable to being ‘mopped up’ after the fact by monetary policy.

### The GFC and the central bank role

The GFC provided an impetus for rethinking financial stability frameworks – including the nature and design of regulatory rules and the best institutional architecture to develop and enforce those rules (BIS, 2009 and 2011; Nier, 2009). In particular the crisis prompted some countries to re-examine the central bank’s role in the overall regulatory architecture.

There are two dimensions to this:

1. As a result of the GFC, policy-makers focused on better understanding and addressing ‘systemic risk’, which led to a distinction between ‘micro-prudential’ policy and a new area called ‘macro-prudential’ policy. As Nier (2009) argues, central banks are appropriately at the centre of the development of this new area, given macro-prudential policy implies an “expanded role of central banks that goes beyond the tools already typically at their disposal, and may enhance the overall effectiveness of financial regulation, allowing synergies to be exploited between existing and new regulatory tools to mitigate systemic risk” (p. 4).
2. The GFC refocused the discussion on whether a central bank should be assigned a role as a (micro) prudential regulator and supervisor of individual financial institutions, particularly in countries hardest hit by the crisis. Whereas before the GFC a number of jurisdictions were separating prudential functions from their central banks, more recently this has reversed somewhat (as discussed in Part 2). Examples include: the reconsolidation of prudential responsibility within the Bank of England (2010) and the Irish Financial Services Regulatory Authority’s merger with the central bank (2010).

It is worth noting that the post-GFC debate on giving prudential functions to central banks must consider the political concerns about the accumulation of power in a single organisation (Restoy, 2018) and questions of political legitimacy. The latter reflects the fact that Parliament delegates considerable power to unelected agency officials, and it is important that this delegation be accompanied by appropriate checks and balances, particularly where an agency performs a number of functions.

The BIS is a strong advocate of an enhanced role for central banks in financial stability, but notes “[s]ome adjustment to the current operational and governance procedures as well as some restraint in the specific functions assumed by central banks may help in striking the right balance between the benefits of the expansion of their mandate beyond price stability and the need to maintain their legitimacy as independent authorities” (Restoy, 2018).<sup>16</sup>

Paul Tucker, former Bank of England Deputy Governor, is similarly concerned with the question of how independent central banks can maintain and enhance their legitimacy (Tucker, 2018). He has developed a framework for a central bank’s ‘multiple missions’, founded on the intrinsic link between the monetary and credit systems – the “money-credit constitution”. To justify a prudential role, this function should have clear objectives and a distinct decision-making body within the central bank.

In contrast, Buitier (2014) argues that, to preserve its legitimacy, a central bank requires a narrow role in financial stability that is largely confined to providing emergency funding and liquidity in times of stress.

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<sup>16</sup> The restraint in terms of expansion of function envisaged by Restoy is in relation to the lack of synergy with a consumer protection mandate, including for banking services. This objective best sits with a separate conduct authority.

## Arguments for a central bank prudential mandate

The merits or otherwise of assigning additional financial sector functions to a central bank have been extensively debated and analysed.<sup>17</sup> However, as noted above, the GFC has prompted a rethink of some of the traditional arguments against this assignment, particularly in countries hardest hit by the crisis.

The international literature includes the following arguments in support of a prudential role for the central bank:<sup>18</sup>

- **Complementarity between price stability and financial stability:** Central banks are naturally concerned with the financial system's soundness as a precondition for the effective transmission of monetary policy (with banks the instruments of this transmission). Moreover, stability in prices is also regarded as a precondition for financial stability. Price stability and financial stability are therefore different sides of the 'same coin'.
- **Synergies between prudential supervision and monetary policy:** A central bank can harness its expertise and understanding of financial markets gained from its monetary policy role for business-as-usual prudential supervision and during periods of stress. For example, a central bank's experience with liquidity management in implementing monetary policy – which requires regular interactions with commercial bank asset and liability managers – can contribute insights to the overall funding profile of banks. This is of benefit to prudential supervisors.
- **Synergies between prudential supervision and LoLR:** A central bank's LoLR role implies a natural concern with crisis prevention and management. Crises are potentially costly for a central bank, with risks to its own balance sheet stemming from lending to illiquid institutions, and risks to its reputation if this liquidity support fails. This concern suggests the central bank has an interest in the micro-prudential regulation and supervision of systemically important financial institutions, particularly in concentrated financial systems such as New Zealand, to minimise the frequency of periods of financial stress (Kremers, Schoenmaker and Wiertz, 2003, p. 234). In addition, supervisory information about individual firms can support the LoLR role if required. During the GFC central banks were at the frontlines providing sizable policy support where decisions to lend on exceptional terms, and managing the resulting exposures, required insights that might not have been readily obtainable without a close relationship with the supervisory function (BIS, 2009). This suggests obvious synergies and economies of scale from data collection and the use of resources in this area.
- **Addressing financial stress:** Periods of financial stress require swift, decisively and effective action. Coordination between multiple agencies could stifle this. A number of commentators cite the failure of UK's Northern Rock as an example, where coordination between the Bank of England, the Financial Services Authority (FSA) and the UK Treasury proved inadequate (Cecchetti 2007; Schoenmaker and Veron 2017, p. 3-4). See Appendix 4 for a discussion of the UK crisis experience.

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<sup>17</sup> For earlier perspectives, see Goodhart and Schoenmaker, 1995; Goodhart, 2000; and Kremers et al, 2003.

<sup>18</sup> There are also specific benefits in consolidating sectoral prudential regulation (banks, non-bank lenders, insurers etc.) in one organisation in terms of cost savings and synergies (the cross-fertilisation of skill sets etc.). These would eventuate if prudential supervision both sat outside or inside the central bank.



- **Synergies between prudential supervision, systemic oversight and macro-prudential policy:** Housing prudential regulation and supervision in a central bank further helps to support its systemic oversight role (macro-financial analysis). In turn an expertise in macro-financial analysis informs the design and use of macro-prudential tools, while at the same time reinforcing the arguments for assigning responsibility for macro-prudential policy to the central bank. This can complete the policy toolkit when monetary and macro-prudential policies are used in a complementary way (Nier, 2009).
- **Internalising trade-offs:** The central bank gets to coordinate outcomes across three policy domains: micro and macro-prudential policy, and monetary policy. This coordination (and the in-house management of any policy trade-offs) may be more efficient and readily manageable than when the functions are separated.
- **Staff capability:** Small countries like New Zealand with a limited pool of macro-financial and supervisory experts may find that locating these functions under one roof minimises their 'key person' risk. It also provides more varied career paths for staff, as well as an ability to attract and retain high-quality staff. Central banks may also have a comparative advantage in recruiting and retaining staff than separate supervisory authorities, given the prestige often associated with working for the central bank in many countries.
- **Enhanced independence for financial policy:** Prudential regulation and supervision is generally more effective if conducted at arm's length from government – and locating both micro- and macro-prudential policy in a credible organisation that already acts independently will help to minimise the threats of financial policy politicisation and 'capture' by supervised entities (financial institutions lobbying politicians or trying to inappropriately influence the regulator).
- **Cost savings:** Assigning a prudential mandate to a central bank saves on costs from merging various administrative and corporate functions such as human resources, information technology and data collection. This is likely to be relatively more important for smaller countries like New Zealand.

## Arguments against a central bank prudential mandate

A number of jurisdictions separated prudential regulation and supervision from their central banks in the decade before the GFC (including Australia in 1997 and the UK in 1998). Their rationales were based on some of the following arguments found in the international literature:

- **Management and decision-maker distraction:** In an organisation tasked with a number of functions, the attention of senior management and decision-making bodies may become increasingly stretched, reducing their ability to make effective decisions demanded by a specific policy area. Additionally, there may be a risk that appointments of key senior staff are biased, or over-weighted, towards macro-economists ('traditional central bankers') at the expense of those with experience in prudential supervision.
- **Conflict with monetary policy:** In times of financial stress the central bank could be hesitant to impose the appropriate degree of tightening of policy (increasing the policy interest rate) implied by its price stability mandate. Conversely, in low-inflation environments coupled with rising financial imbalances, the central bank could be reluctant to impose the degree of policy loosening implied by the price stability mandate. Given this tension, there is a risk that policy trade-offs may not be managed in an optimal way and one policy area could be prioritised over

the other. Moreover, the central bank might prioritise monetary policy over prudential outcomes since a price stability goal (e.g. an inflation target) is quantifiable so outcomes are readily measured. By contrast financial stability is harder to define. This implies it is easier to hold the central bank to account for monetary policy outcomes. As a result the central bank may prioritise the business cycle over the financial cycle, and as a result focus mainly on monetary policy outcomes (Balls, Howat and Stansbury 2018, p. 36).

- **Reputational risks to monetary policy:** This can arise from the failure of supervised financial institutions. Market confidence in a central bank's price stability mandate could be undermined if its competence in other areas were questioned. Price stability relies on market participants having confidence in a central bank's inflation forecasts, and their ability to deliver on them. This helps to anchor private sector inflation expectations to those of the central bank.
- **Reputational risks to prudential supervision:** On the flip side, the integrity of a central bank's financial system related responsibilities could be undermined by poor monetary policy outcomes (e.g. a central bank failing to deliver on its price stability mandate consistently).
- **Conflict with LoLR role:** The central bank could 'forebear' and direct resources to sustain an insolvent institution under its supervision, amplifying the wider damage caused by the institution when it is eventually allowed to fail. This situation could result from 'bureaucratic gambling', where the central bank wants to escape blame for poor performance or hide problems at the insolvent institution by using other non-prudential tools at its disposal. There is also a moral hazard argument tied to the LoLR role where banks may become less risk averse in situations where the banking supervisor also has this emergency liquidity role.
- **Lack of transparency:** The central bank's in-house management of policy trade-offs between micro/macro-prudential policy and monetary policy may be opaque to external stakeholders, especially when decisions are not made by separate decision-making bodies.
- **Compromises to central bank independence:** There is a risk of the central bank's involvement in financial sector regulation and supervision politicising its monetary policy mandate. While there are very good reasons for financial policy to be undertaken at arm's length from government, prudential regulation and supervision involves circumscribing the business and operating models of regulated financial institutions and can have significant impacts on other stakeholders (e.g. the ability of borrowers to access the housing market). What is 'arm's length', and the boundaries of 'operational independence' in the area of financial policy, may be somewhat less clear than for monetary policy. There is a danger that Government may 'rein in' the central bank more generally if it felt the central bank was overreaching its financial policy mandate.
- **Concentration of power:** The co-location of a prudential mandate and responsibility for monetary policy in a single agency places a significant degree of delegated power in unelected officials. There may be a 'bureaucratic effect' argument where government is naturally hesitant to concentrate functions and powers within one organisation (Masciandaro et al, 2011, p. 16). This concentration also naturally reduces the 'competition' for policy advice across the regulatory system.
- **Underweighting of some prudential objectives:** While a central bank is naturally concerned with, and may prioritise, the soundness of the financial system as a whole, Government may prefer prudential regulation to include other objectives, such as the soundness of all institutions within the regulatory perimeter (not just the large, systemically important ones), or even wider objectives such as consumer protection (although this would be unusual internationally). The

risk of this underweighting would depend on how the objectives the central bank is tasked with are specified in legislation, and how the central bank subsequently interprets its mandate.

## A central bank prudential mandate: benefits and costs in practice

The potential benefits of co-locating several additional functions in the central bank will show in the central bank's everyday operations. On the positive side, there will almost always be conflicts of interest and policy trade-offs, and it may be easier and more effective to resolve such tensions within a single organisation than by coordinating across separate agencies.

On the negative side, organisational 'silos' could develop, preventing the conceptual benefits of co-location being achieved (especially those that result from willing and open exchanges of information, perspectives, experience, and expertise). There is also the ever-present risk of 'management distraction' in an organisation with multiple missions (see Tucker, 2018).

It is possible to design ways to mitigate the potential issues of locating prudential supervision within a central bank. Some of these are relevant to the 'enhanced status quo' option for New Zealand, described in Part 5.

For example:

- a conflict of interest between prudential and monetary policy could be mitigated through having separate decision-making processes, while still maintaining overlaps to retain the benefits of coordination and synergy (see Tucker, 2018)
- in relation to any conflict with a central bank's LoLR role, an obvious mitigant is the central bank's incentive to undertake robust prudential supervision to protect its balance sheet and maintain its reputation. A clear explanation of the terms and conditions of extending emergency funding to institutions in distress (i.e. ensuring it was only extended to solvent and viable institutions) would further help to reduce any moral hazard
- the potential reputational risks to the conduct of monetary policy arising from the failure of a supervised institution can be mitigated by the central bank's incentive to improve the resilience of the financial sector
- management distraction can be overcome by having separate and well-resourced decision-making bodies for different policy areas
- any natural tendency to prioritise one policy area over another can be mitigated by ensuring that each policy function has the right skills and other resources to support high-quality analysis and policy.

Appendix 2 has an overview of how the Reserve Bank strives to maximise the synergies identified in the literature, while managing conflicts of interest.

## Part 4: The pros and cons of the ‘mega-regulator’ model

As discussed in Part 2, almost 30 percent of all countries surveyed by the BIS locate a **prudential** mandate in an institution that also has a **financial market conduct** responsibility. This ‘integrated’ institution may be the central bank (in 11 percent of cases) or a separate agency (in 18 percent of cases).

This section focuses on the separate agency model, as it is an option being considered for New Zealand – see Part 5 for more. Note that the options’ analysis in Part 5 does not consider the central bank integrated model, because it does not involve *separating* any functions from the Reserve Bank. Instead, this other model would involve adding a financial market conduct mandate to the Reserve Bank’s existing financial system responsibilities.

### Arguments for integrating prudential and financial market conduct into a separate agency

The separate agency model offers a number of benefits:

- **Complementarity between prudential and financial market conduct regulation:** Both functions ultimately contribute to a well-functioning financial system – the first through supporting the system’s stability and/or the soundness of individual institutions, and the second through protecting the informed participation of consumers and investors and ensuring market integrity. These objectives can be mutually supporting; for example, well-informed consumers and investors can help to impose some degree of ‘market discipline’ on financial service providers.
- **Reducing gaps in financial sector regulation:** A separate agency tasked with prudential and financial market conduct responsibilities may result in less scope for regulatory ‘underlap’ (pockets of unregulated financial activity) and less opportunities for regulatory ‘arbitrage’ on the part of financial institutions (restructuring business and operating models to take advantage of two parallel sets of regulatory rules, in order to minimise overall compliance costs or regulatory burden).
- **Synergies:** These may come from the coming together of different perspectives, analytical frameworks and skill sets across the two functions.
- **Cost savings:** These are likely to come from reducing duplication in areas like data collection, or sharing resources like corporate services (e.g. accounting, human resources, IT services and risk management).
- **Benefits for industry:** As a ‘one-stop shop’ for regulated entities, a single agency could help to reduce overall compliance costs for industry. This could result from a single process for licensing entities to undertake certain businesses or activities, and the potential harmonisation and streamlining of regulatory rules and guidance. Relatedly, a more consistent approach to supervision and enforcement could be delivered, resulting in a ‘level playing field’ for regulated entities.

- **Powerful voice in the financial system:** A single agency that is seen to be achieving its statutory goals would have significant authority and credibility in the financial system.
- **Single point of accountability:** The accountability for financial sector outcomes may be clearer for consumers and regulated entities, as there is no opportunity for ‘passing the buck’ between separate agencies, or opportunities for potentially damaging disputes between agencies.
- **Staff capability:** Career opportunities are enhanced in an organisation with a variety of functions, so a higher calibre of staff might be able to be recruited. This is likely to be relatively more important for smaller countries.

## Arguments against integrating prudential and financial market conduct into a separate agency

The arguments against this model are summarised as follows:

- **Conflicts between prudential and financial market conduct regulation:** The two functions may be in conflict at times. For example, the need for confidentiality in the orderly management of problems within a distressed institution may conflict with a conduct emphasis on disclosure and transparency for consumers and investors. Although rare, a prudential authority may also be willing to overlook some questionable market practices if it helps to increase institutions’ profitability and solvency.
- **Reputational risks:** There is a risk of reputational contamination across the two functions, arising from high profile issues in either the prudential or the financial market conduct policy area.
- **Synergies may be limited:** The two functions have different focuses and skill sets. Prudential supervision is largely preventive, with a requirement for skills in economic and financial analysis, while financial market conduct largely involves investigations and enforcement, requiring mainly legal skills. Their individual ‘cultures’ may be so different that significant synergies are simply not possible.
- **Management distraction:** Investigation and enforcement can be a time-consuming process, and there is a risk that the agency will place greater weight on this function during non-crisis periods at the expense of its prudential objectives. This potential for management distraction was a common criticism levelled at the UK’s Financial Services Authority (FSA) in the lead-up to the GFC (see Appendix 4).
- **Accountability challenges:** Holding the single agency to account may be difficult if there is no clear focus on the different objectives of financial stability and consumer/investor protection. However the risk of this problem materialising would depend on how these respective objectives are specified in legislation, and how the agency communicates its approach to achieving outcomes across the two policy areas.
- **Risks from harmonising and streamlining regulation:** There is a risk that a drive to harmonise and streamline regulatory requirements will reduce or eliminate the distinctions between different financial products and institutions. Such a distinction may be appropriate given different risk characteristics. This may contribute to a public perception that the risk spectrum across different sectors has disappeared if they believe that all institutions are being regulated and supervised in the same way.

- **Coordination in time of stress:** Where a single-agency supervisor sits outside the central bank, a robust mechanism for coordinating crisis resolution is required (given the central bank's LoLR role).
- **Responsibility for macro-prudential policy and payments system:** It is not clear where the functions of macro-prudential policy or payment and settlement systems oversight would naturally sit if the integrated supervisor were not the central bank. External coordination mechanisms would need to be established in any event.
- **Concentration of power:** There may be concerns about accumulating too many functions within a single organisation – the bureaucratic effect argument noted in Part 3.
- **Dis-economies of scale:** A single agency may become unwieldy and unresponsive to changing financial market conditions. There is also the risk of a 'Christmas tree' effect, where the agency is gradually given more functions and eventually becomes overburdened by activities not connected with its two primary functions. This could be the case if the agency was given a competition mandate, for example.

## The central bank as the 'mega-regulator' – a note

The cost-benefit calculation for the 'mega-regulator' model changes somewhat when both functions are located in the central bank. Some of the arguments in Part 3 are equally relevant here, where a single organisation would be responsible for a prudential and financial market conduct mandate, systemic oversight, LoLR, as well as monetary policy. Done well, the central bank essentially internalises any trade-offs in four key policy areas: monetary policy, micro- and macro-prudential policy, and financial market conduct issues.

Briefly, the additional benefits of this model relative to the separate agency model arise from:

- the central bank's ability to act swiftly and decisively in times of financial stress
- the synergies possible from the addition of macro-financial analysis and the monetary policy function.

Conversely, some of the potential problems with the integrated model are accentuated:

- any concerns around the concentration of power within one organisation are exacerbated
- the potential for reputational cross-contamination from functions is magnified
- management is further stretched across a wider variety of functions
- potential policy conflicts may not be addressed and resolved effectively.

# Part 5: Options analysis

Chapter 5 of the consultation document outlines three institutional models for consideration and stakeholder feedback. The status quo is not considered, as the Review will likely lead to changes in the Reserve Bank's current prudential mandate even if separation is not pursued.

The three options are:

- **an enhanced status quo** – this option would take the current twin peaks model as a given, but could include a number of changes to arrangements within the Reserve Bank (stemming from the wider Phase 2 Review) that would potentially address some of the concerns of stakeholders who are advocates for separation. Changes could include developing clearer objectives for the Reserve Bank, changing the governance and accountability arrangements, and increasing resourcing to enable a greater focus on the Reserve Bank's financial system responsibilities
- **a New Zealand Prudential Regulation Authority (NZPRA)** – this option would loosely resemble the twin peaks arrangements in Australia (see Appendix 3). At a minimum, the Reserve Bank would still be responsible for monetary policy and the LoLR role
- **a New Zealand Financial Services Authority (NZFSA)** – this separate agency would assume responsibility for the Reserve Bank's prudential role and the FMA's financial market conduct mandate. The Reserve Bank would still be responsible for monetary policy and LoLR.

Each models' strengths and weaknesses are assessed against four general criteria derived from the international literature discussed in Part 3: **focus, synergies, conflicts of interest, and costs**. These are discussed in more detail below.

It is worth noting that:

- given these criteria, there are trade-offs in selecting an institutional model. How these are managed would be important in any model in practice
- effective regulatory outcomes are also a function of the interplay between the powers delegated to the regulatory authority, its internal culture and behaviours, and the resources allocated to the agency
- all options considered here could be compatible with more or fewer powers delegated by Parliament (different degrees of operational autonomy) and more or less funding
- developing an appropriate organisational culture would take time in a new agency (as would any desired cultural change in existing agencies).

This section does not provide an overall evaluation of the three models or indicate any preferred model.

## Focus

Generally speaking, agencies tasked with a narrow set of functions and objectives (the scope of their mandate) will potentially enable a greater focus among the relevant decision-makers. Where the mandate is broader (with multiple functions or objectives assigned to an agency), there should be some natural 'complementarity' – that is, the functions or objectives should be similar enough to suggest that the performance of any given function or promotion of any given objective can



materially benefit from co-location with the others. On the other hand, functions or objectives that are inherently incompatible with one another should typically be assigned to different agencies.

Note that, while multiple functions may be similar enough to warrant their being located under one roof, trade-offs across policy areas will often arise. How these are dealt with by decision-makers will depend on the governance structure and the resources assigned to each function.

Also, even in an organisation with a narrow mandate, a vague or ambiguous specification of its statutory objectives or functions can result in a lack of focus.

## Synergies

Synergies are the benefits that result from co-locating functions or objectives in an agency. They can arise from a number of sources, including the insights that come from having different analytical perspectives under one roof, the sharing of different data sources, and the cross-fertilisation of skill sets and experience across staff. These gains are called ‘economies of scope’. When exploited they can lead to higher-quality results in the different policy areas, and support the wider benefits of coordinating those policy areas.

However, simply co-locating functions within one organisation will not necessarily result in the synergies or benefits of coordination. Silos are possible in any structure, in part reflecting the agency’s organisational set-up, culture and behaviours.

## Conflicts of interest

Conflicts of interest can arise when a trade-off is required between different policy areas. As noted above, functions or objectives that are generally incompatible with one another should be assigned to different agencies.

That said, conflicts can arise in any situation, and they can often be resolved effectively and efficiently in-house. However, there is a risk that this internalisation will have poor outcomes because one objective or function is prioritised over another. Solutions that typically help to resolve policy trade-offs in a single agency include:

- using an organisational ‘department’ structure according to functions or objectives
- having separate decision-making bodies for different policy areas with overlapping membership.

Alternatively, policy trade-offs can be resolved externally through allocating functions to different agencies. This requires coordination between the agencies through mechanisms such as Memoranda of Understanding and cross-agency bodies.

The risk of this approach is that there may be limited coordination (or no coordination at all), leading to unsatisfactory outcomes for the financial system as a whole. For example, multiple agencies may have incomplete information about each other, forcing one agency to move first and the other to react. The second agency’s reaction may result in poorer policy outcomes than could have been achieved if both policies were coordinated.



## Costs

In addition to delivering synergies, locating different functions together may save on costs owing to the elimination of gaps or duplication, lower overall staff numbers, shared support services (IT, HR etc.), improved data collection, and increased flexibility in using resources.

Where policy functions are assigned to different agencies, the ongoing costs of external coordination mechanisms (if these exist) need to be factored in, and considered relative to the costs of coordinating different policy functions in a single organisation.

However, any consideration of overall costs must be framed in terms of the benefits. For example, separating functions into different institutions may increase the direct overhead costs of regulation, but it could also enable these institutions to focus more on their mandates.

### Transition costs

Costs are also important when considering fundamental changes to institutional arrangements. The transition costs of change can be difficult to quantify, but they might arise from:

- the direct costs of setting up new institutions by amalgamating separate functions, or
- breaking up an existing institution and reallocating functions to separate institutions.

These costs can relate to:

- the potential loss of key personnel
- managerial diversion from the core activity of regulation during the transition
- the loss of potential synergies, where relevant
- the unpredictability and uncertainty of the change process itself in the run-up to any final decisions on institutional arrangements (Llewellyn, 2006, p. 21). This can include any bargaining processes between different stakeholder groups, and the involvement and participation of certain interest groups (e.g. industry bodies) in the legislative process that may sit alongside changes to the regulatory architecture.

It is important to remember that transition costs are short term, while the benefits of any change accrue over a longer horizon.

## Option 1: enhanced status quo

In this model the Reserve Bank would keep its role as prudential regulator and supervisor. However, changes as a result of the Review are assumed in a number of areas, including objectives, governance, and funding.

Note that it is not possible to provide much detail on these possible changes, as this would prejudice the outcomes of other parts of the Review. Comparisons with the status quo are therefore somewhat difficult.

Table 4 summarises the potential strengths and weaknesses of this model for New Zealand, based on changes explored in the consultation document.

Table 4: Option 1 – enhanced status quo

Enhanced status quo	
Focus	<ul style="list-style-type: none"> <li>– Potential for mandate clarity through re-specification of high-level statutory objectives for the financial system.</li> <li>– Any additional financial system objectives might require a potential refocus of the regulatory and supervisory approach.</li> <li>– Focus on financial system responsibilities could be enhanced by increased funding and/or governance changes (e.g. a statutory Financial Policy Committee).</li> <li>– However, general risk of ‘cultural inertia’ and senior management distraction remains (given broad range of responsibilities).</li> </ul>
Synergies	<ul style="list-style-type: none"> <li>– Pre-existing synergies across three policy areas (micro/macro-prudential and monetary policy) preserved. Reserve Bank still gets to internalise outcomes across these policy areas.</li> <li>– Additional funding and some internal organisational changes could help to further exploit potential benefits from co-locating these functions.</li> </ul>
Conflicts of interest	<ul style="list-style-type: none"> <li>– Separate formal decision-making bodies, if implemented, could mitigate any adverse outcomes, while preserving benefits of coordination via overlapping membership.</li> </ul>
Costs	<ul style="list-style-type: none"> <li>– Could rise from increased resourcing of the prudential function, servicing the collective decision-making bodies, or more intensive approach to supervision.</li> <li>– Funding model changes (e.g. industry levies) could accommodate cost increase.</li> </ul>

## Focus

The Reserve Bank’s objectives might change as a result of the Review. Chapter 2 of the consultation is exploring whether to refine current objectives or give the Reserve Bank additional objectives, over and above its current purpose of promoting and maintaining a sound and efficient financial system. One outcome could be greater clarity for stakeholders on the financial system-related objectives of the Reserve Bank, and how the Reserve Bank might seek to achieve them. The Review will also explore appropriate ways for the government to inform the Reserve Bank’s objectives, where clarity is necessary for high-level statutory objectives.

On the other hand, the Reserve Bank could be given objectives that make its overall mandate less clear (particularly where objectives might conflict). This would be an undesired, but still possible, outcome of changes stemming from the Review process.

The final decision on the objectives will have some impact on decision-makers’ specific focus – and any changes to governance arrangements and funding levels would affect the Reserve Bank’s focus on its financial stability mandate. For example, the establishment of a committee structure for financial policy decisions would create a formal focal point for this function, reducing any propensity for ‘management distraction’ or weighting/prioritising other policy areas. In addition, the Reserve Bank’s overall resourcing could increase as a result of Phase 2 recommendations and outcomes – supporting the policy process and supervisory outcomes.

## Synergies

This model preserves all the benefits of co-location that currently occur in practice (see Appendix 2). There may be some internal organisational changes for the Reserve Bank arising from the Review that could further enhance the exploitation of synergies, while greater funding could result in a wider policy and supervisory skill set (and more industry-based experience), engendering greater cross-fertilisation of ideas and analytical frameworks.

Any shift to a formal committee-based structure would need to maintain the current coordination of different policy areas (e.g. via overlapping membership).

## Conflicts of interest

Trade-offs can arise even in policy areas that are highly complementary. Separate formal decision-making bodies for different policy areas could help in managing such tensions, while preserving the benefits of coordination via some overlapping membership.

## Costs

The overall costs of the prudential function could increase as a result of the Review. These costs might come from more resource for policy development and supervision, or from those associated with formal committees, particularly if these involve external membership. The potential regulatory and compliance costs for industry are unclear, and will depend on the outcomes for the Reserve Bank's supervisory model.

The transition costs would depend on the breadth and nature of the decisions and outcomes of the Review. They would include set-up costs for any new arrangements, as well as staff time (Reserve Bank and Treasury) in areas such as policy development and drafting and amending legislation. Any proposed changes could also affect other government agencies, and there would likely be costs involved in managing the involvement of regulated entities and other stakeholders in the consultation process.

## Option 2: NZPRA

As discussed in Part 2, 10 percent of the countries surveyed by the BIS are using the twin peaks model of financial sector regulation. In half of them, an agency separate from the central bank is responsible for the 'solvency peak'.

Table 5 summarises the strengths and weaknesses of this model for New Zealand.

Table 5: Option 2 – NZPRA

New Zealand Prudential Regulation Authority (NZPRA)	
Focus	<ul style="list-style-type: none"> <li>– Narrower set of responsibilities for both the Reserve Bank and the NZPRA by design, less potential for ‘management distraction’ at both agencies. Potential to develop distinct organisational culture.</li> <li>– Greater focus on appointing senior management with industry experience and/or greater familiarity with prudential issues.</li> <li>– NZPRA will still need to decide on the relative attention both between and within the sectors for which it is responsible.</li> <li>– Mandates are potentially clearer (unless NZPRA and the Reserve Bank are both given financial stability objectives, creating some confusion for stakeholders).</li> <li>– Not clear where macro-prudential policy or oversight of the payments system would naturally sit in this model.</li> </ul>
Synergies	<ul style="list-style-type: none"> <li>– Retain synergies associated with cross-sectoral approach to prudential regulation, and those between policy and supervision/enforcement.</li> <li>– Lose synergies between prudential, and monetary policy and systemic oversight roles of the Reserve Bank.</li> <li>– Less varied staff development opportunities for staff in NZPRA and the Reserve Bank. However, opportunities for greater focus for NZPRA on recruiting staff with deep knowledge of relevant sectors and/or regulatory issues.</li> </ul>
Conflicts of interest	<ul style="list-style-type: none"> <li>– Internal Reserve Bank conflicts reduced by design.</li> <li>– Policy trade-off management will require establishment of external coordination mechanisms with the Reserve Bank, FMA and Treasury.</li> </ul>
Costs	<ul style="list-style-type: none"> <li>– High, from loss of economies of scale and transition costs (setting up the NZPRA).</li> <li>– Question of whether New Zealand can sustain three agencies (NZPRA, FMA and Reserve Bank) in terms of overall regulatory costs (and capabilities).</li> <li>– Some increase in costs could come from generally better resourcing of prudential function that comes with greater focus, relative to the baseline.</li> <li>– Funding model would need to be considered (e.g. industry levies).</li> </ul>

## Focus

One of the key benefits of this model is the narrowing in focus for both the Reserve Bank and the new institution. This would be a natural mitigant against ‘management distraction’, since both institutions would have more limited objectives and functions to undertake. Reinforcing this focus would be a greater opportunity to focus on appointing senior managers with specific industry experience and/or career records in prudential regulation and supervision.

Another potential strength is that the NZPRA would be able to develop an organisational culture appropriate to a modern prudential regulator and supervisor, unencumbered by any (perceived) baggage of being part of a monetary authority – although this would take time. This could be complemented by the development of a new type of relationship with the regulated sectors, reinforced perhaps with a more intensive approach to supervision.

With narrower mandates, the objectives of the NZPRA and the Reserve Bank should be clearer. However, the Reserve Bank would keep its ‘natural interest’ in outcomes for the financial system (to

reflect its LoLR role), and a systemic monitoring role that would sit alongside. It is conceivable that the Reserve Bank and NZPRA both might have a financial stability-related objective.

The specified mandate for the NZPRA and the role retained for the Reserve Bank could therefore create some confusion about which organisation is ultimately responsible for financial system outcomes. The range of objectives and the levels to which they are specified in legislation would influence the clarity of the NZPRA's role.

This issue is also reflected in questions about where macro-prudential policy development and decision-making should sit. In models where prudential supervision sits outside the central bank, there are a number of choices about where macro-prudential policy could be located: in the central bank, in the NZPRA, or via some cross-agency macro-prudential council or other coordinating body. A decision on the location of payment and settlement system oversight and regulation would also have to be made. In Australia, for example, it sits with the Reserve Bank of Australia, with APRA representation in the decision-making body. In New Zealand, it could be vested in the NZPRA, with co-responsibility with the FMA in this area. Alternatively the Reserve Bank (together with the FMA) could jointly retain this function.

## Synergies

The creation of the NZPRA would retain synergies in relation to locating the prudential regulation and supervision of various financial sectors (i.e. banks, NBDTs, and insurers) under one roof. Indeed, the NZPRA could potentially exploit further the benefits of this interaction.

However, the NZPRA's enhanced focus on prudential outcomes alone would likely see the loss of other existing synergies (detailed in Part 3), between the (micro and macro) prudential functions, monetary policy, and the Reserve Bank's role in providing liquidity in both normal periods and times of stress. As a result, the quality of these respective areas' outputs might decline.

The narrower focus of both the Reserve Bank and the new NZPRA would likely reduce career opportunities for staff, along with their ability to expand their skill sets or be exposed to different ideas and analytical frameworks. However, separation could provide each organisation with a greater opportunity to focus on ensuring that it had the specialist skill sets required to undertake its mandate.

## Conflicts of interest

The potential for sub-optimal policy outcomes from co-locating a number of functions within a central bank, as detailed in Part 3, would be reduced by design. These arise from the potential conflicts between monetary policy and prudential policy, and that between prudential supervision and the LoLR function.

However, separation does not remove the need for coordination, nor does it prevent trade-offs across policy areas arising. With the Reserve Bank no longer able to internalise these trade-offs in its policy-making, the creation of the NZPRA will necessarily require formal external coordination mechanisms in the area of macro-prudential policy and crisis management and resolution. How these coordination arrangements are designed will have an important bearing on how the agencies work together in practice.

## Costs

Under this model the overall costs of financial sector regulation would likely increase, largely owing to the duplication involved in creating a new institution (e.g. in IT, HR and other corporate functions) and in undertaking parallel functions such as financial system monitoring and data/information gathering.

The costs would also go up if the NZPRA were better resourced than the current prudential function. It would be important to consider an appropriate funding model, as, unlike the central bank, the NZPRA would not be able to use seigniorage or the investment of foreign reserves to generate income and cover costs. The model could include some form of Parliamentary appropriation or industry levies.

The transition costs of setting up the organisation (moving to a new location, embedding new corporate services, recruiting staff etc.) would likely be significant, as would the costs of management time and resources in developing the internal structure and processes. There would also be 'uncertainty costs' in relation to employing Reserve Bank staff, as some may prefer to stay at the Reserve Bank or move to the private sector.

On the other hand, the NZPRA might be well-placed to attract staff directly from the private sector if it were seen as appropriately focused, well-resourced and offering competitive salaries.

## Option 3: NZFSA

The NZFSA model aligns with the 'mega-regulator' model discussed in Part 4.

In some overseas jurisdictions (e.g. the Czech Republic, Singapore) the prudential and financial market conduct mandates are integrated in the central banks. This is not considered an option for New Zealand as it does not involve any separation of functions from the Reserve Bank.

Note there are differences between the current models for prudential and financial market conduct regulation in New Zealand – for example, the Reserve Bank has more discretion to develop policy and creating rules than the FMA. While bringing both functions together in a single agency does not necessarily require harmonisation of these models, such a divergence would add complexity to this institutional form. The issue is not explicitly addressed in the assessment of this model.

Table 6 summarises the strengths and weaknesses of this model for New Zealand.

Table 6: Option 3 – NZFSA

New Zealand Financial Services Authority (NZFSA)	
Focus	<ul style="list-style-type: none"> <li>– Narrower focus for the Reserve Bank, broad focus for NZFSA. Potential for management distraction within NZFSA across its prudential and financial market conduct mandates.</li> <li>– Less scope for regulatory underlap in prudential and conduct functions.</li> <li>– Depending on specification, mandate could blur prudential and conduct functions.</li> <li>– Not clear where macro-prudential policy or oversight of the payments system would naturally sit in this model.</li> </ul>
Synergies	<ul style="list-style-type: none"> <li>– Retain synergies associated with cross-sectoral approach to prudential regulation, and those between policy and supervision/enforcement.</li> <li>– Exploit synergies for any complementarities between prudential and conduct roles.</li> <li>– Lose synergies with monetary policy, systemic oversight role of Reserve Bank.</li> <li>– Reduced development opportunities for Reserve Bank staff, but enhanced for NZFSA staff.</li> </ul>
Conflicts of interest	<ul style="list-style-type: none"> <li>– Internal Reserve Bank conflicts reduced by design.</li> <li>– Potentially new conflicts created between prudential and conduct (e.g. looking after customers of a financial institution versus promoting the soundness of the institution, and confidentiality v. transparency).</li> <li>– Need for external coordination with Reserve Bank and Treasury.</li> </ul>
Costs	<ul style="list-style-type: none"> <li>– Steady-state costs for regulatory system are not clear.</li> <li>– Transition costs high – this option would be disruptive to both the Reserve Bank and FMA. The new authority would need to be established quickly to minimise disruption and to ensure that the Reserve Bank and the FMA are not undermined while carrying out their existing functions.</li> <li>– Funding model would need to be considered (e.g. industry levies).</li> </ul>

## Focus

The NZFSA would have a broad focus on both prudential and financial market conduct matters. This would unlikely be an improvement on the status quo in addressing the potential issues associated with management distraction.

If anything, the NZFSA would have a wider focus than the Reserve Bank's current mandate given the breadth of financial market conduct issues across a wide variety of entities. This suggests that there is potential for a less focused institution, depending on its resourcing and internal organisational structure. It might pay to heed the UK experience, which indicates that institutions like these tend to focus more on conduct issues during normal periods (given the time-consuming nature of investigations and enforcement), at the expense of prudential supervision (see Appendix 4).

The NZFSA's objectives would need to carefully delineate the outcomes of both its functions to avoid blurring the two. If it were tasked with an explicit 'financial stability' objective alongside the Reserve Bank, this could have the potential for confusion.

As in option 2, it is unclear where macro-prudential policy would naturally sit: in the NZFSA, within the Reserve Bank, or mediated through a cross-agency council. It might be logical to make the NZFSA responsible for payment and settlement system oversight and regulation, given the current joint FMA-Reserve Bank role in the status quo.

As in option 2, the NZFSA would be able to develop an organisational culture appropriate for prudential supervision. However, there could be issues with aligning this with the financial market conduct function.

## Synergies

This model would exploit any potential complementarities between prudential and financial market conduct regulation, while cross-fertilisation from the differing skill sets and insights could work to improve overall outcomes for both policy areas. That said, if the two functions had very different cultures, silos could develop and inhibit any potential benefits.

As in option 2, this model would reduce any synergies arising from the interaction between a prudential mandate and the Reserve Bank's monetary policy and systemic monitoring functions.

## Conflict of interest

As in option 2, any potential conflicts of interest that arose in a central bank tasked with prudential regulation and supervision would be reduced by design.

However, new potential conflicts could arise from locating the prudential and financial market conduct responsibilities together (see Part 4). That said, the organisation could coordinate the two functions in a way that did not necessarily lead to sub-optimal outcomes or the prioritisation of one function over the other. This would ideally include a consideration of internal decision-making arrangements, as well as ensuring that each function was appropriately resourced within the NZFSA.

Robust external coordination mechanisms would need to be established between the NZFSA, the Reserve Bank, and the Treasury.

## Costs

The overall costs for financial sector regulation are unclear in this model. Economies of scale would result from integrating the Reserve Bank's former prudential functions with the FMA, but there would likely be a duplication of effort between the NZFSA and the Reserve Bank in some areas.

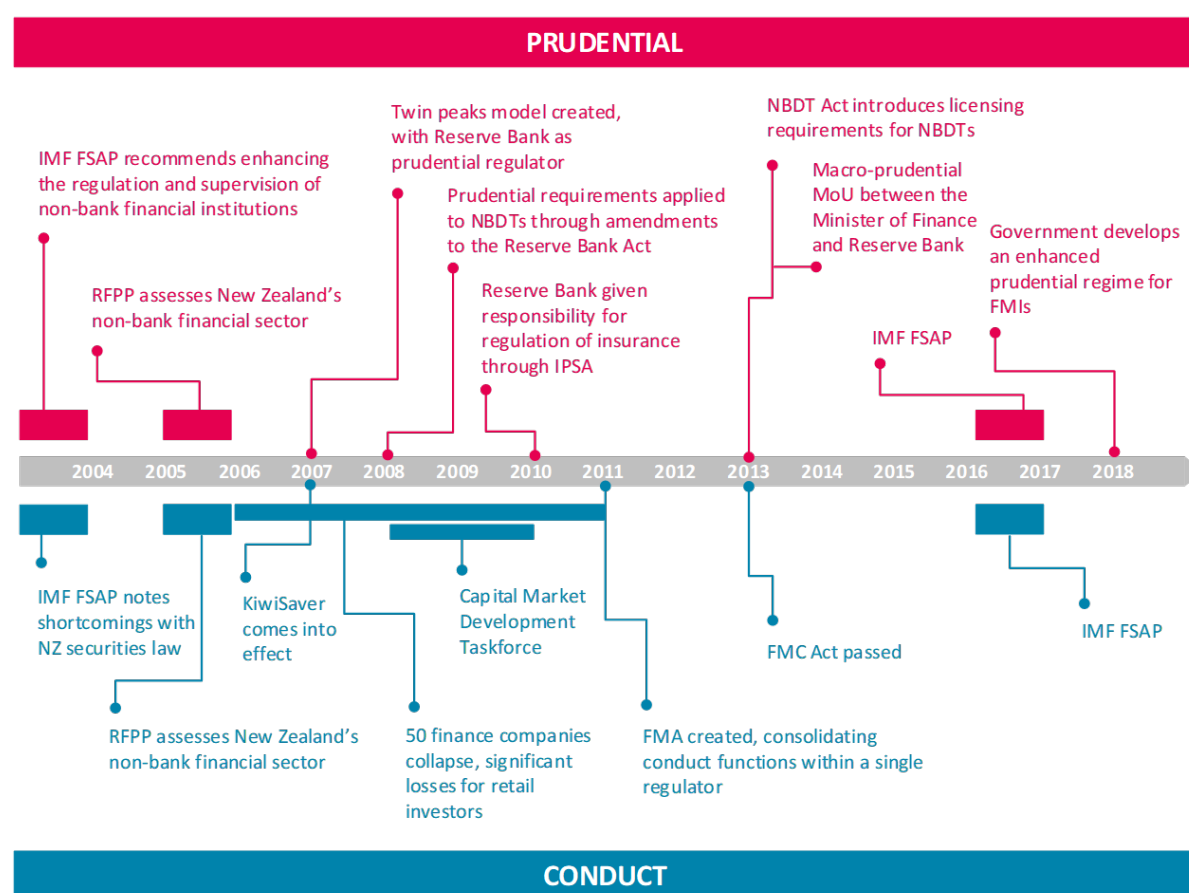
The transition costs would likely be much greater than those for option 2, and the Reserve Bank, the FMA, and potentially MBIE would be significantly disrupted. The new single agency would need to be established quickly to minimise disruption and ensure the Reserve Bank and the FMA could continue to undertake their functions properly during the transition.



# Appendix 1: The evolution of New Zealand's twin peaks model

The origins of New Zealand's twin peaks framework trace back to the mid-2000s (Figure 7).

Figure 7: The development of New Zealand's twin peaks framework



In 2003/04 the International Monetary Fund (IMF) conducted a review of the New Zealand financial system known as a 'Financial Sector Assessment Program' (FSAP). FSAPs gauge the stability of the country's financial sector, identify any potential sources of systemic risk, and assess the quality of regulatory frameworks.

At the time of this FSAP, the Reserve Bank was only responsible for the prudential regulation and supervision of registered banks. The IMF identified a number of weaknesses with the regulation and supervision of non-bank financial institutions (NBFIs) such as insurers, non-bank lenders, and managed investment schemes. The regulatory framework for NBFIs was fragmented and insufficiently developed, and there were gaps in oversight.

## Development of the ‘solvency peak’

In response to the FSAP recommendations the Government established the RFPP working group in 2005 led by the then Ministry of Economic Development (MED). The group recommended that parts of the NBFIs sector be subject to a more coherent regulatory structure and oversight.

To complement the RFPP working group, a Domestic Institutional Arrangements (DIA) working group was established to “consider the most appropriate institutional structure for domestic institutional supervisory arrangements, including consideration of a single prudential regulator or a mega-regulator” (DIA working group *Terms of reference*).

Led by the Treasury and supported by the Reserve Bank, MED, the Securities Commission, and the State Services Commission, the DIA working group considered various institutional models and the arguments for and against each. In 2005 the DIA working group concluded that:

- there were significant benefits in consolidating prudential regulation and supervision across individual sectors (i.e. banks, non-bank deposit takers [NBDTs], and insurers)
- no significant synergies or economies of scale would arise from co-locating prudential regulation and financial market conduct
- there were strong enough synergies between prudential regulation and the Reserve Bank’s traditional systemic oversight functions (the payment system role, LoLR, macro-financial monitoring, and the publication of *Financial Stability Reports*) to warrant the Reserve Bank’s continued role as the prudential authority for the banking system, and therefore as the new integrated prudential authority
- co-locating monetary policy and an expanded prudential role would require enhanced governance and accountability requirements, in part to preserve the operational independence of monetary policy.

Based on these conclusions, Cabinet made an in-principle decision in 2005 to appoint the Reserve Bank as the single prudential regulator and supervisor, while rejecting the ‘mega-regulator’ model. In 2007 Cabinet agreed on the governance and accountability arrangements required to support this expanded role, providing the basis for amendments made in 2008 to the Reserve Bank of New Zealand Act.

The 2008 amendments expanded the Reserve Bank’s remit to include NBDTs (insurers were to follow in 2010), and added enhanced accountability arrangements, which included:<sup>19</sup>

- elevating the Reserve Bank’s financial system-related functions with a new statutory purpose (section 1A), so that promoting and maintaining a sound and efficient financial system sat alongside the Reserve Bank’s price stability objective
- rebalancing the Reserve Bank Board’s monitoring role to include an explicit assessment of the Reserve Bank’s functions tied to financial system soundness and efficiency.

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<sup>19</sup> See Hunt (2017) for a fuller discussion of the accountability enhancements introduced in 2008.

In 2013 a new policy area for the Reserve Bank was formalised with the signing of a Memorandum of Understanding between the Minister of Finance and the Reserve Bank Governor on [macro-prudential](#) policy. This provided for a specific focus on identifying and addressing systemic risk across the financial system, and the use of prudential instruments in a more proactive manner to mitigate this risk.

## The development of the ‘financial market conduct peak’

In 2008, and largely in response to the RFPP and the failure of a number of finance companies from 2006, the Government appointed a Capital Market Development Taskforce (CMDT). The CMDT supported a shift to a more formalised twin peaks model and prompted a broader review of securities law that saw New Zealand’s historical disclosure-focused model for securities regulation move towards a focus on financial market conduct.

The CMDT also recommended a number of changes to improve the performance of New Zealand’s historically underdeveloped domestic capital markets as an ‘engine of economic growth’. These recommendations were developed in an MED-led review that identified concerns with market regulator fragmentation and the adequacy of regulators’ powers. The Government responded to the review with a consolidation of functions similar to that done earlier for the prudential mandate, and created the FMA in 2011 to oversee financial market conduct regulation. The FMA was established as an independent Crown entity, and incorporated the functions of the Securities Commission and Government Actuary and some of the regulatory roles of the Registrar of Companies and the New Zealand Stock Exchange.

MED’s [Regulatory Impact Statement](#) (RIS), which recommended the FMA’s establishment, argued that consolidating financial market conduct regulation would provide greater clarity and certainty for firms and investors. The RIS also considered the pros and cons of a single financial regulator carrying out prudential and market conduct functions.

On the plus side, the RIS noted that this model could encourage the “development of economies of scale and the reduction of duplication. It would also provide a high level of role clarity and reduce costs for firms and investors by making it clear who they should deal with on particular issues” (p. 22). On the other hand, the RIS identified that a single integrated authority could lead to:

- problems associated with making an organisation too large (the separate parts of a very large organisation may not work together any better than two separate organisations)
- a lack of significant synergies between the prudential and financial market conduct mandates.

The RIS concluded that the FMA option was “preferable to the option of combining prudential and market conduct functions into a single regulator, which is unlikely to achieve the desired objectives more efficiently than [sic] the option of having separate prudential and market conduct regulators, while at the same time creating substantial additional costs” (p. 38).

# Appendix 2: Synergies and conflicts of interest in practice at the Reserve Bank

## Synergies between the LoLR role and prudential supervision

In practice locating the prudential mandate within the Reserve Bank has served New Zealand reasonably well.

The New Zealand financial system weathered the global financial crisis (GFC) well in comparison to other countries – the banking sector did not experience a major deterioration in asset quality, and non-performing loans remained low by international standards. However, turbulence in offshore funding markets did expose a long-standing concern for the Reserve Bank – the banking system’s reliance on wholesale market funding.

This prompted the Reserve Bank to act in its capacity to provide emergency liquidity assistance to the banking system – a move that was supported by the co-location with prudential supervision. Commercial bank treasurers came first to the Reserve Bank’s Financial Markets Department (FMD) to flag problems they were starting to experience. FMD shared this information with the Prudential Supervision Department (PSD), and decisions on the actions to take were made by internal committees that each had wide Reserve Bank representation and cross-membership.<sup>20</sup>

PSD’s role in bank supervision benefits from a flow of information from the operational parts of the Reserve Bank. This information includes:

- open market operations tied to monetary policy
- information acquired through financial market intelligence-gathering
- advice on warning signs that emerge from the Reserve Bank’s operation of its payment and settlement systems (the Exchange Settlement Account System [ESAS] and NZClear).<sup>21</sup>

In turn, the Reserve Bank benefits from having PSD’s expertise in and knowledge of the banking sector in-house when making decisions on emergency funding. These decisions require quick and decisive action and can be easily facilitated in an organisation that co-locates the prudential and financial market operations tied to monetary policy.

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<sup>20</sup> Note the internal organisational arrangements (e.g. department structure; internal committees) discussed in this appendix reflect those in place at the time of publication. The Reserve Bank is currently reviewing its internal organisational structure.

<sup>21</sup> ESAS, along with Real-time Gross Settlement, enables individual transactions between financial institutions to be settled electronically as the transactions happen. NZClear provides the financial markets with clearing and settlement services for high-value debt securities and equities.

## Synergies between monetary policy and prudential policy

Another area of synergy comes from the interrelationship of the Reserve Bank's price and financial stability mandates. Monetary policy and prudential policy benefit from being co-located because it enables coordinated decision-making with (non-statutory) internal committees that have overlapping memberships. Representation from other parts of the Reserve Bank on the respective committees enables unique insights and perspectives to be applied to policy deliberations.

Another synergy is the monitoring and analysis that goes into the production of the *Financial Stability Report* (FSR). The FSR analysis benefits from input from the Economics Department and their macro-economic expertise. In turn this macro-financial analysis can feed back into the Economic department's assessment of the wider economy and implications for the inflation forecast. PSD's knowledge of individual banks and aspects of their business (such as access to funding and their lending practices) are also important inputs to the FSR analysis.

The production of the FSR benefits from an editorial committee comprising Reserve Bank staff across a number of departments. The FSR is a product of the Macro-financial Department (MFD), which was formed in 2013 to support the Reserve Bank's new macro-prudential policy area.

The tools at hand to implement macro-prudential policy are fairly standard 'set and forget' prudential tools (capital, liquidity and quantitative restrictions on mortgage lending), but used in a pro-active or 'time-varying' manner to address the build-up of systemic risk over the cycle. MFD works closely with PSD on policy development, calibrating the toolkit, and deciding how the tools will be put to work in practice. Cross-membership of supporting committees is used to discuss the potential trade-offs between macro-prudential policy, the longer-standing prudential function, and monetary policy.

Stress testing (modelling economic scenarios and their effects on individual financial institutions and the financial system) is also a responsibility of MFD, and this requires close collaboration with staff from other departments.

## Synergies from consolidating prudential regulation and supervision

Synergies can be seen in PSD itself, owing to the co-location of teams responsible for policy development and the calibration of prudential requirements, and the frontline supervisors who are responsible for implementing those requirements and monitoring compliance among regulated entities.

There are also synergies in the co-locations of teams responsible for overseeing banks, NBDTs, insurers, and FMIIs.

Locating different prudential functions within the Reserve Bank provides potentially diverse career pathways for staff. There is considerable staff movement within PSD, between policy and supervisory teams, and between the supervisory teams responsible for monitoring banks and insurers.

## Staff capability and development

The Reserve Bank is conscious of the silos that can develop in an organisation tasked with a number of functions. It is always looking at how different teams and departments might work more collaboratively. For example, it encourages staff to move between departments and has formal policies for secondments and junior staff rotation, which also help to capitalise on potential synergies in different areas of responsibility. While these movements were limited before the GFC, the GFC itself and the subsequent focus on the Reserve Bank's financial system responsibilities have now made this commonplace.

Resourcing in this area has had a significant boost, supported by the creation of MFD and the additional functions given to PSD since 2008 (the regulation of NBDTs, the regulation and supervision of insurers, and the AML/CFT supervision of banks, life insurers, and NBDTs). However, the Reserve Bank's financial system activities are still under-resourced by international standards, a point underlined by the IMF in its 2016/17 FSAP for New Zealand. The Reserve Bank is also conscious of the need to attract the right mix of skill sets for its prudential functions (staff with industry experience, lawyers, actuaries, etc.), which can be a challenge given salary differences between the public and private sectors.

## Managing trade-offs and conflict of interests

It is important to note the potential conflicts of interest connected with locating prudential supervision in an entity that is also the monetary authority.

For example there are the following operational conflicts of interest which need to be managed:

- As part of its market operation functions the Reserve Bank has commercial banks as counterparties. This means 'Chinese wall' arrangements are needed to ensure that the Reserve Bank's financial markets area does not have insider information, such as on upcoming PSD supervisory actions.
- The Reserve Bank has a conflict of interest in its role as both the operator of the Exchange Settlement Account System (ESAS) and NZClear payment and settlement systems, and the monitoring body for these systems. It manages this by allocating these functions to different departments; for example, the monitoring function sits with PSD and operations sits with the Financial Services Group.

The Reserve Bank's internal governance arrangements are structured to support coordination across different policy areas, while acknowledging that potential trade-offs may arise from time to time.

The Reserve Bank has four internal policy committees:

- The Monetary Policy Committee (MPC), Assets and Liability Committee (ALCO), and Financial System Oversight (FSO) Committee, which are longstanding committees that have provided analytical support to the single-decision-maker model as defined in legislation and, since 2013, the internal (non-statutory) Governing Committee.
- MFC, which was established in 2010 with a specific focus on financial system issues and the development of a macro-prudential policy framework.

The three members of the Governing Committee (the Governor, the Deputy-Governor and the Head of Financial Stability, and the Assistant Governor and Head of Economics), sit on all four of these policy committees. Senior staff representing a range of disciplines are also members.

Each internal committee focuses on the objective of the relevant policy area. In the case of monetary policy it is price stability, and for prudential policy it is the soundness and efficiency of the financial system. However, the Reserve Bank recognises the interactions between, and the secondary effects on, price and financial stability, and ensures there is appropriate coordination between policy areas.

For example, the latest [policy targets agreement](#) for monetary policy states that, in pursuing the inflation target, the Reserve Bank shall “have regard to the efficiency and soundness of the financial system”.

Conversely, the 2013 Memorandum of Understanding (MoU) on macro-prudential policy states that the Reserve Bank will consider any interaction with monetary policy when setting macro-prudential policy, and will explain any implications for monetary policy. However, macro-prudential instruments may not be imposed for the primary purpose of achieving price stability – there must be a financial stability purpose. That said, the Reserve Bank recognises that some stakeholders have interpreted the use of loan-to-value restrictions as de facto monetary policy instruments. This suggests that further work is required in clarifying the objectives of macro-prudential policy and its relationship with monetary policy. These issues will be reviewed in subsequent consultation rounds.

## Minimising management distraction

Allocating specific functions to specific internal committees helps to ensure that senior managers dedicate time and effort appropriately, while also helping to ensure that any trade-offs are managed in-house.

The Reserve Bank also takes a risk-based approach to its prudential function to help ensure that its oversight of regulated entities is proportionate. Those entities with the greatest potential impact on financial system outcomes receive the most supervisory and management attention. That said, it can be challenging to get this balance right, and issues with smaller, non-systemic firms can, at times, attract a disproportionate amount of the Reserve Bank’s attention – as was the case with the insurer CBL since 2017. In an organisation that is fairly lightly resourced, such cases may be a distraction from the Reserve Bank’s core responsibilities – ensuring price stability, and the soundness and efficiency of the financial system.

## External coordination arrangements

Domestic external coordination and collaboration are facilitated through the Council of Financial Regulators (CoFR), which was established in 2013.

CoFR is an information-sharing body comprising the Reserve Bank, the FMA, MBIE, and the Treasury. It has a sub-body, the Banking Forum, which coordinates the work of several entities involved in bank regulation. The Banking Forum members are the four permanent CoFR agencies, the Ministry of Justice, and Inland Revenue.

The relationship between the Reserve Bank's financial system responsibilities and the FMA's financial market conduct role is supported by a 2011 MoU. Under the MoU the two agencies cooperate in areas of common interest with the aim of contributing to more effective and efficient financial system regulation. In doing so they are helping to identify emerging risks in the financial system and prevent unnecessary duplication. The Reserve Bank and the FMA are also working together on issues resulting from developments in Australia from their Royal Commission into *Misconduct in the Banking, Superannuation, and Financial Services Industry* (see brief discussion in in Appendix 3). Culture within banks and life insurers is a joint area of interest across the Reserve Bank's and the FMA's respective interests in prudential soundness and treating customers fairly. They are due to release a joint report on 5 November.

In the trans-Tasman context, the Reserve Bank works closely with APRA on supervisory issues related to the big-four Australian-owned banks.<sup>22</sup> For example, Reserve Bank frontline supervisors participate in APRA's on-site inspections of these banks' New Zealand subsidiaries.

In another trans-Tasman initiative, the Reserve Bank and other New Zealand agencies participate in the Trans-Tasman Banking Council (TTBC). Established in 2005, the TTBC monitors and coordinates home-host issues between the two countries, and where possible fosters coordination and harmonisation. A 2010 MoU sets out its high-level principles for promoting and reviewing crisis preparedness. The TTBC undertook crisis simulation exercises in 2011 and in 2017.

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<sup>22</sup> There is a MoU between the Reserve Bank and APRA setting out the framework for cooperation between the two authorities.



## Appendix 3: Financial sector institutional arrangements in Australia

Australia has a twin peaks model for financial sector regulation. The key participants in this model are:

- APRA, which specialises in the prudential regulation and supervision of banks and other authorised deposit-taking institutions, the insurance sector, and superannuation schemes<sup>23</sup>
- the Australian Securities and Investments Commission (ASIC), which is the conduct regulator<sup>24</sup>
- the Reserve Bank of Australia (RBA), which is the monetary authority. The RBA also has a mandate for financial stability, consistent with its role as liquidity provider, and oversight of payment, clearing and settlement systems
- the Council of Financial Regulators (CFR), which is a coordinating (and non-statutory) body established to contribute to the efficiency and effectiveness of financial regulation and promote the stability of the Australian financial system. The CFR is chaired by the RBA, with other members being APRA, ASIC and the Australian Treasury.

Australia's regulatory architecture arose from recommendations from the 'Wallis Inquiry', finalised in 1997. The new twin peaks model replaced a prior industry-based structure for regulation that was decentralised across states. APRA was established in 1998 from 11 predecessor agencies, including parts of the RBA (which had responsibility for banking supervision) and the Insurance and Superannuation Commission.

The changes were predicated on the following:

- Economies of scale from the elimination of duplicated functions in the 11 predecessor agencies, together with synergies from bringing together skill sets related to individual sectors.
- A more effective supervision of financial conglomerates.
- A separation of banking supervision from the RBA, which would enable both APRA and the RBA to focus on their primary objectives. Separation would also provide clarity that the central bank could provide liquidity support for the financial system, without the risk of implying regulated financial institutions might be guaranteed against insolvency.
- A reduction in supervisory costs for regulated entities on the one hand, and the development of a harmonised approach to the supervision of similar activities and risks on the other.

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<sup>23</sup> In 2006 APRA was given a financial stability mandate to complement an initial focus on the soundness of individual institutions. With the amendment to the APRA Act there is now an overarching requirement to "promote financial system stability". This role is shared with the RBA.

<sup>24</sup> ASIC was originally formed as the Australian Securities Commission (ASC) in 1991. ASIC was created in 1998 and assumed additional responsibilities for consumer protection in the deposit-taking, insurance and superannuation sectors.

The 'lender of last resort' (LoLR) role stayed with the RBA, but there was some concern that decision-making would be too slow as the RBA would no longer be as familiar with banks. It was suggested that APRA have a 'compulsory' ability to require LoLR from the RBA for a bank. This was not followed up as the CFR was set up to address this potential problem. Australian Parliamentary commentary at the time noted that the split would remove any possibility of coordination between monetary policy and the use of prudential tools.

The creation of APRA did realise benefits through reductions in duplication, particularly in corporate services. In addition, a lot of time was spent on upskilling staff to help realise potential synergies – this included training to familiarise staff from predecessor agencies with industries and issues they were less familiar with. However, the decision to consolidate the functions and agencies in Sydney, NSW, meant many frontline staff from other states left, and a lot of management time was spent on internal organisational issues during the transition (Australian House of Representatives Standing Committee on Economics, Finance and Public Administration, 2001, p. 14). The loss of staff, particularly those in insurance supervision, was partly implicated in the collapse of HIH Insurance in 2001. Changes that followed included a refocusing on the insurance sector and an increase in supervisory intensity in all the sectors under APRA's remit (APRA, 2014, p. 19).

Australia's regulatory arrangements were reviewed again during the 2014 Australian Financial System Inquiry. The final report (known as the Murray report after the independent committee's chair) noted that the twin peaks model had proven robust and effective during the GFC, and that Australia's regulatory structure did not require major change. However, it stated, "Australia needs strong, independent and accountable regulators to help maintain confidence and trust in the financial system, thereby attracting investment and supporting growth. This requires proactive regulators with the right skills, culture, powers and funding" (Australian Government, 2014, p. xx). Recommendations from the report included setting up a new Financial Regulator Assessment Board to allow the Government to assess the regulatory regime's overall performance, and improved funding arrangements and enforcement tools, particularly for ASIC. The Australian Government did not support the creation of an Assessment Board (Australian Government, 2015).

Regulatory arrangements in Australia are likely to be once again under the spotlight as a result of the current [Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry](#). The Royal Commission was established in December 2017 to examine whether any behaviour by financial service entities in Australia might have amounted to misconduct, and whether any conduct, practices, behaviour, or business activities by those entities "fall below community standards and expectations". An interim report was released in September 2018, suggesting that ASIC's remit might be too broad while arguing for annual reviews of regulator performance (including APRA) against legislative mandates (Australian Government, 2018, p. 299).

## Appendix 4: The UK model during the GFC

The UK's financial system did not fare well during the GFC. The regulatory architecture at that time centred on the integration of prudential and financial market conduct mandates in the Financial Services Authority (FSA), with external coordination with the Bank of England (BoE) and Her Majesty's Treasury (HMT).

Numerous official inquiries and other research into the poor performance of the UK's financial system in the crisis have put at least some of the blame on the nature of the UK's institutional arrangements.

For example, a [report](#) from the House of Lords' Economic Affairs Committee (2009) concluded that the UK 'tripartite' arrangements, between the BoE, the FSA and the HMT, did not work well. A number of issues became apparent:

- The BoE was responsible for emergency liquidity provision and macro-financial stability. However, although the FSA was willing and able to share information with the BoE, it was difficult to manage the three-way communications between the tripartite. This hampered the BoE's and HMT's ability to form a view on macro-prudential risks.
- Micro-prudential supervision had become too siloed. The FSA's focus on prudential supervision on a firm-by-firm basis meant it did not have an overall view of the systemic risks building up in the financial system as a whole.
- The FSA and the BoE had differing views on the trigger points for official action in response to stresses and risks building up in the system. The BoE appeared to be philosophically opposed to bailing out banks because of moral hazard, and HMT was frustrated at the BoE's slowness to react.
- A major problem (in HMT's view) was that no authority had clear overall responsibility for identifying, monitoring, and responding to risks building up in, and fault lines in, the system as a whole.
- The FSA Board and management seemed, in the lead-up to the GFC, to focus primarily on the FSA's financial market conduct function to the detriment of prudential regulation and supervision. For example, of the 'major topics' discussed by the FSA Board between January 2006 and July 2007, only one out of 61 related to bank prudential risks and issues. Of the items reported to the Board in the Chief Executive's report, one out of 110 related to bank prudential issues either in general or in relation to specific banks.<sup>25</sup>

The model also necessitated some degree of duplication between the FSA and the BoE. To fulfil its responsibilities, the BoE had a section dedicated to financial stability (including the publication of its *Financial Stability Report*), which included a number of people who in effect 'shadow-monitored' the soundness of the major financial institutions. Meanwhile, the FSA did have a (fairly small) central economic monitoring team undertaking sectoral overviews.

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<sup>25</sup> Taken from the [summary](#) of the FSA's report into the failure of the Royal Bank of Scotland, which is available on the UK Parliament website.

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