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RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Safeguarding the future of our financial system

The role of the Reserve Bank and how it should be governed

Consultation 1

Phase 2 of the Reserve Bank Act Review

November 2018

New Zealand Government

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Ministerial foreword

The Government's economic plan is designed to improve the wellbeing and living standards of all New Zealanders by building a productive, sustainable, and inclusive economy. A well-functioning, resilient, and efficient financial system has an important role in this. Our financial policy regulatory framework is a key driver of the performance of the financial system, and the Reserve Bank has a substantial role in shaping and delivering that regulatory framework.

The Reserve Bank derives its role, responsibilities, and functions from the Reserve Bank of New Zealand Act, which has been in place for nearly 30 years. In that time there have been many changes to the economy and the financial sector. The volume of transactions has increased and financial institutions have grown in size, complexity, and the range of financial services offered. The global financial system is now both larger and more interconnected than it was in 1989.

The standards and practice of financial policy have changed dramatically in recent years. Most advanced countries have undertaken significant reforms since the global financial crisis. At the same time, new international standards have been developed that increase the attention given to consistency and comparability across jurisdictions. The role and mandate of prudential regulators have increased both in New Zealand and abroad.

Changes to the Reserve Bank's statutory framework by previous governments have to date been implemented through a series of separate, targeted amendments rather than through a comprehensive review. The Coalition Government announced a two-phase review of the Act to ensure that New Zealand's monetary policy and financial regulation frameworks are fit for purpose. Phase 1 of the Review focussed on modernising the Act to improve our monetary policy framework and decision-making processes.

The second phase of the Review now provides an opportunity to ensure that the Reserve Bank Act is fit for purpose and able to provide a strong, flexible, and enduring regulatory framework that enjoys broad public and industry support.

Hon Grant Robertson
Minister of Finance

Executive Summary

This consultation document is seeking views on the role the Reserve Bank should have in safeguarding New Zealand's financial system, and how the Reserve Bank should be governed. You are invited to provide your views on these important issues. Submissions on the consultation document and the questions it asks are welcome by 25 January 2019. An easy-access guide to this consultation has been prepared and is available at http://treasury.govt.nz/rbnz-act-review.

Last year the Government announced that it would undertake a review of the Reserve Bank of New Zealand Act 1989 (the 'Review'), with the aim of modernising the Reserve Bank's monetary and financial policy frameworks and its governance and accountability arrangements.

The Review is one of the Government's initiatives to "grow and share New Zealand's prosperity more fairly". It supports the development of a productive, sustainable, and inclusive economy.

Phase 1 of the Review (which is largely complete) focused on improving the Reserve Bank's monetary policy framework, and led to Cabinet announcing agreed policy changes in March 2018.

Phase 2 (the subject of this consultation document) focuses on the Reserve Bank's financial policy framework. This framework underpins the Reserve Bank's role in prudential regulation and supervision, which aims to ensure that financial institutions adequately manage their own financial risks and the risks they collectively pose to the financial system. Phase 2 also considers other matters, such as how the Reserve Bank is governed.

The terms of reference for Phase 2 are broad and comprehensive, so the consultation has been split into three rounds. This first round focuses on five key topics that are important in shaping the Review outcomes. They are summarised below.

1. What high-level financial policy objectives should the Reserve Bank have?

The Reserve Bank's high-level financial policy objective is to **promote the maintenance of a sound and efficient financial system**. This objective:

- defines the Reserve Bank's purpose as a regulatory authority
- provides the focus for the work of Reserve Bank staff
- provides the context for other lower-level objectives directed at specific financial sectors, such as banks, non-bank deposit takers (NBDTs), and insurers
- provides a benchmark for holding the Reserve Bank to account for the performance of its financial system responsibilities.

A sound and efficient financial system is a critical foundation for a sustainable and productive economy. While the Reserve Bank's current financial policy decisions are focused on safeguarding our financial system, they also affect the everyday lives of New Zealanders in a multitude of ways – from influencing the cost of borrowing and the returns to saving, to affecting the availability of credit for households to buy homes and businesses to invest. The Reserve Bank's legislative objectives guide all of these policy decisions – deciding what these objectives should be is a key focus of this review.

Chapter 2 asks whether 'soundness' and 'efficiency' are still appropriate goals for the Reserve Bank's financial system role, and whether they need to be clarified. They are not defined in legislation and can be widely interpreted – and the relationship between them is not clear. Do they work together or conflict with one another? If there are trade-offs, how should the Reserve Bank prioritise one over the other?

In parallel with this, the consultation document asks whether the Reserve Bank should be given more high-level objectives, such as in the areas of competition, consumer protection, and promoting public trust and confidence.

Chapter 2 examines the pros and cons of five potential high-level objectives: financial soundness; efficiency; competition; consumer protection; and public confidence. It evaluates the potential definition of each term, as well as its ideal place in the legislative hierarchy (as a high-level objective, as a lower tier objective, or excluded from the Reserve Bank's legislation).

2. Who does the Reserve Bank regulate and how should the regulatory perimeter be set?

The 'perimeter' for prudential regulation is the boundary between entities required to operate according to certain prudential rules and requirements, and those that are not. This consultation round asks whether the current perimeter is appropriately targeted and capable of adapting to emerging risks.

The Reserve Bank currently regulates three sectors – banks, NBDTs, and insurers – and each has its own prudential regime. In addition, a process is currently underway to enhance the oversight regime for financial market infrastructures (FMIs). Banks and NBDTs are both regulated to address the risks from borrowing and lending, and Chapter 3 asks whether it may be more efficient to integrate them into one regime. This is the more common approach in other countries.

In the wake of the 2007/08 global financial crisis, there has been growing recognition of the risks to financial stability of entities that do not fit neatly into existing regimes, such as 'shadow banks' and FinTech. Regulators are also using macro-prudential tools that can potentially be applied beyond the traditional prudential perimeter. Chapter 3 therefore asks whether it would be desirable to provide greater flexibility for the perimeter to adjust or develop over time.

3. Should there be depositor protection in New Zealand?

Unlike almost all other advanced countries, New Zealand does not have a formal system for protecting depositors against the risk of losing their deposits if a registered bank or NBDT fails.

Instead, those making deposits are encouraged to do so responsibly, as neither the deposit-taking institutions nor the government promise to protect them from the consequences of their actions. This approach also incentivises institutions taking deposits to act responsibly in managing their risks.

While these disciplines may help support financial stability, some form of special treatment of depositors could help to meet public policy objectives – especially given that ordinary depositors may be less aware than others of the risks of placing their money in a bank or NBDT, and deposit accounts provide essential transactional services that make it easy for people and organisations to buy and sell goods and services.

Depositor protection could also support financial stability by reducing the risk of a 'bank run', while helping to underpin depositor confidence and trust in the financial system. However, in keeping depositors 'safe' through some form of protection, someone else will have to bear the losses if a deposit-taking institution fails.

With these potential objectives and costs in mind, Chapter 4 considers three options:

- The **status quo** – this would leave New Zealand with no formal depositor protection mechanism. However, the Reserve Bank does have an Open Bank Resolution policy, which when used can protect depositors from a small amount of loss when a bank gets into difficulty.
- Depositor **preference** – this involves ranking the claims of ordinary depositors within the legal framework ahead of other general creditors if a deposit-taking institution is liquidated. Depositors with a preference would be less likely to lose money (and more likely to be repaid) than general creditors, but would still not be immune from loss.
- A deposit **insurance scheme** (sometimes called a guarantee or compensation scheme) – this would pay eligible depositors up to a pre-set maximum amount or 'coverage limit'.

4. Should prudential regulation and supervision be separated from the Reserve Bank?

Under New Zealand's current financial regulation model, the Reserve Bank is responsible for prudential regulation and supervision, and the Financial Markets Authority is the 'conduct' authority with an objective to promote and facilitate the development of fair, efficient, and transparent financial markets. Belgium, the Netherlands, and the United Kingdom use a similar model, but in other countries with similar models (e.g. Australia and Canada) the prudential authority is separate from the central bank.

Chapter 5 looks at the pros and cons of the central bank having a prudential mandate. The arguments in favour typically focus on the coordination benefits of grouping functions that are complementary to a degree (e.g. prudential regulation, lender of last resort, and monetary policy) and where synergies can be exploited. Arguments in favour of separation tend to focus on some tension or trade-off between monetary policy and prudential regulation.

The variety of institutional models around the world suggests there is no 'best' regulatory arrangement. Instead, they tend to reflect the size and nature of each financial system, experiences in dealing with past financial crises, and a broad range of legal, historical, cultural, and political factors. All models have advantages and disadvantages and all involve trade-offs.

Since the global financial crisis, arguments have tended to be more in favour of assigning a prudential mandate to the central bank. Today, in close to two-thirds of all countries, the central banks have prudential authority for the banking systems.

Chapter 5 discusses three options for New Zealand:

- An '**enhanced status quo**' based on potential changes to the Reserve Bank's objectives, governance, or funding as a result of this Review
- A separate '**New Zealand Prudential Regulation Authority**' (similar to Australia's)
- A separate '**New Zealand Financial Services Authority**', which would be responsible for prudential regulation and financial market conduct regulation. For example, Germany, Switzerland, and the Nordic countries use this model.

Each option's strengths and weaknesses are assessed against four general criteria: focus, synergies, conflicts of interests, and cost.

5. How should the Reserve Bank be governed?

Governance encompasses the way an organisation is controlled and operates, the mechanisms by which it and its people are held to account, and the people who make particular decision types.

As a public sector organisation – to which Parliament delegates specific functions and responsibilities – the Reserve Bank's governance regime is different from that of private sector organisations. As well as having the above characteristics, it involves the allocation of responsibilities between elected officials and the Reserve Bank, and how elected officials oversee the Reserve Bank's performance.

Currently, the 'governing body' of the Reserve Bank is the **Governor** (the 'single decision-maker'). The Governor also serves as the Reserve Bank's Chief Executive Officer (CEO). The **Reserve Bank Board** is the principal monitor of the Governor's performance on behalf of the Minister of Finance. The Board is not a 'board' in the conventional sense, as it is not the governing body.

This arrangement will change as a result of Phase 1 of the Review, which led to the establishment of a **Monetary Policy Committee** (MPC). The group of four internal Reserve Bank officials (of whom one is the Governor) and three external members will take responsibility for monetary policy decisions away from the exclusive domain of the Governor.

Chapters 6-9 examine whether the scope of the Reserve Bank's operational independence in financial policy needs to be defined more clearly, and whether further changes to the Reserve Bank's governance arrangements are desirable.

The scope of operational independence

The terms of reference for Phase 2 note the importance of the Reserve Bank's operational independence and the need to ensure that it is protected. Chapter 7 examines three issues relating to that independence:

- The Minister's role in clarifying the Reserve Bank's financial policy objectives
- The Minister's role in approving various policies and decisions
- Who should be the 'steward' of primary legislation.

Changes to governance arrangements

Chapter 8 considers the pros and cons of the Reserve Bank's governance arrangements moving away from a single-decision-maker model to a more typical board structure. This would see a board take formal responsibility for all the Reserve Bank's functions except monetary policy, which will be covered by the MPC.

The board would be responsible for the oversight of the Reserve Bank's performance, strategic guidance, risk and audit, operational policy, and important decisions relating to financial policy. It would typically delegate corporate functions to the Governor as CEO, and financial policy functions to the Governor, senior staff and internal committees. This model is consistent with the structure of State sector organisations set up as Crown entities.

In addition, a **Financial Policy Committee** could be established, with formal responsibility for financial policy decisions (just as the MPC will be responsible for monetary policy decisions). This consultation round looks at the merits of such a committee against criteria including the complexity of financial policy decisions, the breadth and depth of these decisions, and flexibility required in times of crisis.

Accountability

Alongside changes to governance arrangements, the Review considers how the Reserve Bank should be held to account, including who should monitor its performance. It examines the pros and cons of a dedicated **supervisory council** (similar in concept to the Reserve Bank Board), and compares this to shifting the monitoring role to a Crown-entity-style **monitoring department** (e.g. the Treasury).

Background to this consultation document

In November 2017 the Government announced a review of the Reserve Bank of New Zealand Act 1989 (the Reserve Bank Act), with the aim of ensuring that the Reserve Bank's monetary and financial policy frameworks are the most efficient and effective for New Zealand.

A glossary at the end of this document explains many of the technical terms used in this document.

In December 2017 the Minister of Finance established an Independent Expert Advisory Panel to support and advise the officials undertaking the Review.

What does the Review involve?

The Review has two phases:

- Phase 1 (which is largely complete) focused on improving the Reserve Bank's **monetary policy framework**. Final Cabinet decisions were announced on 26 March 2018. These included a decision to add 'maximum sustainable employment' to 'price stability' as an objective of monetary policy. In addition, Phase 1 instituted a 'Monetary Policy Committee' (MPC), which will operate from within the Reserve Bank, make decisions on monetary policy, and include a minority of external members. The legislative changes needed to support Phase 1 are now underway.[1]
- Phase 2 (the subject of this document) focuses mainly on the Reserve Bank's **financial policy framework**, which provides the basis for prudential regulation and supervision. Phase 2 also deals with the Reserve Bank's governance arrangements. The Minister of Finance released the terms of reference for this phase on 7 June 2018.[2] As part of preparing the terms of reference, the Independent Expert Advisory Panel talked to a range of stakeholders about the Reserve Bank's role and its effectiveness in meeting its financial policy objectives.

Phase 2 is being carried out by a Review Team comprising members of both the Treasury and the Reserve Bank, and is overseen by a Steering Committee that will make policy recommendations to the Minister of Finance as the Review progresses. In addition, the Independent Expert Advisory Panel (which now has three additional members) will continue to contribute to and challenge the Review Team's work.[3] The chair of the Independent Expert Advisory Panel is also a member of the Steering Committee.

This Review is distinct from the Financial Services Conduct and Culture Review, which is being led by the Financial Markets Authority (FMA) and the Reserve Bank.

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1 You can find further information on Phase 1 at https://treasury.govt.nz/news-and-events/reviews-consultation/reviewing-reserve-bank-act/phase-1-reviewing-reserve-bank-new-zealand-rbnz-act

2 You can find the terms of reference for Phase 2 at https://treasury.govt.nz/news-and-events/reviews-consultation/reviewing-reserve-bank-act/phase-2-reviewing-reserve-bank-new-zealand-rbnz-act

3 The Independent Expert Advisory Panel for Phase 2 consists of Suzanne Snively (Chair), Malcolm Edey, Girol Karacaoglu (the original members of the panel) along with Belinda Moffat, Barbara Chapman and John Sproat. You can find further information on the panel at https://treasury.govt.nz/news-and-events/reviews-consultation/reviewing-reserve-bank-act/independent-expert-advisory-panel and https://www.beehive.govt.nz/release/reserve-bank-review-panel-appointments.

Where do you fit in?

Phase 2 will include three rounds of public consultation, in which you and other stakeholders are invited to take part (see Figure A). This document applies to the first round, and covers topics that will be crucial in shaping the Review's overall outcome, such as:

- the Reserve Bank's overarching objectives
- the 'perimeter' for prudential regulation
- the case for and against depositor protection
- the case for and against separating prudential supervision from the Reserve Bank
- the Reserve Bank's institutional governance and decision-making framework.

First group of topics

Once the first round of consultation is complete – and using the information and feedback it provides – a second round of consultation planned for 2019 will consider other issues covered by the terms of reference, such as:

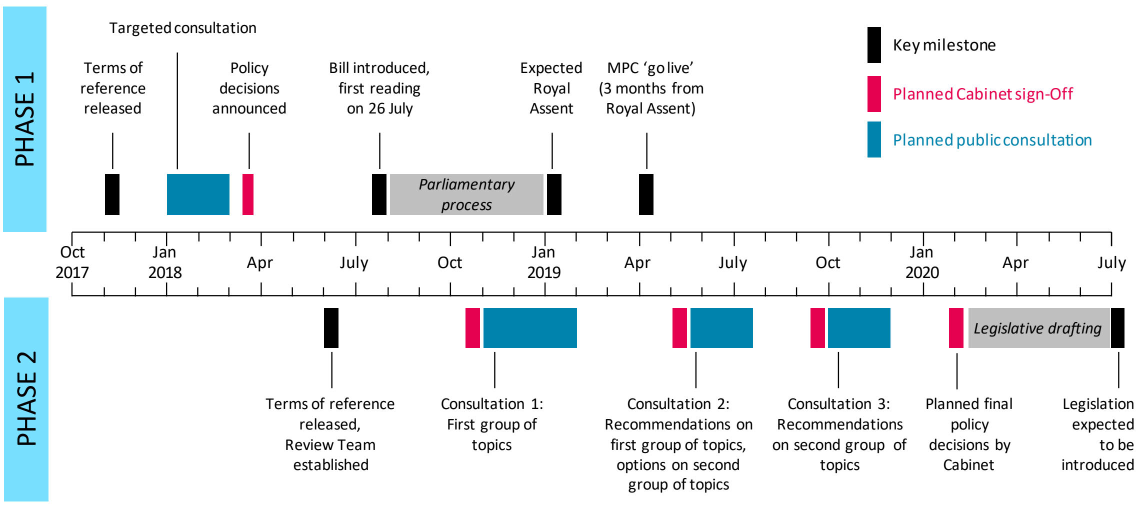
- the legal basis for bank regulation
- the approach to supervision and enforcement of bank regulation
- macro-prudential policy
- crisis management
- the Reserve Bank's resourcing and funding.

Second group of topics

The second round will also seek feedback on the preferred options developed as a result of this first consultation. A third and final consultation later in 2019 will seek feedback on the preferred options developed from the second consultation. After that, final recommendations will be delivered to the Minister of Finance.

Throughout this consultation comments are invited from everyone who has an interest in the future of New Zealand's financial system, including financial market participants, businesses, and all members of the public. The Review Team welcomes your feedback on all topics and the options for change – your views will help to ensure that the Reserve Bank's legislation is fit for the future.

Figure A: Illustrative timeline of the Review



Questions for consultation

Your views are sought on the following questions:

What high-level financial policy objectives should the Reserve Bank have? (Chapter 2)

1. Are the Reserve Bank's existing high-level financial policy objectives still appropriate and fit for the future?
   a) Should 'soundness' remain a high-level financial policy objective of the Reserve Bank, or would a 'financial stability' objective be more appropriate?
   b) What role should the Reserve Bank play in promoting 'efficiency'? Should it have a narrow mandate (e.g. focused on regulatory efficiency) or a broad one (e.g. including allocative efficiency and promoting sustainable growth)?
   c) Should 'efficiency' remain a high-level objective of the Reserve Bank, or should it be demoted to a lower tier of the legislation?
2. Should the Reserve Bank be given additional high-level financial policy objectives?
   a) How many high-level financial policy objectives should the Reserve Bank have – are the gains of having multiple objectives worth the costs of lost focus?
   b) Should 'competition' be promoted to a high-level objective of the Reserve Bank, or should it remain as a lower-tier objective?
   c) Should 'consumer protection' be added to the Reserve Bank's objectives?
   d) Should 'public confidence (or trust)' be reinstated as a high-level financial policy objective of the Reserve Bank?
   e) Are there any other objectives you think the Reserve Bank should be given?

Who does the Reserve Bank regulate and how should the regulatory perimeter be set? (Chapter 3)

3. What are your views on the costs and benefits of moving from the current perimeter to an ADI (authorised deposit-taking institution) type of framework? Based on your views, is this an issue worth pursuing?
4. Is new legislation the most appropriate way to adjust the prudential perimeter, or could a timelier mechanism be better? What accountability processes would be necessary to accompany any new mechanism?

Should there be depositor protection in New Zealand? (Chapter 4)

5. Have the key benefits of the status quo and the identified depositor protection options been correctly identified?
6. Is the high-level assessment of the risks and costs under the status quo and the identified depositor protection options reasonable?

7. On balance, do the arguments support a case to progress work on depositor protection in New Zealand? Why or why not? If yes, which protection approach do you prefer and why?
8. (To the extent possible) what are the potential implications of your preferred approach to depositor protection, for depositors, other bank creditors and investors, banks and other financial firms, taxpayers, and the operation of the New Zealand financial system?
9. Are there any alternative protection options, design principles, or complementary policies that could improve outcomes for the stakeholders identified above?

Should prudential regulation and supervision be separated from the Reserve Bank? (Chapter 5)

10. In your view, have the key conceptual arguments both **for and against** assigning a prudential role to a central bank been considered? If not, what other important arguments are there?
11. In the New Zealand context, are there any significant problems associated with locating monetary and prudential policy within the Reserve Bank (i.e. the status quo)? If so, how would 'separation' address these problems?
12. Do you agree that the three alternative models for institutional arrangements (a New Zealand Prudential Regulation Authority, a New Zealand Financial Services Authority and an 'enhanced status quo') are the correct options to consider? If not, please suggest any alternative options of institutional arrangements not discussed here. Please indicate your preferred option, and your reasons for preferring it.
13. What do you consider would be the main impact on relevant stakeholders (industry, ordinary depositors etc.) arising from each option?
14. Do you agree with the evaluative criteria and the assessment of the three options? If not, please suggest any evaluative criteria and/or alternative assessment you think should be included here.
15. If the 'enhanced status quo' is your preferred option, what features of this option are likely to be most important in addressing any problems you might see with current arrangements?

What should be the scope of the Reserve Bank's operational independence? (Chapter 7)

16. Do you consider there is a case for a Ministerial role in clarifying the Reserve Bank's financial policy objectives?
17. If the Reserve Bank's objectives are to be clarified:
    a) what should the Minister of Finance's role be?
    b) what other mechanisms could be used to clarify the Reserve Bank's objectives?
18. Do you think there is a case for making the Reserve Bank's operational independence more explicit, for example by removing the requirement for Ministerial consent for certain policy instruments and direction powers? If so, will this require any process or governance changes?
19. Should the administration of the Reserve Bank Act (and other Acts creating regulatory regimes operated by the Reserve Bank) remain with the Reserve Bank or transfer to the Treasury?

How should the Reserve Bank be structured? (Chapter 8)

20. Should the governing body of the Reserve Bank be a single decision-maker or a board? What are the key considerations in support of your view?
21. Should there be a Financial Policy Committee, and if so, what should it do? What are the key considerations in support of your view?
22. Are there any other legislative structures for the governance of the Reserve Bank's powers and functions that you think should be considered?

How should the Reserve Bank be monitored and held to account? (Chapter 9)

23. Who should monitor the Reserve Bank? What do you see as the key considerations in determining who the monitoring agent should be?
24. If the existing Board is retained as a monitoring agent only (e.g. in the form of a supervisory council), what changes do you see as necessary to improve its effectiveness?
25. Are existing statutory accountability and transparency requirements sufficient? If not, in what areas would you like to see more?

How you can contribute

This public consultation process provides New Zealanders with the opportunity to give their views on the future shape of financial policy in New Zealand, the appropriate role for the Reserve Bank in safeguarding the financial system, and how the Reserve Bank should be governed.

You are encouraged to make your views known on these important issues. An online form to assist you with providing written comments is available on the Treasury's website at http://treasury.govt.nz/rbnz-act-review.

All responses should be emailed to rbnzactreview@treasury.govt.nz. Alternatively, responses can be sent to the address below:

Phase 2 of the Reserve Bank Act Review
The Treasury
PO Box 3724
Wellington 6140

The deadline for submissions is **25 January 2019**.

Further information about Phase 2 of the Reserve Bank Act Review can be found on the Treasury's website at http://treasury.govt.nz/rbnz-act-review.

Questions about the consultation process can be sent by email to rbnzactreview@treasury.govt.nz.

Following the completion of the consultation process, the intention is to publish all submissions as well as a report summarising the key messages and emerging themes. If you have any objection to your submission or parts of it being published, please state this in your submission. If you wish your submission to be anonymised, please indicate this in your submission.

Submissions and the Official Information Act 1982

Submissions received are subject to the Official Information Act 1982 (OIA). Please set out clearly with your submission if you have any objection to any information in the submission being released under the OIA. In particular, clearly state which part(s) you consider should be withheld, and the reason(s) for doing so.

The OIA sets out reasons for withholding information. Reasons could include that the information is commercially sensitive or that you wish us to withhold personal information, such as names or contact details. An automatic confidentiality disclaimer from your IT system is not a reason to withhold information.

Your objections will be considered when responding to requests under the OIA.

Part A: What role should the Reserve Bank play in safeguarding New Zealand's financial system?

Key topics covered in Part A

This Part focuses on the Reserve Bank's role in New Zealand's financial system and how it could evolve in the future.

Chapter 1 sets the scene by describing New Zealand's financial system, the purpose of the financial sector, why financial firms need to be regulated, who the main regulators are, the role of the Reserve Bank, and how the system has evolved in recent years. The Chapter then discusses some potential issues with New Zealand's financial system, which are the focus of Chapters 2-5.

Chapter 2 focuses on the Reserve Bank's high-level financial policy objectives. These have been in place for almost 30 years and help to define the Reserve Bank's role in the financial system. The key question for consultation is whether the existing objectives are still the most appropriate goals for the Reserve Bank, or whether they should be refreshed.

Chapter 3 outlines the firms the Reserve Bank regulates and how the boundary between regulated and unregulated firms is defined. This 'regulatory perimeter' could be adjusted to create a more unified, simple, and future-proofed regulatory regime. The key question is whether the potential benefits of adjusting the perimeter are worth the costs.

Chapter 4 explores the issue of depositor protection. Unlike most advanced countries, New Zealand does not currently have a formal depositor protection regime, so customer deposits are potentially at risk if a bank fails. The key question is whether the potential merits of a depositor protection regime outweigh the costs.

Chapter 5 explores whether the Reserve Bank should continue to have a prudential mandate, or whether this function should be moved to a separate agency. While the Government has expressed an initial preference that current responsibilities continue to sit with the Reserve Bank, it has tasked this Review with exploring this question further.

Additional details on the Reserve Bank's role in specific policy areas, including crisis management, prudential regulation and supervision, and macro-prudential policy will be addressed in a subsequent consultation in early 2019 once feedback has been received on the issues above.

Chapter 1: Introduction to New Zealand's financial system

Introduction

This Chapter provides background information on the purpose of the financial sector, why financial regulation is needed, who the main regulators are and a brief history of how New Zealand's regulatory framework has evolved, and notes some emerging challenges and opportunities. It also highlights some potential issues with the existing regulatory framework, partly prompted by comments and concerns raised by stakeholders, which are then addressed in Chapters 2-5.

What is the purpose of the financial system?

A stable and efficient financial system is a critical foundation for a sustainable and productive economy. The financial system affects the wellbeing and living standards of all New Zealanders and fulfils a number of important functions for the economy:

- **Intermediation** – the financial sector sits between savers and borrowers, using funds from savers (e.g. through deposits) and lending them to those who wish to borrow (e.g. households and businesses). This intermediary role allows the financial sector to pool resources so that a number of small deposits can be used to make a larger loan. Financial firms also create financial products that meet the needs of investors and borrowers, so capital (society's accumulated wealth) can be allocated to its most productive use. This includes issuing securities to savers at short maturities while extending loans to borrowers at long maturities – a process known as 'maturity transformation'.
- **Value exchange** – matching buyers and sellers of goods and services to facilitate trade. The ability to exchange goods, services, and assets is aided by a stable and reliable currency and payment and settlement systems. Trade enables individuals and countries to maximise welfare by focusing their economic output on areas where they have a comparative advantage.
- **Risk transfer** – matching participants with different risk appetites to allow risks to be distributed and diversified to those most willing and able to hold them. Risk should be priced efficiently to adequately compensate risk-takers for bearing risk. For example, bank accounts pay interest to compensate depositors (people and organisations that place money into accounts with institutions such as banks) not only for the time value of money but also for the risk of loss. Insurers provide a method for pooling risk and allow participants to manage their risk by paying a premium today to cover losses that may occur in the future. The financial system offers many forms of risk transformation.[4]
- **Liquidity** – allowing participants to convert certain assets into cash with minimal loss of value. This enables capital to be used effectively; firms and households do not have to hoard cash for unplanned expenditure. Central banks play an important role in providing the financial system with sufficient cash (or liquidity) so that the price of this cash is set at the official short-term interest rate. Central banks also act as a 'lender of last resort' (LoLR) where they provide cash to banks in exchange for assets during times of stress when the demand for cash is particularly high.

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[4] See Reserve Bank of Australia (2014) for a useful explanation of the different types of financial risk.

Central to all these functions is the notion of trust. Banks and other financial firms are able to fulfil these functions only to the extent that they are trusted by their customers to meet their obligations and commitments.

Why is financial regulation needed?

If left unchecked, some of the functions described above may not be performed effectively, leading to market outcomes that may be inefficient or socially undesirable. Such situations are referred to as market imperfections or failures. They include:

- **negative externalities** – a negative externality is an unintended consequence of an action undertaken by someone that has a negative effect on someone else who is not compensated. One example of this in the financial system happens when a financial firm takes excessive risk that could harm not just its own investors but the wider financial system
- **moral hazard** – when individuals or firms act irresponsibly and engage in risky behaviour because they believe they will not bear all losses (they are protected from the risk). For example, banks may take excessive risk if they believe the Government will bail them out if they fail (i.e. the 'too big to fail' problem). In New Zealand, some finance companies took excessive risk and failed to manage their cash flow prudently in the run-up to the 2007/08 global financial crisis (GFC). Subsequently the Government issued a sector-wide guarantee, which led some firms to take on even more risk. Some of these firms later failed and a portion of the losses was borne by the taxpayer
- **information asymmetries** – financial institutions may have access to more information than their customers, which can prevent the customers making informed decisions and lead to a mispricing of risk. For example, depositors may not have enough information or the necessary financial literacy to determine the riskiness of different banks and hence whether the rates of interest they receive on their savings are adequate compensation for that risk. Over half of New Zealanders do not know their deposits in banks are at risk if their bank were to fail (FMA, 2014b)
- **monopoly powers/market control** – a lack of competition or abuse of market power. High transactions costs and significant pricing power can develop when few firms provide financial products and services
- **under-provision of public goods and services** – the inadequate provision of financial products or services that benefit all members of society. Some financial products and services may be under-provided by the private sector because they are unprofitable and because they entail too much risk for little reward. For example, private insurers may be unwilling to provide earthquake insurance for high-risk areas, because of the high chance of losses.

The GFC emphasised the importance of comprehensive and effective financial sector regulation. It showed that, if left unaddressed, market failures could lead to a build-up of risks and precipitate a financial crisis. Historically, recessions accompanied (or caused) by financial crises have been more severe and resulted in a greater social costs than those without financial crises (Claessens et al, 2011).

Effective financial sector regulation can help to reduce the frequency and magnitude of such crises by reducing market failures – internalising externalities, ensuring adequate information is released to the public, and moderating excessive risk-taking. However, it is impossible to eliminate all financial risk nor is it desirable to do so, as financial risk is a key part of an innovative and dynamic economy.

Regulation imposes costs on institutions and the economy more broadly, so should strive to meet its goal without placing an undue burden on the financial ecosystem. The overall goal of regulation is to create a financial system that is efficient, sound, stable, fair, and transparent. High-quality regulation supports this goal by supporting confidence in the system, encouraging participation and prudent behaviour, and facilitating the efficient allocation of resources and risk in the economy.

Market failures can be hard to identify and can sometimes lead to 'regulatory' failures. Such failures include the inadequate intensity of regulation and/or supervision and unintended consequences (e.g. such as moral hazard and the distorted allocation of capital).

Regulation is not the only possible response to market failures. The government may also act to influence the financial sector in other ways (e.g. tax rules, or subsidies for certain sorts of lending, such as Welcome Home Loans). These functions are generally under the control of government departments.

In principle, central banks could also assist in the allocation of credit through their ability to issue physical and electronic cash and lend directly. However, in advanced economies this is not usually seen as a major role for the central bank, particularly outside crises. Tucker (2018) suggests that central bank independence in this area should be carefully controlled.

Financial regulation is typically undertaken outside government departments and within separate organisations that have varying degrees of independence from government. This delegation of responsibility from government to independent agencies is necessary to avoid the politicisation of the enforcement of financial sector regulation, while helping to promote a stable and consistent regulatory environment. Table 1 below describes the attributes and indicators of best-practice regulation.

Table 1: Attributes and indicators of best practice regulation

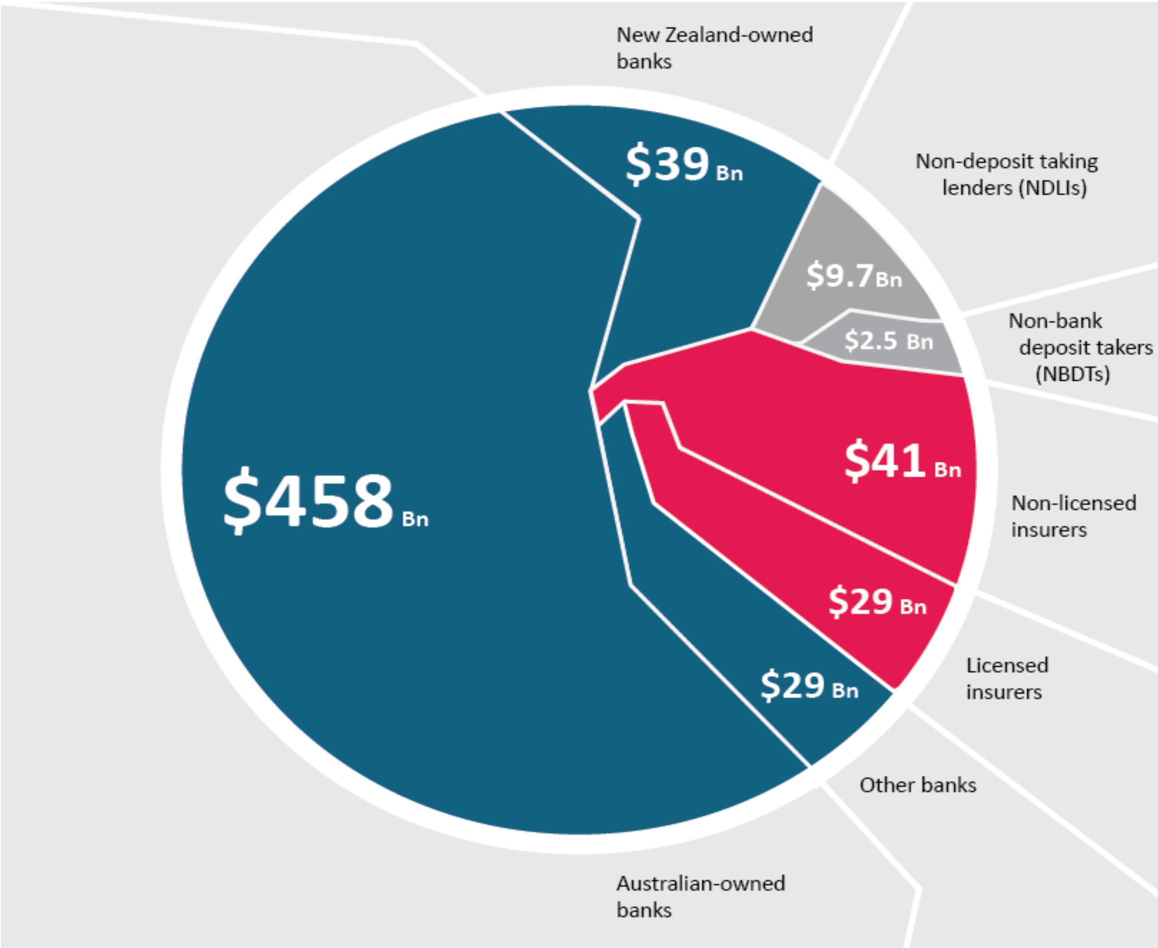
Growth compatible	Economic objectives are given appropriate weightings relative to other specified objectives, including factors contributing to higher living standards.
Proportional	The burden of rules and their enforcement should be proportional to the issues being addressed and the expected benefits of the regulation.
Flexible, durable	Regulated entities have scope to adopt cost-efficient and innovative approaches to meeting legal obligations. The regulatory system has the capacity to evolve in response to changing circumstances (such as market disruptions).
Certain, predictable	Regulated entities have certainty about their legal rights and obligations. The regulatory regime provides predictability over time.
Transparent, accountable	The development, implementation, and enforcement of rules are transparent (clear and easily understood by all those affected).
Capable regulators	The regulator has the people and systems necessary to operate an efficient and effective regulatory regime.

Source: Paraphrased from Treasury (2015).

What does New Zealand's financial system look like?

New Zealand's financial system is relatively simple by advanced-economy standards and is dominated by banks (Figure 1A).

Figure 1A: The relative size of selected financial institutions in New Zealand (by total assets)



Source: Reserve Bank of New Zealand

A bank is a financial intermediary that takes customer deposits (and other sources of funding such as equity and wholesale market debt), and lends them out as loans and mortgages. Banks also facilitate the transfer of money by providing payment services. In New Zealand, to use the word 'bank' (or any derivative thereof), a financial firm must register with the Reserve Bank. There are 26 registered banks in New Zealand, but the four largest banks – all Australian owned – account for 87 percent of bank assets. New Zealand's banking system is relatively small in dollar terms, but similar to the average of other OECD countries when compared with the size of the economy. In March 2018 the banking system's assets were worth $527 billion, equivalent to 186 percent of GDP.

Other sectors of the financial system are much smaller. Financial firms that offer deposit products, but are not registered banks, must obtain a non-bank deposit taker (NBDT) licence from the Reserve Bank. There are 25 licensed NBDTs in New Zealand, with a total asset value of $2.5 billion. In addition, there are other non-bank lenders that do not take deposits, and therefore are neither banks nor NBDTs. These other lenders have total assets of $9.7 billion.

New Zealand's insurance sector has around $70 billion in total assets, equivalent to 25 percent of GDP. The sector is split between 90 licensed private insurers and an unlicensed sector. The Reserve Bank regulates and supervises licensed insurers. The three largest unlicensed insurers are all government owned (the Accident Compensation Corporation, the Earthquake Commission and Southern Response Earthquake Services), while the remainder of the unlicensed sector is made up of small private insurers.

In addition to financial firms, New Zealand's financial system includes capital markets. These markets involve the buying and selling of bonds (debt) and equity instruments. Capital markets are used to fund investment or facilitate takeovers, and to provide risk mitigation and diversification.[5] These markets are small compared with the size of the banking sector. The total value of the stock market is around $135 billion, the total value of the domestic private debt market is around $132 billion, and the fund management sector has around $125 billion of assets (domestic and offshore) under management.

Who regulates New Zealand's financial system?

New Zealand operates a 'twin peaks' model for financial regulation. The twin peaks model sees regulation split into two broad functions: **conduct regulation** and **prudential regulation**.

- Conduct regulation focuses on behaviours and outcomes in financial markets. Conduct regulation aims to ensure that consumers are adequately informed and that regulated entities act fairly, transparently, and 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's twin peaks model, the Reserve Bank is currently responsible for prudential regulation and the FMA is responsible for conduct regulation. Both agencies have operational independence from government, and have their objectives and functions set out in legislation.

The twin peaks agencies are complemented by a number of other financial regulators and policy agencies (see Figure 1B), each of which has specific objectives and functions that interact with the others.

Several other countries have twin peaks regulatory models, including the United Kingdom and Australia. However, in the case of the latter, responsibility for the prudential peak rests not with the central bank but with a separate agency (the Australian Prudential Regulation Authority, APRA).

The roles of New Zealand's key financial regulators are outlined below.

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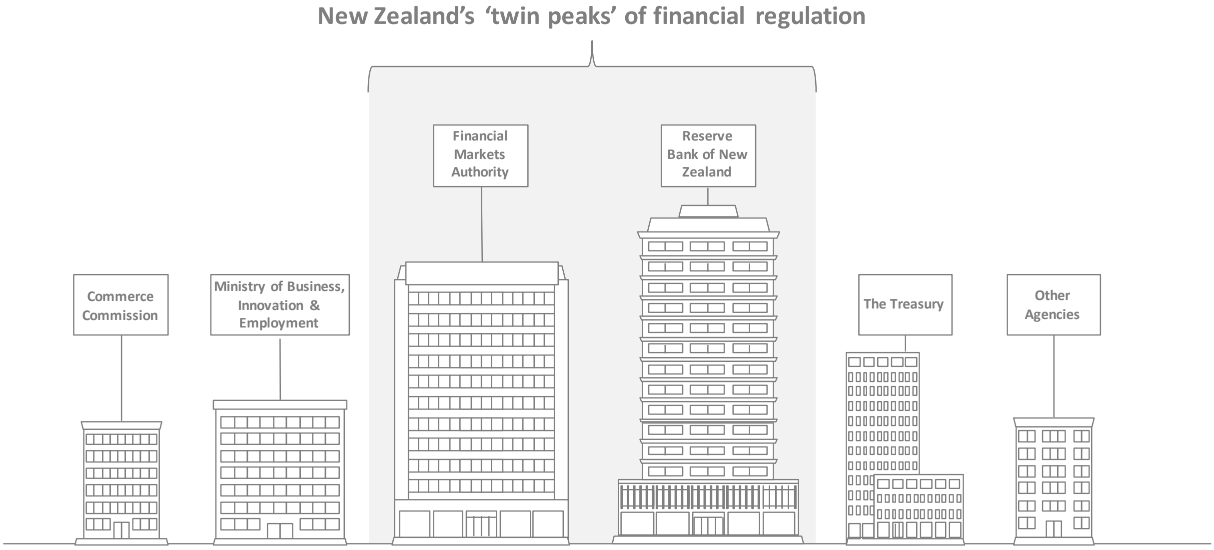
5 For an overview of New Zealand's capital markets and the role they play in the functioning of the financial system and economy, see https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Bulletins/2015/2015may78-3.pdf.

Figure 1B: New Zealand's financial system regulators and policy agencies



The Reserve Bank of New Zealand – New Zealand's prudential regulator

As New Zealand's prudential regulator, the Reserve Bank is responsible for promoting the maintenance of a sound and efficient financial system. It does this both by monitoring the build-up of risks and vulnerabilities in the system, and through its role as the prudential authority for banks, NBDTs, and insurers. Prudential regulations, such as the requirement for banks to hold certain levels of capital, ensure that these institutions adequately manage their risks and the risks they collectively pose to the financial system. The Reserve Bank supervises banks and insurers (but not NBDTs) to ensure that they abide by the regulations and undertakes enforcement action when necessary.[6] The Reserve Bank is also responsible for 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:

- **banks** – registration, prudential regulation, supervision, and crisis management
- **insurers** – licensing, prudential regulation, supervision, and crisis management
- **NBDTs** – licensing, prudential regulation, and crisis management
- **macro-prudential policy** – systemic risk monitoring, policy formulation and implementation
- **payment systems** oversight and **settlement systems** designation (jointly with the FMA)
- supervising banks, NBDTs, and life insurers in relation to their obligations under the **Anti-Money Laundering and Countering Financing of Terrorism** (AML/CFT) Act 2009.

The Reserve Bank also has a number of other functions (see Box 1), some of which will be considered in detail later in the consultation process in 2019. The focus of this first consultation is on the Reserve Bank's role in financial policy and how the Reserve Bank should be governed.

6 NBDTs are separately supervised by trustees, licensed by the FMA.

Box 1: Other functions of the Reserve Bank

In addition to prudential regulation and supervision, the Reserve Bank has a range of other functions.[7] As Tucker (2018) explains in detail, many of these functions are enabled by the central bank's ability to create currency (New Zealand dollars in the Reserve Bank's case) and supply it to the financial system:

- **Setting interest rates (monetary policy)** – monetary policy involves changing the supply and price (interest rate) of money in the economy to manage the business cycle. Following Phase 1 of this Review, the two high-level objectives for monetary policy are expected to be: to achieve and maintain stability in the general level of prices over the medium term; and to support maximum sustainable employment.
- **Supplying banknotes and coins** – the Reserve Bank is the sole provider of physical currency. The Reserve Bank provides as many notes and coins as the financial system demands. There is an interaction or synergy here with monetary policy: for physical currency to be a store of value and viable medium of exchange, prices must be stable.
- **Being LoLR** – the Reserve Bank can support the banking system and economy during crises. In stressed situations, when banks are short on cash (liquidity) but have good-quality assets, they can borrow cash from the Reserve Bank. This helps the financial system to function throughout periods of market instability. The Reserve Bank needs to establish rules for this emergency lending and to scrutinise borrowers (King, 2016) – there are synergies between this and bank regulation.
- **Dealing in foreign currency markets** – the Reserve Bank's ability to 'create' New Zealand dollars and purchase foreign currency allows it to influence prices in foreign exchange markets and support monetary policy and financial stability objectives.
- **Providing settlement services** – the Reserve Bank acts as the banker for the banks by providing settlement accounts.

The Financial Markets Authority

As conduct regulator, the FMA's overarching objective is to promote and facilitate the development of fair, efficient, and transparent financial markets. 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.

[7] See the Reserve Bank's *Annual Report*, *Statement of Intent*, *Monetary Policy Statements* and *Financial Stability Reports* for more detail on how the Reserve Bank undertakes these functions.

The other agencies supporting New Zealand's twin peaks

The twin peaks of the Reserve Bank and the FMA are complemented by a number of government departments and independent regulators that address other aspects of regulation.

- The **Commerce Commission** is the competition and fair-trading regulator responsible for protecting consumers and promoting competition across the economy by enforcing New Zealand's competition, fair-trading, and credit contract laws.
- The **Treasury** and the **Ministry of Business, Innovation and Employment (MBIE)** are key Government representatives in the financial regulatory system. They represent the Government's interests and priorities and help to coordinate policy development between the regulatory institutions.
- The **Department of Internal Affairs**, alongside the Reserve Bank and the FMA, supervises various entities under the AML/CFT Act. The **Ministry of Justice** is responsible for AML/CFT policy development.

As policy and regulatory responsibilities are distributed across a number of agencies, it is important to have mechanisms to coordinate policy among them, where appropriate. This is particularly true in a twin peaks model. The objectives of financial stability and conduct regulation can at times diverge, requiring a mechanism for efficient and effective resolution of conflicts.

A number of coordination mechanisms exist, including various Memoranda of Understanding. Most of these arrangements are largely for information-sharing purposes and have no formal status.

The key domestic forum for financial regulators is the Council of Financial Regulators (CoFR). CoFR fosters high-level cooperation and information-sharing between the FMA, RBNZ, the Treasury and MBIE. It is a forum to consider and address any financial markets regulatory issues, risks or gaps that arise or are being monitored. This ensures a whole of government approach to manage regulatory risks.[8] CoFR's risk register also helps CoFR and core agencies to prioritise and monitor action on prudential, conduct and regulatory framework risks.

Coordination mechanisms, including trans-Tasman coordination with Australia's financial regulators, will be reviewed in the next consultation in early 2019, alongside relevant policy issues, once the Reserve Bank's role has been clarified.

Other financial sector entities

All providers of financial services must register on the Financial Service Providers Register. These providers must also be members of approved dispute resolution schemes so that consumers have avenues to resolve issues with financial market service providers.

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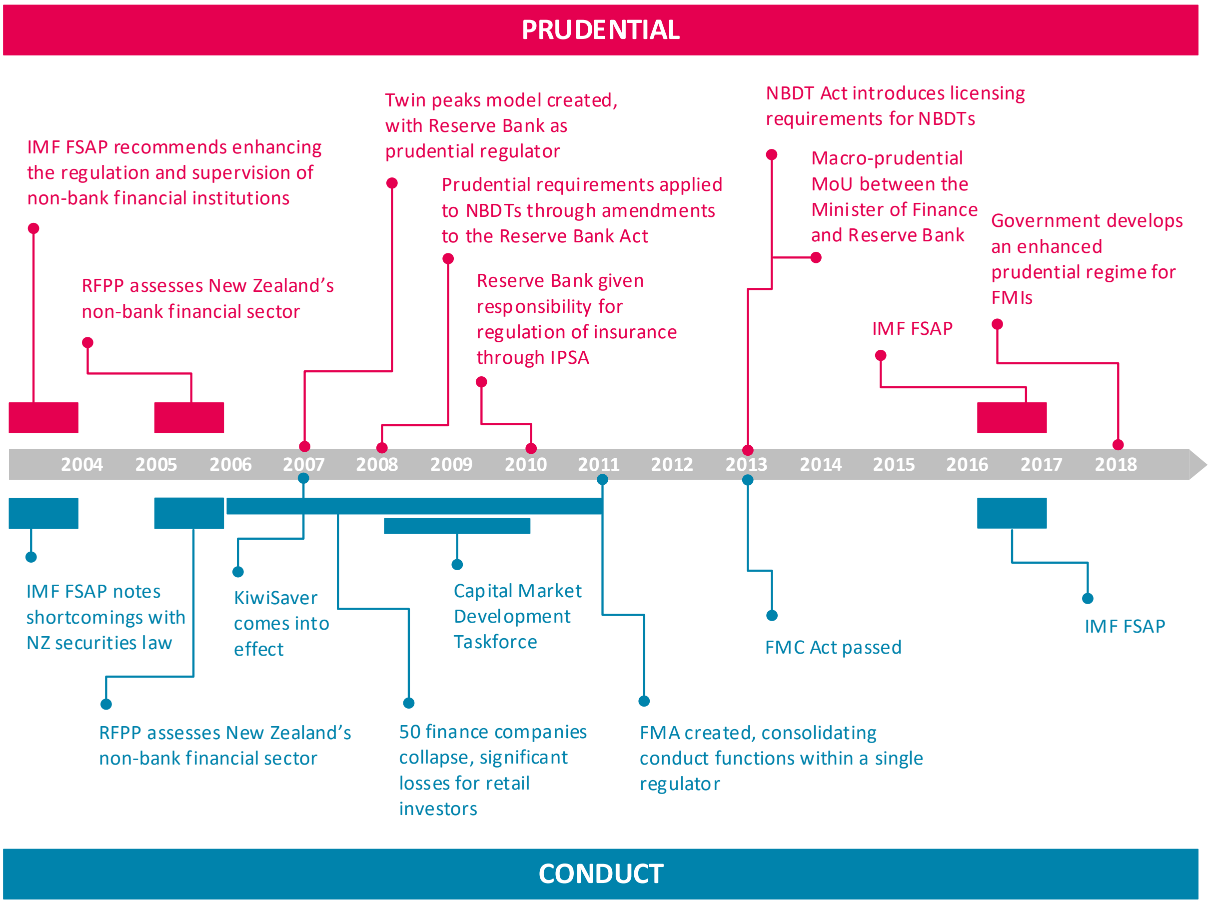
[8] From time to time, CoFR may invite representatives from other regulatory agencies and public authorities, as required.

How did New Zealand's financial regulatory system evolve?

The origins of New Zealand's twin peaks framework can be traced back to the mid-2000s (Figure 1C).

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). The goal of an FSAP is to gauge the stability of a country's financial sector, identify any potential sources of systemic risk, and evaluate the quality of the regulatory framework.

Figure 1C: The development of New Zealand's twin peaks framework



At the time of the 2003/04 FSAP, the Reserve Bank was only responsible for the prudential regulation and supervision of banks. The IMF identified a number of weaknesses with the regulation and supervision of non-bank financial institutions, such as insurance companies, NBDTs, and managed investment schemes. The regulatory framework for non-bank financial institutions was fragmented and insufficiently developed, and there were gaps in oversight.

The Government responded to the IMF's recommendations by completing a Review of Financial Products and Providers (RFPP) between 2005 and 2007. One of the key outcomes of the RFPP was a decision to consolidate prudential responsibility for NBDTs (in 2008) and insurers (in 2010), alongside banks, with the Reserve Bank.

While New Zealand's banking sector was only moderately affected by the GFC from a financial soundness perspective, the development of the NBDT regime occurred too late to prevent the failure of around 50 NBDTs (primarily 'finance companies'), beginning in 2006. In 2008, and largely in response to the RFPP and the failure of the finance companies, the Government appointed a Capital Market Development Taskforce (CMDT). The CMDT supported a shift to a more formalised twin peaks regulation model and prompted a broader review of securities law that saw a shift away from New Zealand's historical disclosure-focused model for securities regulation towards a focus on conduct.

The CMDT also made a number of recommendations designed 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 MBIE-led review that identified concerns with the fragmentation of market regulators and the adequacy of regulators' powers. The Government responded to the review with a similar consolidation to that which had occurred earlier in prudential regulation, creating the FMA in 2011 to provide oversight across conduct regulation.

Future challenges and opportunities

The financial system is dynamic – responding to opportunities and presenting new challenges. While there are many opportunities and challenges, two key topics (which are not unique to New Zealand) include the continual development of financial technologies (FinTech) and climate change.

FinTech's promise is to unbundle banking into the core functions of intermediation, value exchange, risk transfer, and liquidity (referred to above under the heading "What is the purpose of the financial system?"). It is being driven by new entrants and new modes of delivery: payment service providers, mobile applications, robo-advisers, peer-to-peer lenders, and digital currency platforms. FinTech presents both risks and opportunities. While many of the underlying risks remain the same (such as credit and liquidity risk, cyber risk, and information security), the way in which these risks present themselves is changing (e.g. the security of a debit card is different from the security of a mobile phone application). A more diffuse and dynamic financial sector presents a challenge for regulators to keep up with developments, but also provides opportunities for a more efficient financial system. Mark Carney has noted (Bank of England, 2017):

> Our starting point is that there is nothing new under the sun. We need to be disciplined about consistent approaches to similar activities undertaken by different institutions that give rise to the same financial stability risks. Just because something is new doesn't necessarily mean it should be treated differently. Similarly, just because it is outside the regulatory perimeter doesn't necessarily mean it needs to be brought inside.

Climate change is also disrupting the financial system through two main channels – risk and transition. Firstly, the increased risk of climate-related events, such as severe storms, floods, and drought, has financial implications. For example, the increased frequency of such events poses challenges for insurance pricing and availability and the use of physical assets as collateral for lending (such as a house in a region with a high risk of severe weather). Secondly, the financial system may need to adjust as part of the transition to a lower-carbon economy. One financial implication of the transition could include the reallocation of capital towards 'greener' investments as investor attitudes change and as incentivised or required by climate-related policies. Regulators face the challenge of ensuring that affected industries acknowledge climate-related risks and manage any transition costs, and ensuring that the financial system is resilient to these changes. The Reserve Bank's role with regard to climate-related policies will be considered alongside the prudential policy framework in later consultations.

This Review provides the opportunity to address potential issues with the Reserve Bank's current role in the system, and ensure that it is fit for purpose and sufficiently flexible to adapt to new developments and challenges.

Potential issues to consider in the New Zealand model

The Reserve Bank's roles and responsibilities have evolved over time as issues have been identified. However, during this process its overall objectives, roles, and structure have not necessarily been considered in a holistic manner and have not necessarily kept pace with the disrupted dynamics and emerging new players in the financial sector. In addition, while the twin peaks model does provide some role clarity and economies of scale (cost savings) across the regulatory system, there are some potential issues with the current regulatory framework.

The IMF's second FSAP for New Zealand, conducted in 2016/17, identified a number of areas where the system could be strengthened, and some stakeholders raised a number of issues during the scoping process of the Phase 2 Review. The issues raised are discussed below.

Are the Reserve Bank's objectives clear?

Clear legislative objectives are the bedrock of an independent regulator's role: they define the regulator's purpose for its staff, allowing them to prioritise and establish boundaries for their work, and they provide the means for the public to hold the regulator to account (OECD, 2014).

The Reserve Bank's overarching soundness and efficiency objectives were set almost 30 years ago and have provided the regime with significant flexibility. However, the legislation does not define soundness or efficiency, explain their relative weightings, or provide guidance on how to make trade-offs between them. For example, the Reserve Bank and stakeholders have struggled to interpret the Reserve Bank's efficiency objective (Bloor and Hunt, 2011) and a number of stakeholders consider that the Bank places too little weight on this objective. In addition, the FMA has an efficiency objective, creating a shared objective between the institutions.[9]

Some stakeholders also consider that:

- the Reserve Bank's objectives focus too heavily on the financial system as a whole, and that they should also place more emphasis on the stability of individual financial institutions and risks to depositors
- the Reserve Bank's objectives should be reviewed for their relevance and coverage.

Chapter 2 discusses potential high-level objectives for the Reserve Bank, and future consultations will consider whether additional lower-tier objectives should also be specified.

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9 Efficiency as it applies to the FMA is defined as improving competition in financial markets by (i) promoting the confident and informed participation of investors and consumers in financial markets and (ii) facilitating capital raising and promoting commercial certainty. See MBIE's Regulatory Impact Statement for more details.

Is New Zealand's financial regulation and supervision comprehensive enough?

Maintaining public trust in the financial system is crucial. A key part of establishing and maintaining this trust is the confidence that the regulatory framework for the financial system is robust and well calibrated and fit for the future. Over the years, New Zealand has built a relatively light-touch regulatory regime. However, both the IMF and some stakeholders continue to question whether this regime is comprehensive and intensive enough. This criticism applies to a number of regulatory areas, including conduct, competition, and prudential regulation.

Conduct – a number of reviews are taking place regarding the behaviour of financial institutions and market participants. These reviews indicate that there may be areas of the regulatory system that require further development. Ongoing reviews include:

- **conduct and culture** – the Reserve Bank and the FMA are jointly reviewing the conduct and culture of banks and life insurers. One of the purposes of this review is to check whether conduct issues, such as those exposed by the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, are present in New Zealand. MBIE is also currently reviewing the regulation of conduct in the insurance sector as part of its 'Insurance Contract Law Review'.
- **borrower protection** – the Credit Contracts and Consumer Finance Act 2003 was amended in 2015 to strengthen the level of consumer protection. The Commerce Commission enforces conduct regulation specific to consumer credit, but does not have a supervisory role under the Act.[10] MBIE is undertaking a review of the 2015 amendments. Submissions on the review have indicated that, despite the reforms, there is still a widespread problem of consumers being provided with loans that are unaffordable or unsuitable. These issues could indicate the need for some supervisory oversight in the consumer credit space.

Competition – the regulation of financial sector competition is currently reactive rather than proactive. The Commerce Commission is the primary competition regulator, but its actions are limited to mergers that would generate substantial pricing power, the regulation of natural monopolies, and anti-competitive behaviour.

The efficiency objective of the Reserve Bank could be considered to include competition. However, some stakeholders are uncertain whether this is the case. The responsibility for ensuring that the regulatory regime lowers, or does not increase, barriers to firm entry and promotes or encourages competition could be attributed (e.g. through regulatory principles) to the Reserve Bank in relation to its regulated entities and activities. This review provides an opportunity to consider whether the Reserve Bank should address such competition issues.

Prudential regulation and supervision – the IMF's 2016/17 FSAP raised some questions about some of the Reserve Bank's implementation of its prudential regulatory and supervisory functions. A number of stakeholders have also raised concerns about the Reserve Bank's ability to carry out its current roles and meet its current responsibilities. They have noted:

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[10] The Commerce Commission takes enforcement action based on prioritisation criteria, which take into account facts such as detriment, seriousness of conduct, and public interest.

- a lack of focus owing to it being tasked with multiple and potentially ambiguous objectives (as noted above)
- a lack of resourcing of prudential policy and supervision (which will be addressed in the next round of consultation)
- concerns about its governance (see Part B).

These concerns will be addressed in the review of the Reserve Bank's objectives (see Chapter 2) and governance structure (see Part B). A few stakeholders have also suggested that establishing a separate institution responsible for prudential regulation could address these issues. Chapter 5 considers the case for and against a separate prudential authority.

Who and what should the Reserve Bank be able to regulate and supervise?

The financial firms and activities that the Reserve Bank has the power to regulate or supervise are referred to as being within its 'regulatory perimeter'. They include banks, NBDTs, and insurers. The financial services landscape has changed markedly in the past 30 years and market failures can occur if firms outside the perimeter offer financial services that are unregulated and unsupervised. They can distort the market and potentially undermine the stability of the rest of the system.

The current regulatory perimeter lacks flexibility and has been slow to adjust to financial innovation and emerging risks. While the perimeter has expanded to include NBDTs and insurers, the method for expanding the perimeter to capture emerging risks has not been reconsidered in the past 30 years, since the current Reserve Bank Act was implemented. There are now a number of financial entities and activities outside the perimeter, so it is appropriate to consider **who** and **what** the Reserve Bank should regulate and supervise, and **how** the perimeter should be defined so that it is dynamic and durable for the long term. This is discussed in Chapter 3.

Should depositors be protected?

Deposits have an important role in the functioning of New Zealand's financial system. They allow people and organisations to participate in the New Zealand economy by facilitating transactions, while providing an important investment product. Deposits are also a major source of bank funding.

There are information asymmetries between depositors and deposit taking institutions (such as banks) that limit the ability of depositors to make informed decisions. However, depositors' interests are not explicitly protected in a bank failure; customers with deposits at the bank could lose some of their money, just like any person who has invested in the bank (i.e. shareholders and creditors other than depositors). However, there are trade-offs and costs associated with any form of depositor protection.

The Government could consider changing the law to protect customer deposits more than other creditors in a bank failure. Chapter 4 considers the case for and against this. A separate issue is whether the Reserve Bank should have an explicit lower-tier objective related to depositor protection. This could alter the Reserve Bank's regulatory choices (e.g. lead the Reserve Bank to force banks to operate more safely). Stakeholders supported a review of both matters.

Chapter 2: What high-level financial policy objectives should the Reserve Bank have?

The aim of this Chapter

The Reserve Bank's existing high-level financial policy objective is to:

Promote the maintenance of a **sound** and **efficient** financial system.

The two goals within this objective are important – they define the Reserve Bank's role in financial policy and are the basis on which the Reserve Bank is held to account for its policy decisions.

This Chapter examines whether 'soundness' and 'efficiency' are still the most appropriate goals for the Reserve Bank, or whether other high-level financial policy objectives should be considered to address the issues with New Zealand's financial system raised in Chapter 1.

The focus of the Chapter is solely on the Reserve Bank's **high-level** objectives. The Reserve Bank also has a number of **lower-tier** objectives, which apply to specific policy areas (e.g. crisis management) and sectors (e.g. banks and insurers). The Chapter does not seek to clarify what these lower-tier objectives should be as future consultations will address these issues directly.

The Chapter begins by outlining the importance of clear objectives and some potential issues with the Reserve Bank's existing objectives. The bulk of the Chapter then considers a range of high-level objectives and the pros and cons of including them in the Reserve Bank's mandate.

The importance of the Reserve Bank's objectives

Clear objectives are the bedrock of an independent regulator's role: they define the regulator's purpose for its staff, allowing them to prioritise and establish boundaries for their work; and they provide the means for the public to hold the regulator to account (OECD, 2014).

A sound and efficient financial system is a critical foundation for a sustainable and productive economy. The Reserve Bank has a major role in steering our economy and overseeing the financial system. While the Reserve Bank's financial policy decisions are focused on safeguarding our financial system, they also affect the everyday lives of New Zealanders in a multitude of ways – from influencing the cost of borrowing and the returns to saving, to affecting the availability of credit for households to buy homes and businesses to invest. The Reserve Bank's legislative objectives guide all of these policy decisions – deciding what these objectives should be is a key focus of this review.

The Reserve Bank currently has a range of 'objectives' that feature at different points in its legislation. Figure 2A provides a stylised illustration of the Reserve Bank's legislative pyramid.[11]

At the top of the pyramid is a purpose statement, which sets out the reason for creating the Reserve Bank Act and for giving the Reserve Bank its monetary and financial policy objectives. If recommendations from Phase 1 of this Review are enacted, this purpose statement will become:

The purpose of this Act is to promote the prosperity and wellbeing of New Zealanders and contribute to a sustainable and productive economy.

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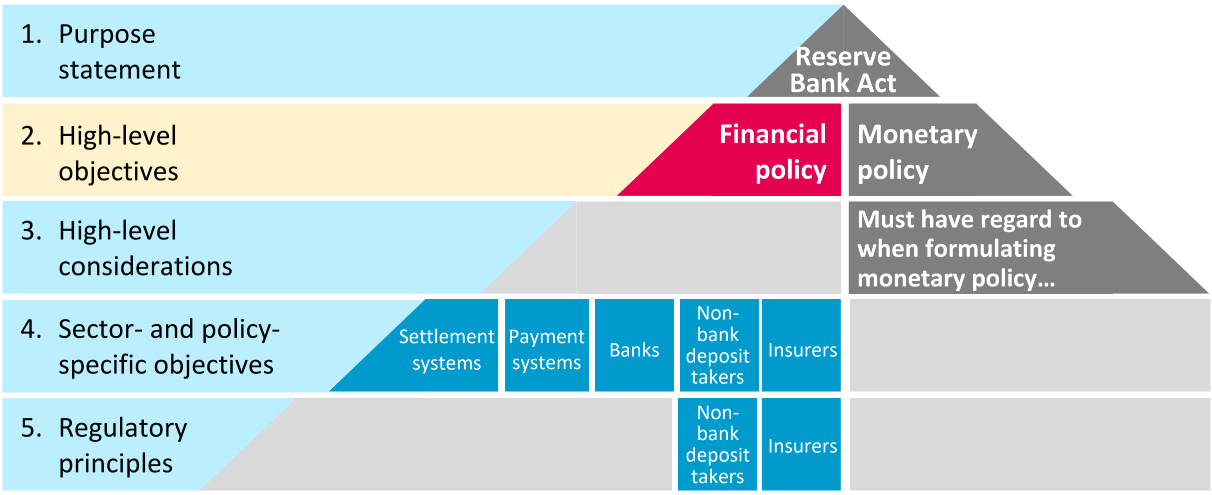
[11] There is some debate over what constitutes an 'objective' in the Reserve Bank's legislation. Figure 2A interprets the term broadly to capture any goals that the Reserve Bank must consider when formulating policy, then illustrates them in a stylised hierarchy. In reality, the legislation is not as clear cut. A key aim of this Review is to establish a clearer hierarchy and ensure it is reflected in the legislation.

Figure 2A: Stylised illustration of the Reserve Bank's legislative hierarchy of objectives



	Legislative examples
1. Purpose statement	**Reserve Bank Act:** "the purpose of this Act is to promote the prosperity and wellbeing of New Zealanders and contribute to a sustainable and productive economy", RBNZ (Monetary Policy) Amendment Bill, Section 1.
2. High-level objectives	**Financial policy:** "promote the maintenance of a sound and efficient financial system", RBNZ Act 1989, Section 1A. **Monetary policy:** "achieve and maintain stability in the general level of prices over the medium term, and support maximum sustainable employment", RBNZ (Monetary Policy) Amendment Bill, Section 8.
3. High-level considerations	**Financial policy:** none currently. **Monetary policy:** "the MPC must have regard to the efficiency and soundness of the financial system", RBNZ (Monetary Policy) Amendment Bill, Section 8.
4. Sector- and policy-specific objectives	**Deposit takers and settlement systems:** the Reserve Bank must avoid significant damage to the financial system that could result from the failure of: ▪ a registered bank, RBNZ Act 1989, Section 68 ▪ an NBDT, NBDT Act 2013, Section 3 ▪ a participant in the settlement system, RBNZ Act 1989, Section 156K. **Insurers:** promote public confidence in the insurance sector, IPSA 2010 Section 3.
5. Regulatory principles	**Insurers and NBDTs:** the Reserve Bank must take into account the following principles when performing its functions and exercising its powers: ▪ The need to avoid unnecessary compliance costs ▪ The need to maintain competition ▪ The importance of recognising that it is not the purpose of the Reserve Bank to eliminate all risk and that members of the public are responsible for their own decisions ▪ The desirability of providing consumers with adequate information to make informed decisions ▪ The desirability of sound governance of NBDTs/insurers ▪ The desirability of effective risk management by NBDTs/insurers. Paraphrased examples from NBDT Act 2013, Section 8 and IPSA 2010, Section 4.

This new purpose statement is intended to clarify that the Reserve Bank's monetary and financial policy objectives are not ends in themselves, but a means to support wider prosperity.[12] It is intentionally broad and therefore insufficient on its own to provide clarity on the Reserve Bank's role in policymaking – for that, additional objectives are required.

At the second layer of the pyramid is a set of high-level objectives that span broad policy areas and set the strategic direction for the Reserve Bank's work. These objectives are defined in the Reserve Bank Act, but also apply (and are replicated where relevant) in the Reserve Bank's other sector-specific legislation (IPSA 2010 and NBDT Act 2013). Phase 1 of this Review focused on updating the Reserve Bank's high-level objectives for **monetary policy**. This Chapter focuses on whether the Reserve Bank's high-level **financial policy** objectives also need refreshing.

Sitting below the high-level objectives are a number of 'lower-tier' objectives that take various forms:

- High-level considerations that apply to broad policy areas but are subordinate to the high-level objectives
- Sector- and policy-specific objectives that apply to particular firm types (e.g. banks, NBDTs, insurers) or specific policy areas (e.g. crisis management)
- Regulatory principles that must be considered when changing regulations for a particular policy area or sector.

These lower-tier objectives have mainly been legislated for financial policy, rather than monetary policy, as financial policy is a broader area covering multiple policies and sectors where further clarity can be helpful. The next consultation, in 2019, will consider whether these lower-tier objectives should be refreshed, including whether additional objectives should be considered for macro-prudential policy, prudential regulation of banks, and crisis management. For example, some stakeholders have queried whether the Reserve Bank should have an explicit depositor protection objective, similar to APRA's. New Zealand does not currently have a depositor protection scheme, unlike Australia, but this issue is being actively considered as part of this consultation (see Chapter 4). Depending on feedback on that issue, the next consultation could explore whether a deposit protection objective could be added as a lower-tier objective.

The Reserve Bank's high-level financial policy objectives (which are the focus of this Chapter) are a beacon for this diverse range of policy areas and provide a guide to which any new policy-specific or sector-specific objectives should be aligned. Any high-level objectives therefore need to be broad enough to encompass the current, and any new, lower-tier objectives.[13]

Potential issues with the Reserve Bank's existing financial policy objectives

Stakeholders have raised a number of potential issues with the Reserve Bank's existing objectives:

- **Relevance: are the Reserve Bank's existing financial policy objectives still appropriate?** – the Reserve Bank's existing objectives are almost 30 years old, and the nature and tools of financial regulatory policy have evolved significantly since 1989. Are 'soundness' and 'efficiency' still the right overarching terms to use?

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[12] The Reserve Bank also undertakes other functions (e.g. issuing New Zealand banknotes) that contribute to this overarching purpose.

[13] These high-level financial policy objectives also influence the way the Reserve Bank pursues its other statutory functions (e.g. its LoLR role and its foreign exchange interventions). See Box 1 in Chapter 1 for a full list of the Reserve Bank's functions.

- **Coverage: should the Reserve Bank be given additional financial policy objectives?** – there may be gaps in New Zealand's financial regulatory architecture, related to the intensity with which consumer protection and competition objectives are pursued. Should the Reserve Bank contribute to plugging such gaps? Should it be given other, new objectives?
- **Weighting: how much weight should be put on its different objectives?** – the Reserve Bank's current financial policy objectives can conflict with one another. Should an explicit hierarchy be prescribed in legislation, or should weightings be determined by another mechanism? If so, by whom?
- **Specificity: should the Reserve Bank's objectives be specified in more detail?** – there is a lack of clarity in how to interpret the Reserve Bank's existing objectives. What mechanisms can be used to clarify and further specify them? Or is the current flexibility helpful?

The remaining sections of this Chapter focus on the first two issues (what the Reserve Bank's objective(s) should be). The latter two are largely about how to give the Reserve Bank additional clarity in interpreting its objectives. A number of mechanisms could be used to provide this clarity, including adding detail to the legislation itself. For example, the Reserve Bank Act could define objectives more explicitly and prescribe weights using a clear legislative hierarchy (similar to the stylised illustration in Figure 2A).

However, while these legislative solutions are potentially useful, they are unlikely to provide a full description of how the Reserve Bank should act – objectives must be interpreted and balanced and may need to evolve with time. It may therefore be appropriate for the legislation to create other mechanisms that provide further clarity. The Reserve Bank of New Zealand (Monetary Policy) Amendment Bill does this for monetary policy by requiring the Government to issue a remit setting out explicit targets for monetary policy. Chapter 7 (in Part B) discusses whether this mechanism or others might be appropriate for financial policy, and seeks your feedback.

Factors to consider when assessing different financial policy objectives

The remainder of this Chapter considers five potential financial policy objectives for the Reserve Bank – the two existing objectives (soundness and efficiency) and three others that could help to address some of the issues with New Zealand's financial regulatory system outlined in Chapter 1 (competition, consumer protection, and public confidence). For each objective, your feedback is sought on two areas:

- **Objective scope** – each objective could be defined narrowly or broadly depending on the responsibilities it is intended to cover. For example, the Reserve Bank's efficiency objective could be interpreted narrowly to focus on minimising the regulatory burden on financial firms, or more broadly to promote the efficient allocation of financial resources to boost economic growth. There is an inherent trade-off: narrow objectives are more specific and potentially provide clearer accountability, but may create regulatory gaps over time, while broad objectives will inevitably mean more discretion and flexibility for the regulator in interpreting and achieving them.
- **Legislative position** – an objective's 'legislative position' determines how actively the Reserve Bank will pursue one objective relative to others. For example, if the Reserve Bank's existing efficiency objective were demoted to a lower-tier objective, and soundness were retained as a high-level objective, the Reserve Bank would be mandated to pursue soundness first and, subject to achieving that, also promote efficiency. Figure 2A provides a stylised view of the legislation's existing structure and hierarchy. This consultation is primarily interested in your views on whether each of the five objectives should be:
  - included as a high-level financial policy objective of the Reserve Bank, as soundness and efficiency are now

  - excluded from the Reserve Bank’s legislation, for example to avoid a concentration of power or due to a lack of synergies with the Reserve Bank’s other policy areas
  - included in the legislation but at a lower tier, for example applying to a specific sector (e.g. banks) or policy area (e.g. crisis management).

When considering whether to amend or add high-level objectives to the Reserve Bank’s mandate, a number of points should be kept in mind:

- **Minimising conflicts** – the more objectives and functions an independent agency is given, the harder it may be to achieve all of them at once, particularly if the objectives conflict with one another. Conflicting objectives can reduce role clarity and the effectiveness of decision-making, and undermine trust in the institution. The OECD (2014) notes, “the assignment of potentially conflicting functions to any regulator should only occur if there is a clear public benefit in combining these functions and the risks of conflict can be managed effectively.” If the Reserve Bank were given conflicting objectives, this would raise the importance of having a robust and transparent governance framework to manage such conflicts (as discussed in Part B).
- **Protecting against a blinkered view** – if an independent agency is given too narrow a focus, it may pursue its objectives at the cost of other socially beneficial outcomes (e.g. too much focus on financial stability at the cost of the dynamism of the economy). To avoid this, the agency could be given lower-tier objectives to ensure it embeds policy trade-offs, or be required to coordinate policy with other independent agencies that have competing objectives.
- **Minimising concentration of power** – if the Reserve Bank were given broader objectives or more objectives, it would need to be given sufficient powers and tools to achieve them. The Reserve Bank already has considerable legislative power over monetary policy and many aspects of financial policy – it is already a ‘multi-mission’ agency. Tucker (2018) notes that central banks should avoid being given additional missions that have only tangential relevance to their core roles, to avoid too much power becoming vested in one institution.
- **Maximising synergies** – the Reserve Bank’s objectives should ideally focus on policy areas that benefit from similar skills, expertise, and information. If the Reserve Bank were given objectives in a new policy area with few synergies with its existing work, it would have to recruit and upskill new staff. This may be an inefficient use of public funds, particularly if another regulatory agency has more expertise in that area.
- **Shared objectives** – the OECD (2014) notes that “the effectiveness and efficiency of a regulatory system depends, in part, on the extent to which potential duplication and gaps between regulators are anticipated and avoided in legislative drafting”. Minimising the degree of overlap between the Reserve Bank’s objectives and those of other regulators (e.g. the FMA) would help to ensure that each agency is clear about its role and can be held to account. However, shared objectives could be necessary if an objective is sufficiently broad to require multiple agencies to achieve it, or desirable to encourage agencies to cooperate and avoid a blinkered view. If the Reserve Bank were to share objectives with other agencies, the legislation would have to clearly specify each agency’s role and establish a clear mechanism to coordinate policy. One way to do this would be to replicate relevant objectives from other agencies at a lower tier in the Reserve Bank’s legislation and require it to cooperate with other agencies where feasible.[14]

[14] The issue of how to coordinate policy domestically and with the Australian authorities will be picked up in the next consultation round.

The pros and cons of different financial policy objectives

This section describes five potential financial policy objectives and reviews the pros and cons of including them as high-level objectives. A summary follows at the end of this Chapter.

1. Financial soundness (or stability)

Objective scope – financial soundness has been a high-level Reserve Bank objective since 1989. It applies to the whole financial system (rather than to individual financial institutions).[15]

The objective differs from those of other central banks, which tend to focus on 'financial stability'. Neither 'soundness' nor 'financial stability' has an internationally accepted definition, but while 'soundness' is often interpreted as promoting the resilience of a country's financial system (see, for example, the IMF's Financial Soundness Indicators), financial stability is interpreted more broadly as empowering the central bank to intervene to help dampen the financial cycle and hence minimise the incidence of costly financial booms and busts.

According to these definitions, a 'financial stability' objective could give the Reserve Bank full authority to use macro-prudential tools to stabilise the financial cycle, and would be consistent with the way the Reserve Bank interprets its objective already (it has published a *Financial Stability Report* since 2004).

Legislative position – most central banks operate under the presumption that they have high-level policy objectives to support financial stability, even though fewer than half have formal legislative mandates (Bank for International Settlements [BIS], 2009). This reflects their role in providing emergency liquidity assistance, overseeing payment systems, and often supervising and regulating banks (see Chapter 5). A key lesson from the GFC was that a single authority should be responsible for overseeing the financial system. We therefore suggest that some form of financial soundness or financial stability objective should continue to be a high-level objective for the Reserve Bank.

2. Efficiency

Objective scope – although efficiency has been a high-level Reserve Bank objective since 1989, the Reserve Bank and its stakeholders continue to grapple with its interpretation (see Bloor and Hunt, 2011). In principle the term can be interpreted very broadly to cover:

- regulatory efficiency – minimising the regulatory burden on firms
- competitive efficiency – improving competition in the financial sector
- dynamic efficiency – encouraging new investment and financial innovation that raise the productive potential of the economy
- allocative efficiency – ensuring that financial resources are allocated to their most productive uses to maximise long-term economic growth.

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[15] There is some debate on whether the Reserve Bank's soundness objective should apply to individual financial firms. Other prudential regulators, such as the Bank of England, have explicit objectives to promote the safety and soundness of individual firms. However, such firm-level objectives tend to appear at a lower tier in legislation focused on prudential regulation, which sits below a higher-level objective to promote system-wide financial stability. The second round of consultation will explore whether an objective to promote the soundness of individual firms should be included as a specific objective of prudential regulation.

A broad interpretation, encompassing all these terms, would give the Reserve Bank licence to operate in many areas (similar to other central banks that have secondary objectives to promote economic growth). In practice, the Reserve Bank has tended to interpret its efficiency objective more narrowly. It has focused on minimising excessive compliance costs (regulatory efficiency) and taken a targeted approach to promoting dynamic efficiency (e.g. by developing covered bond standards) and allocative efficiency (e.g. by reducing the build-up of debt in the household sector).

Clarifying the scope of the efficiency objective is a key goal of this Review. It could be narrowed (e.g. to regulatory efficiency), or broadened to include more of the terms above. The broader the term, the more politically sensitive policy decisions become, and the more carefully the Reserve Bank's role would have to be defined. For example, a broad definition could encompass the availability of finance to different sectors of the economy (e.g. construction, small businesses) during the economic cycle. But careful thought would need to be given to the tools available to the central bank to influence sectoral credit flows and whether it would be appropriate to do so.

Legislative position – few central banks have high-level efficiency objectives, except in relation to payment systems, so there are arguments on either side of retaining it as a high-level objective:

Potential arguments for retaining 'efficiency' as a high-level objective:

- Taken together, soundness and efficiency are akin to the financial stability mandates of other central banks. 'Efficiency' empowers the Reserve Bank to use its tools to stabilise the financial cycle, since financial booms and busts can be caused by allocative inefficiency.
- Efficiency provides an important counterweight to the Reserve Bank's soundness objective, helping to ensure that regulatory interventions are targeted and a net benefit to society.
- New Zealand's financial sector is dominated by a few large banks. An efficiency mandate could empower the Reserve Bank to promote competition in the financial sector (e.g. by reducing firms' barriers to entry by lowering initial capital requirements for new firms).

Potential arguments for demoting or removing 'efficiency' as a high-level objective:

- Efficiency is not an overarching objective for all the Reserve Bank's financial policy functions. For example, during a banking crisis it has discretion to disregard efficiency in favour of safeguarding the system (RBNZ Act 1989, Section 68).
- The Reserve Bank should only have one high-level financial policy objective (focused on financial stability) to provide a clear focus to the its work and avoid confusion on how to weight competing objectives.
- The term 'efficiency' is broad and poorly defined, so should be narrowed (e.g. to 'regulatory efficiency'). Regulatory efficiency already features as a lower-tier regulatory principle in some of the Reserve Bank's legislation (NBDT Act 2013, Section 8 and IPSA 2010, Section 4).
- Efficiency is no longer needed as a counterweight to soundness, as the Reserve Bank's new overarching purpose statement requires it to work towards broader economic goals.

3. Competition

Objective scope – competition policy is developed by MBIE and enforced by the Commerce Commission. The Reserve Bank is also required to 'maintain competition' as a regulatory principle for insurers and NBDTs. But this is a narrow objective, requiring the Reserve Bank to consider the competitive implications of its regulatory actions, rather than actively promote competition.

Relatively few prudential regulators have explicit mandates to facilitate effective competition. For those that do (e.g. the UK's Prudential Regulation Authority), they are typically interpreted as requiring the regulators to use existing tools to reduce businesses' barriers to market entry, for example by lowering initial capital requirements for new firms. Broader competition mandates are possible, involving powers to investigate and enforce competition issues to prevent market abuse and enhance consumer choice. But these are largely absent from New Zealand's regulatory system, where competition law is based on principles-based prohibitions and ex-post investigations.

A competition objective would have clear overlaps with the Reserve Bank's existing efficiency objective. If one were added, the Reserve Bank's existing efficiency objective would have to be clarified (e.g. to focus only on regulatory efficiency). An explicit competition mandate would also have important resourcing implications for the Reserve Bank, and would require significant regulatory coordination with MBIE and the Commerce Commission.

Legislative position – competition is already a regulatory principle for the Reserve Bank when regulating insurers and NBDTs. The pros and cons of elevating it to a high-level objective are:

Potential arguments for including 'competition' as a high-level objective:

- A competition objective is a helpful counterweight to 'soundness' and is more specific than the Reserve Bank's existing 'efficiency' objective.
- By giving the Reserve Bank new powers to promote competition, a competition objective could help to increase the intensity with which competition policy is pursued in New Zealand. This could result in lower barriers to entry for new businesses, a more dynamic financial sector, and a greater breadth of financial services on offer.

Potential arguments against including 'competition' as a high-level objective:

- Competition could create a trade-off with the Reserve Bank's soundness (or stability) objective. The more competitive a financial system, the lower firms' profitability may be and so the less resilient those firms may be to financial shocks. Greater competition may also incentivise financial firms to take more risks and search for returns.
- Competition is not an overarching objective that applies to all the Reserve Bank's financial policy areas – for example, during a banking crisis a competition objective might impede the orderly resolution of a failing firm by preventing a private sale.
- Competition features only as a regulatory principle in the Reserve Bank's more recent NBDT Act 2013 and IPSA 2010.
- Competition can create greater complexity in the financial sector through the entry of newer and more diverse firms, potentially requiring additional monitoring and supervisory resources.
- The Reserve Bank would have to be given substantial new competition powers to meet a broad competition objective, potentially leading to too much power in one institution.
- A competition objective could create confusion and overlap with the Commerce Commission.

4. Consumer protection

Objective scope – consumer protection is a broad term that could encompass a wide range of policy areas. Such an objective could be pursued through a combination of depositor protection and market conduct regulations. New Zealand does not currently have depositor protection, but it is being considered in this Review (see Chapter 4). Market conduct is the responsibility of both the Commerce Commission (in regulating consumer credit contracts) and more broadly the FMA.

The FMA has extensive powers to address conduct issues in securities markets and the advice and investment management sectors. But its powers are more limited in overseeing other activities (banks, NBDTs, and insurers). The Reserve Bank does not currently have a conduct objective, but it does have an interest in the area, as conduct abuses can signal risks to stability. Reflecting this, the Reserve Bank and the FMA are working jointly on the Financial Services Conduct and Culture Review.

The Reserve Bank FMA or another agency would have to be given enhanced new conduct powers to raise the intensity with which a consumer protection mandate could be pursued in New Zealand. If the Reserve Bank were given such powers, these would have to be carefully designed to avoid overlap with the FMA's role, and the Reserve Bank would need to increase skills in this new area.

By design, central banks do not tend to have broad consumer protection objectives if they operate in jurisdictions with twin peaks models of financial regulation. However, some central banks in such jurisdictions do have narrower consumer protection objectives that apply in specific policy areas (e.g. the Bank of England's depositor protection objective applies when resolving a failing firm).

Legislative position – to date, consumer protection objectives have been excluded from the Reserve Bank's legislation. The key arguments for and against adding a consumer protection objective are:

Potential arguments for including 'consumer protection' as a high-level objective:

- A consumer protection objective could help to intensify the supervision of conduct issues, by making the Reserve Bank responsible for protecting customers of insurers and deposit takers.
- A consumer protection objective could enhance public trust in the financial system by supporting fairness and by protecting the interests of less-sophisticated investors.
- A targeted depositor protection objective could support the Reserve Bank in managing a new depositor insurance scheme, while promoting a more intensive form of prudential supervision.

Potential arguments against including 'consumer protection' as a high-level objective:

- A consumer protection objective could undermine New Zealand's twin peaks model and lead to regulatory attention becoming too focused on consumer protection issues at the expense of system-wide stability (as happened in the UK pre-GFC – see House of Commons, 2009).
- It could reduce accountability by creating confusion with the FMA's conduct responsibilities, as most of the powers relevant to financial consumer protection currently reside with the FMA.
- A consumer protection objective could reduce consumer incentives to manage their own risks.
- Prudential regulation already supports consumer protection by promoting sustainable business models that focus on consumer needs, so an explicit objective is not needed.
- Consumer protection issues require skills different from those of prudential supervision, so the Reserve Bank would require additional resources and upskilling in a new area.
- Conduct issues may crop up more frequently than prudential regulatory issues, potentially increasing political attention on the Reserve Bank and undermining its independence.
- The Reserve Bank already has multiple 'core' missions and substantial powers. To avoid concentrating more power in its hands, it should not be given a consumer protection mandate.

5. Public confidence (or public trust)

Objective scope – public confidence was a Reserve Bank high-level objective before 1989; in the Reserve Bank Amendment Act 1986 it was tasked with “maintaining public confidence in the operation and stability of the financial system”.

Most other central banks have implicit public confidence objectives and some have them in their legislation. For example, APRA is tasked with “enhancing public confidence in Australia’s financial institutions”, while the Bank of England must “protect and enhance public confidence in the financial system’s stability when considering how to resolve a failing bank”.

A broad interpretation of a public confidence objective would:

- give the Reserve Bank responsibility for ensuring confidence in the financial system as a whole. This is in keeping with the original wording in the 1986 Act, and would encourage it to take a stewardship role for the whole system and coordinate with other regulators (e.g. the FMA)
- overlap with the Reserve Bank’s other functions, such as maintaining public trust in banknotes
- potentially require the Bank to promote public understanding of the financial system (improving financial literacy) or ensure that the public always has access to critical financial services.

Legislative position – public confidence remains a sector-specific objective in the Reserve Bank’s oversight of insurers, and for statutory managers when resolving a failing bank, but it could be reinstated as a high-level objective across all the Reserve Bank’s financial policy areas. The arguments for and against including public confidence as a high-level objective are:

Potential arguments for reinstating ‘public confidence’ as a high-level objective:

- Maintaining public confidence in the financial system is essential for avoiding instability during crises (bank runs). Statutory managers must already take this into account when managing bank failures; the same should apply to all the Reserve Bank’s financial policy decisions.
- The Reserve Bank would be required to promote confidence in itself, which would incentivise a greater emphasis on clear public communications and improving legitimacy and accountability.
- A public confidence objective would encourage the Reserve Bank to provide stewardship of the financial system alongside other regulators (e.g. the FMA).
- The Reserve Bank already has a sector-specific objective to promote confidence in the insurance sector (IPSA 2010, Section 3); the same should apply to other sectors (e.g. banks and NBDTs) and to the Reserve Bank’s other core functions (e.g. providing banknotes and coins) that do not currently have high-level objectives.

Potential arguments against including ‘public confidence’ as a high-level objective:

- Public confidence is an outcome of good financial policy, not an objective in its own right.
- Public confidence is too broad a concept, covering issues beyond the Reserve Bank’s direct control. For example, it could include confidence in firms beyond the regulatory perimeter, consumer conduct violations, or even the extent to which consumers make losses. Failure to achieve such a broad objective could undermine the Reserve Bank’s credibility in other areas (e.g. monetary policy).
- A broad public confidence objective, including financial literacy, would require additional resources and could lead the Reserve Bank to lose its focus on financial stability.
- A public confidence objective could erode market discipline by creating a perception that all consumer deposits are protected.

Summary of options

The Reserve Bank's legislation could include a number of objectives. Figure 2B illustrates some of the objective options, ranging from a sole focus on financial stability (Option 1) to a model that includes elements of all five objectives (Option 6). The options are not exhaustive and different combinations could be considered.

A number of points are worth noting:

- **Financial soundness or financial stability** is assumed to be a high-level objective in all options, as it is a core objective of almost all central banks. The debate is over what term to use: 'soundness' or 'stability'.
- **Efficiency** could feature at all levels of the legislation. Arguably, the broader its scope (to encompass regulatory, competitive, dynamic, and allocative efficiency), the higher in the legislation it should sit (and the more it resembles a broad goal to promote sustainable growth).
- **Competition** could feature at all levels of the legislation (as is the case with efficiency) but few central banks have high-level competition objectives. For those that do, they typically feature as lower-tier objectives that do not apply to all financial policy areas.
- **Consumer protection** could be interpreted broadly to cover market conduct issues, or more narrowly to focus on depositor protection (if a new depositor protection scheme were introduced). The broader the scope, the higher in the legislation the objective should arguably sit, but the greater the risk of overlap with the FMA's existing responsibilities.
- **Public confidence** is a broad objective, so naturally sits at a high level in the legislation. The issue is whether such an objective should be explicit in the legislation (and the Reserve Bank should be held to account for it) or whether it should be left implicit.

Figure 2B: Illustrative options for the Reserve Bank's objectives

	1 Sole focus	2 Status quo	3 Primary and secondary	4 Tiered	5 System stewardship	6 All inclusive
High-level objectives	Financial stability	Soundness Efficiency	Soundness	Financial stability	Financial stability Public confidence	Financial stability Public confidence
High-level consideration			Efficiency	Sustainable growth		Protect consumers
Sector-specific objectives				Competition		
Regulatory principles				Regulatory efficiency	Competition Regulatory efficiency	Competition Regulatory efficiency

Questions for consultation:

Your views are sought on the following questions:

1. Are the Reserve Bank's existing high-level financial policy objectives still appropriate and fit for the future?
   a) Should 'soundness' remain a high-level financial policy objective of the Reserve Bank, or would a 'financial stability' objective be more appropriate?
   b) What role should the Reserve Bank play in promoting 'efficiency'? Should it have a narrow mandate (e.g. focused on regulatory efficiency) or a broad one (e.g. including allocative efficiency and promoting sustainable growth)?
   c) Should 'efficiency' remain a high-level objective of the Reserve Bank, or should it be demoted to a lower tier of the legislation?
2. Should the Reserve Bank be given additional high-level financial policy objectives?
   a) How many high-level financial policy objectives should the Reserve Bank have – are the gains of having multiple objectives worth the costs of lost focus?
   b) Should 'competition' be promoted to a high-level objective of the Reserve Bank, or should it remain as a lower-tier objective?
   c) Should 'consumer protection' be added to the Reserve Bank's objectives?
   d) Should 'public confidence (or trust)' be reinstated as a high-level financial policy objective of the Reserve Bank?
   e) Are there any other objectives you think the Reserve Bank should be given?

Chapter 3: Who does the Reserve Bank regulate and how should the regulatory perimeter be set?

The aim of this Chapter

The Reserve Bank regulates some, but not all, financial firms. This Chapter outlines how the boundary between regulated and unregulated firms – the regulatory perimeter – is currently defined.

The Chapter then considers two key issues:

- Whether the potential benefits of adjusting the regulatory perimeter to be more unified and simpler (specifically in relation to deposit taking) are worth the costs
- Whether mechanisms for adding flexibility would help to future-proof the regime.

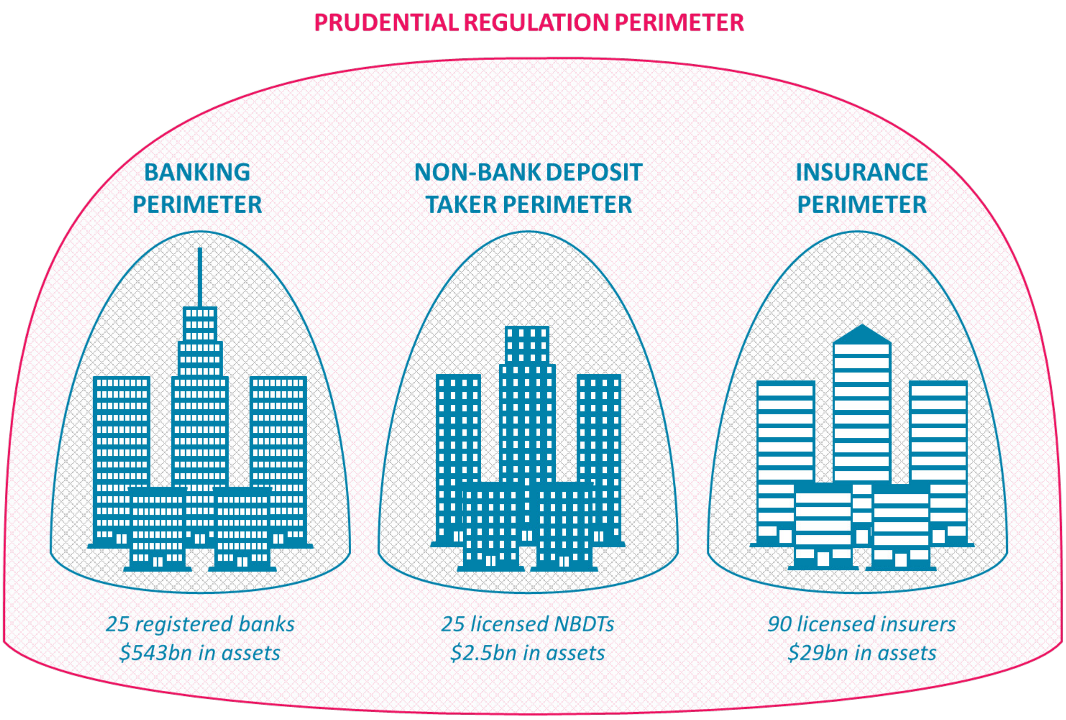
Further detail is set out in an accompanying background paper.

How is the current regulatory perimeter defined?

The regulatory perimeter for prudential regulation is the boundary between the regulated and non-regulated sectors of New Zealand's financial system.

There are three sectors that currently sit within the Reserve Bank's prudential perimeter: banks, NBDTs (which include finance companies and building societies), and insurers (see Figure 3A).

Figure 3A: The perimeter for prudential regulation



These sectors are regulated by the Reserve Bank in order to:

- promote the maintenance of a sound and efficient financial system
- avoid significant damage to either the financial system (banks, NBDTs) or public confidence (insurers) that could result from the failure of a regulated entity.

In addition to these three sectors, a process is currently underway to bring financial market infrastructures (FMIs) more squarely inside the perimeter for prudential regulation. FMIs are entities that provide the 'plumbing' of the financial system. They provide the channels through which payments, securities, derivatives, or other financial transactions are cleared, settled, or recorded.

FMIs are currently subject to a combination of monitoring and information-provision requirements. Bringing FMIs more clearly inside the prudential regulatory perimeter reflects growing recognition that they can be sources of systemic risk given their essential role in the smooth functioning of the economy and strong connections to banks and other financial institutions.

Why does the regulatory perimeter matter?

Events in the past decade (both in New Zealand and internationally) have illustrated the importance of ensuring that the regulatory perimeter is clearly aligned to the objectives of the regulatory framework. During the GFC some of the most significant threats to financial stability originated from entities outside the traditional perimeter; for example, significant risks developed in the securitisation vehicles and hedge funds that were connected to regulated entities. In many cases regulators did not have the tools to oversee these entities directly.

This Review offers a timely opportunity to ensure that the perimeter for prudential regulation remains appropriately targeted and capable of adapting to emerging risks.

Based on the Reserve Bank's current objectives, a case can be made for bringing a sector inside the perimeter where it meets the following criteria:

- The sector poses potential risks to financial soundness that cannot be met using existing regulatory powers.
- The application of prudential regulation (such as capital, liquidity, or risk management requirements) would effectively address those risks.
- Regulatory action would not result in unintended consequences or costs in excess of the benefits.

The regulatory perimeter has been included in this first consultation paper for two reasons. Firstly, the perimeter is a foundational element of the regulatory framework, given its links to other important issues such as objectives and deposit protection. There are therefore advantages in reaching an early consensus on how the perimeter should develop over time.

Secondly, based on the criteria identified above, there is a case to consider whether the perimeter for prudential regulation remains correctly specified. There are currently two sectors (banking and NBDTs) that have similar characteristics but are regulated differently. It may improve the efficiency and coherence of the current perimeter to regulate both sectors in the same way. This will not be without cost, and feedback is being sought on whether the potential benefits of redrawing the regulatory perimeter are worth the transition costs for those firms affected. Any decision to make changes to the perimeter could have material impacts on some sectors. This means that any potential changes will need to be clearly signalled and considered.

We have not identified other specific areas that require further in-depth review. While the prudential regulation of managed investment schemes such as KiwiSaver has previously been raised as an issue for consideration, these schemes pass on both gains and losses to investors rather than promising to repay them fully. This means they do not have the capital or liquidity issues that are core to the prudential regulation of deposit takers. New Zealand, in common with most other jurisdictions, applies conduct regulation to managed investment schemes offered to retail investors. Managers of these schemes must be licensed by the FMA. Through licensing, managers are subject to minimum standards.

Deposit taking

Deposit takers form the core of traditional prudential regimes. Defined as entities with a primary purpose of both borrowing and lending money, they essentially seek to make a profit by lending money at a higher rate than they are borrowing it (a process known as 'credit intermediation').

Deposit takers are subject to prudential regulation because credit intermediation has a number of risks, including credit risk, liquidity risk, and operational risk. For example, deposit takers borrow for relatively short terms through deposits, and lend for long terms on assets such as mortgages. If depositors want to withdraw their funds but they are tied up in long-term loans, the bank or NBDT could face liquidity pressures. To avoid such problems, prudential regulation ensures that banks and NBDTs have sufficient liquidity buffers to meet such demands. The failure of deposit takers can have significant impacts on both financial stability and the real economy.

New Zealand currently has two parallel regimes that regulate entities that apply to deposit takers: the banking regime and the NBDT regime.

The banking regime

The banking regime is 'name-based', which means that if an entity undertakes financial services and wishes to use certain restricted words in its name or advertisements (e.g. 'bank' or 'banking'), it must register with the Reserve Bank. It does not need to register as a bank just to undertake certain activities (e.g. deposit taking). The existing regime has been in place since 1989, at a time when the Reserve Bank did not regulate any entities other than banks.[16]

To date, deposit takers that could be considered systemically important in New Zealand have chosen to register as banks – in part owing to the brand value of using 'bank' in marketing to potential customers, including wholesale customers.

Prudential requirements are primarily applied to banks through 'conditions of registration', an administrative instrument controlled by the Reserve Bank. In order for financial firms to remain registered banks, they have to continually adhere to these conditions and meet the Reserve Bank's regulatory standards.

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16 Bank registration was introduced in the Reserve Bank Amendment Act 1986. This created a prudential framework for the first time in New Zealand. At that time the perimeter also included authorised dealers in foreign exchange and any other financial institutions specified by the Reserve Bank. The 1989 Reserve Bank Act narrowed the regulatory perimeter to banks alone.

The relatively narrow scope of the Reserve Bank Act has historically meant that entities have been able to structure themselves outside the regime relatively easily by opting not to register as banks. This potential weakness was identified by the IMF during the 2003/04 FSAP.

The NBDT regime

Following the 2003/04 FSAP, the regulatory perimeter for prudential regulation was expanded to capture non-bank lenders that rely on deposits or the issuance of deposit-like products as the main sources of their funding. These non-bank deposit takers (NBDTs) included finance companies, credit unions, and building societies.

The impetus for this NBDT regime was strengthened through a period of very large increases in credit intermediation occurring outside the regulatory perimeter by both NBDTs and other non-bank lenders. While innovation is a good thing, much of this expansion took place in a sector where risk management practices were poor. This resulted in the collapse of a large number of these entities from 2006 to 2011 (see Chapter 1 for more on this). The non-bank lending sector, including NBDTs, contracted significantly after the GFC, and NBDTs now have a relatively small role in New Zealand's financial system.

In contrast to the banking regime, the NBDT regime operates on an 'activities-based' framework that is linked to securities law. An entity is defined as an NBDT if it:

- makes a 'regulated offer' of debt securities under the Financial Markets Conduct Act 2013. In broad terms, this is an offer made to at least some retail investors
- carries on the business of borrowing and lending money, or providing financial services, or both.

NBDTs must be licensed by the Reserve Bank. They must also meet certain minimum prudential requirements (e.g. in relation to capital ratios).

The prudential requirements applying to NBDTs are primarily applied through regulations, which means they require Government approval. The Reserve Bank also has a series of legislative and administrative tools in the NBDT Act:

- It can impose individual requirements on NBDTs through licence conditions.
- It has powers to declare persons or a class of persons an NBDT.
- It can grant exemptions.

While NBDTs are licensed by the Reserve Bank, they are primarily supervised by private sector companies known as 'financial markets supervisors' (FMSs). An FMS must oversee an NBDT's compliance with the trust deed for its offer of debt securities. FMSs also have specific requirements under the NBDT Act in relation to risk management.

The case for potential change

At a high level, the banking and NBDT regimes are interlinked. The NBDT regime ensures that all other entities that both take deposits from retail customers and lend are licensed and subject to a minimum level of prudential regulation. New Zealand's largest and most systemically important entities are banks, and they are subject to a comprehensive set of prudential requirements as well as supervision by the Reserve Bank. FMSs provide a frontline oversight of those entities.

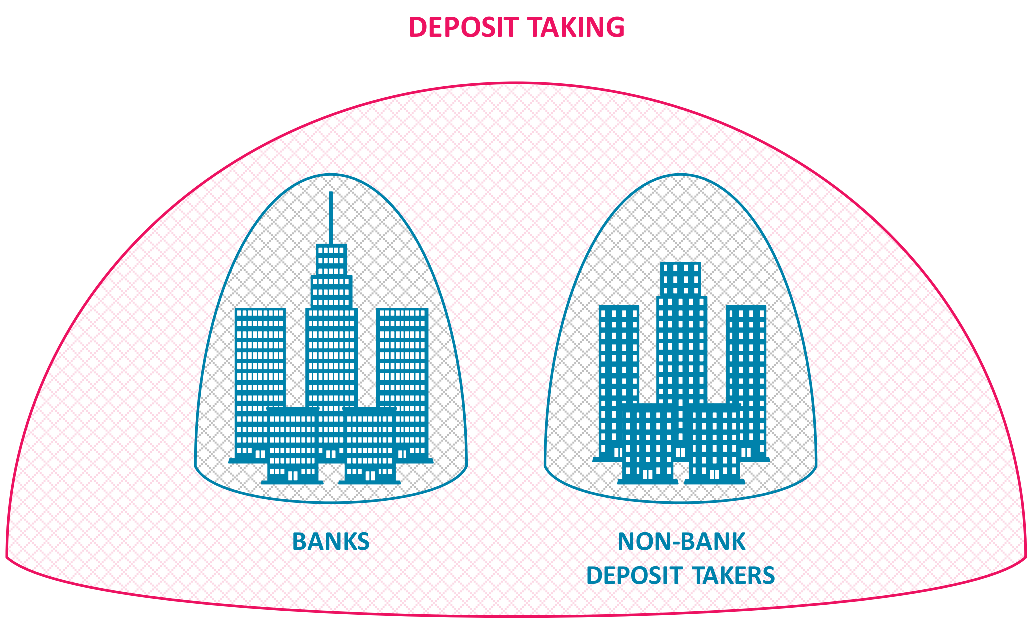
However, the two regimes are not fully integrated, and neither the banking regime nor the NBDT regime directly defines its perimeters on prudential grounds. This raises a range of potential issues, set out in Table 3.

Table 3: Potential issues with the existing approach to deposit taking

Issue	Description
Coverage	The banking and NBDT regimes do not capture all deposit takers that could potentially threaten financial stability or public trust (e.g. wholesale-funded deposit takers). At the same time, the current NBDT definition has resulted in the unintended capture of a number of entities of limited interest to the Reserve Bank given its existing objectives (e.g. broker cash management accounts).
Complexity	Entities that undertake substantively the same activities are subject to different regulations. This adds considerable complexity for both the Reserve Bank and regulated entities.
Efficiency	NBDTs are supervised by FMSs, but unsecured products such as deposits are poorly suited to this type of model. This is because the primary role of FMSs is to oversee trust deeds. There is also an argument that FMSs add cost and complexity to the business models of some smaller lenders, such as building societies and credit unions.

To address the above issues, there may be value in consolidating the two regimes into one. This would bring New Zealand's framework in to line with similar models in Australia, where all deposit-taking lenders are regulated as 'authorised deposit-taking institutions' (ADIs), and in the UK, where the same entities are regulated as 'credit institutions' (see Figure 3B). With a simpler model, there may be scope to make the regime for deposit taking simpler and more growth compatible in the future.

Figure 3B: Deposit-taking perimeter



Based on the Australian and UK precedents, a framework could be based on:

- a single activities-based definition of deposit taking, capturing all entities that are in the business of taking deposits and then lending that money. This definition would likely include wholesale-funded entities, and would enable the Reserve Bank to exempt entities it did not consider would benefit from prudential regulation
- a licensing framework that aligned compliance requirements with each financial firm's risk and scale. The Reserve Bank would regulate and supervise all these firms and, in line with developments in other jurisdictions, the framework could include a restricted or transitional licensing regime. The need for a simple yet flexible core regime is likely to grow given changes happening in the financial sector, including the increased use of technology (Fintech).

An important boundary issue would be whether longer-dated debt securities issued through the capital markets (e.g. debentures) would be considered deposits. They are not treated as deposits in either Australia or the UK. If this approach were followed in New Zealand, it would move some finance companies out of the perimeter for prudential regulation.

Link to deposit protection

If New Zealand were to go down a deposit protection route (see Chapter 4), an obvious question would be 'which financial firms would be covered by that protection?'.

While the specific design of any regime will not be considered until the second round of consultation, one of the core principles behind any deposit protection scheme has typically been competitive neutrality. In Australia, the UK, and other markets, deposit protection schemes are typically extended to all deposit takers on the basis that they are subject to broadly similar requirements.

Risks and transition costs

Moving to a single framework for deposit taking would be a significant undertaking, albeit on a transitional basis. It would take time and would involve making decisions on a number of technical issues. The key issues include:

- the definition of 'deposit'
- the appropriate treatment of wholesale-funded financial firms
- the New Zealand presence required to trigger a licensing requirement, and the recognition of overseas regulatory requirements
- the powers of the Reserve Bank or another agency to either designate or exempt individual institutions as subject to regulation as banks (see below).

These matters are discussed in greater detail in the accompanying background paper.

Increasing the flexibility of the prudential perimeter

The Reserve Bank currently has a mandate that extends beyond the specific sectors it regulates to the stability of the financial system as a whole. However, the tools available to address risks to financial stability can only be applied within the prudential perimeter. This creates a potential deficit between the scope of the Reserve Bank's objectives and its powers to achieve them.

To address this, one option would be to create a mechanism to allow the regulatory perimeter to flex over time. On the rare occasions when threats to financial stability occur outside the perimeter, this would allow the Reserve Bank to bring relevant entities or activities under its remit, and hence subject to prudential regulation. One reason for doing this now is to future proof the regime to potential new risks, and enable it to adapt to new innovations – including FinTech (see Box 3).

Box 3: Adapting to innovation – FinTech

Innovations such as FinTech have resulted in a greater focus on the need for perimeter flexibility. Although FinTech has not yet created any systemic threats to financial stability, this may not be the case in the future, for example if:

- new payment technologies (e.g. Apple Pay or digital currencies) become systemic in scale
- FinTech providers move more directly into maturity transformation, such as deposit taking.

The growing use of technology (both inside and outside the regulatory perimeter) has also seen the emergence of new threats, such as cyber risks.

These risks need to be balanced with their benefits. While a more diffuse and dynamic financial sector presents a challenge for regulators to keep up with developments, it also provides an opportunity for a more efficient financial system with better customer outcomes. Reflecting this balance, the Financial Stability Board states (Financial Stability Board, 2017):

> Regulators should be agile when there is a need to respond to fast changes in the FinTech space, and to implement or contribute to a process to review the regulatory perimeter regularly. This may be more easily and efficiently achieved with an approach that is neutral with regard to technologies and based on financial service activities.

Amending the perimeter currently requires change to primary legislation, which, while ensuring strong democratic accountability, can take a significant amount of time. A more timelier option may be to allow for the Minister of Finance or the Reserve Bank to 'designate' entities or activities within the perimeter. In the UK the Bank of England's Financial Policy Committee has the ability to recommend that the government bring new sectors inside the regulatory perimeter. These recommendations must then be approved by HM Treasury.

Additionally, New Zealand's Council of Financial Regulators may be an avenue for discussions on these matters, given the potential for issues to be addressed through conduct regulation. An example of this process in New Zealand is the FMA's 'designation' power in the Financial Markets Conduct Act, while international examples include:

- in Australia, reserve powers to make rules concerning the lending activities of non-ADI lenders
- in the UK, the ability to apply prudential policy to investment firms acting as principals. To date the Bank of England has applied these powers to the trading arms of a small number of investment banks.

This may be worthwhile if significant delays in addressing the risk could let it build up. Any such mechanism would need a high threshold for activation, with clear processes to ensure accountability for decisions. This would leave the Reserve Bank with a core 'inner perimeter' of entities subject to prudential regulation under the deposit-taking, insurance, and FMI frameworks, as well as an 'outer perimeter' that was subject to risk assessment, with the ability to designate or apply specific prudential requirements if required. This flexibility could help to mitigate the potential for activity and risk to migrate to the non-regulated sector, which could undermine the effectiveness of current regulatory settings. See the accompanying background paper for more detailed considerations relating to this power.

Application to macro-prudential policy

In recent years the toolkit for prudential regulation has expanded. In New Zealand, macro-prudential policies (such as loan-to-value restrictions on mortgage lending) have been applied to reduce the amplitude of the financial cycle and minimise the likelihood of costly financial booms and busts.

Macro-prudential tools are currently applied through conditions of registration, and hence only apply to registered banks. Moving to a unified deposit-taker regime and a more flexible perimeter would enable the Reserve Bank to apply macro-prudential tools such as loan-to-value ratios more consistently to all lenders, including those currently sitting outside the regulatory perimeter (commonly known as non-deposit taking lending institutions, or NDLIs). This would only be relevant where it was appropriate and meaningful, for example if there were a significant shift of lending towards NDLIs during a period of high credit growth.

Questions for consultation

Your views are sought on the following questions:

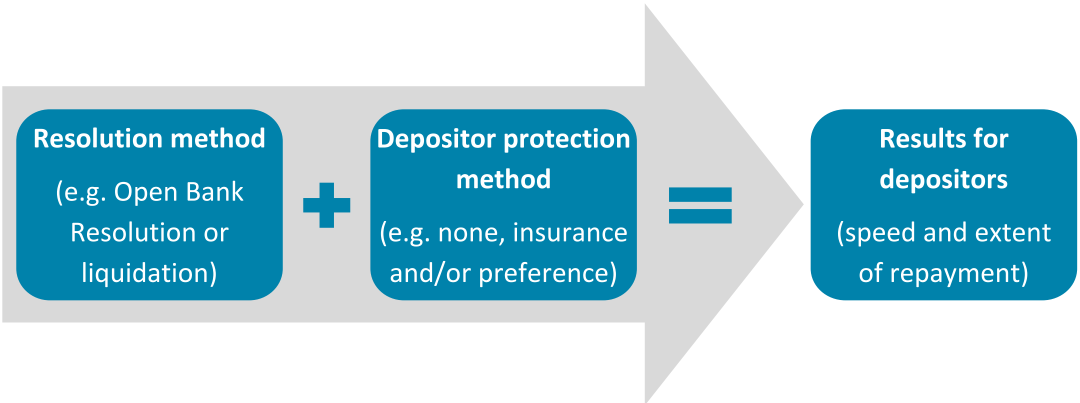
3. What are your views on the costs and benefits of moving from the current perimeter to an ADI-type framework? Based on your views, is this an issue worth pursuing?
4. Is new legislation the most appropriate way to adjust the prudential perimeter, or could a timelier mechanism be better? What accountability processes would be necessary to accompany any new mechanism?

Chapter 4: Should there be depositor protection in New Zealand?

The aim of this Chapter

This Chapter considers the way that depositors should be treated if firms holding their deposits ('banks' for this Chapter) fail. What happens for depositors depends on how the authorities deal with the banks themselves (the resolution method) and how depositors' financial interests in the banks are treated (the depositor protection method). Together, these methods make up a 'crisis management framework' for banks in distress (see Figure 4A).

Figure 4A: What determines how depositors are treated when a bank fails?



The way bank distress is managed can affect every New Zealander who uses financial services or pays taxes; that is, virtually everyone. New Zealand's broad crisis management framework will be reviewed in the next consultation round. The focus for this round is on how depositors sit within the framework. This Chapter:

- identifies high-level options for depositors' treatment and the possible objectives and risks of each option
- compares New Zealand's approach with international practice.

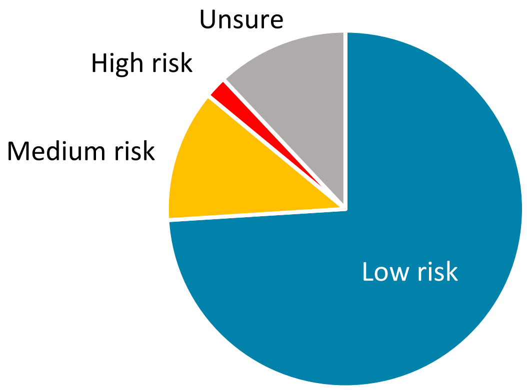
Responses to this consultation will contribute to preliminary recommendations on whether or not there is a case to treat bank depositors in New Zealand differently from the way they are now and, if so, how. If there is a case to strengthen deposit protection methods, final recommendations would only follow further work and public consultation on possible scheme design.

Banks, deposits, and you

Deposits held in banks are one of the most common investments made by New Zealanders. This may be because deposits give consumers and businesses a way to make and receive payments, and offer savers easy access to funds along with reliable returns. A person who deposits money in a bank becomes a 'creditor' to the bank, with a claim that the bank undertakes to honour either on a fixed future date (through a 'term' deposit), or whenever the saver wants (through an 'on-call' deposit).

Most New Zealanders understand deposits to be low-risk investments (see Figure 4B), but the fact that they are not 'no risk' investments may be less well understood. Banks that take deposits (and the New Zealanders who have deposits with them) are exposed to special risks arising from the way banks manage and invest savers' funds (see Box 4A).

Figure 4B: How risky do New Zealanders think bank deposits are?

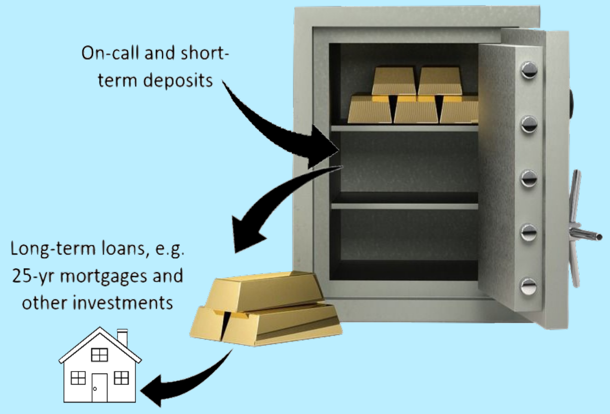


Source: FMA (2018).

Box 4A: Bank deposits – safe as houses?

Deposits are a major source of funding for banks. Money deposited in a bank does not necessarily stay there: the bank can use that money to on-lend for other purposes, such as house mortgages or business loans. This process lets banks match savers' resources to borrowers' needs, but means banks and savers take on risks.

A key challenge for banks is managing the maturity mismatch between deposits and other short-term funding on one hand, and their longer-term lending of those funds on the other.



A bank may get into trouble if its loans or other business operations fail to perform well enough for it to repay its own debts to depositors and other creditors.

Depositors in New Zealand currently have no formal protection if a bank gets into trouble and is unable to repay their money. If the bank fails, they might have to bear some of the bank's losses.

George: *You're thinking of this place all wrong, as if I had the money back in a safe. The money's not here. Your money's in Joe's house... right next to yours. And in the Kennedy house, and Mrs Macklin's house, and a hundred others.*
– It's a Wonderful Life (1946)

A loss of confidence in a bank that triggers a sudden and significant withdrawal of savers' funds (a bank run) could threaten the bank's viability, especially in an environment where markets are distressed and asset values such as house prices are falling. The bank may become insolvent – unable to pay the debts it owes to creditors. This is a 'bank failure', which can impose major costs on bank customers, the financial system, and the economy.

These issues have led regulatory authorities, including New Zealand's, to use rules to encourage banks to behave safely. For example, banks must hold financial buffers ('capital') against the risks they take on, and disclose information to help their customers and investors monitor how these risks might affect them. However, while regulatory rules help to protect against bank failure, they cannot – and are not designed to – prevent it: bank failures, while rare, can happen. For this reason, regulators also have crisis management tools and safeguards to deal with failing banks and contain their wider systemic impacts. Internationally, these tools often include (among other things) methods to protect the depositors and customers of failed banks.

What does depositor protection mean?

In a bank failure, customers could lose access to depositor services and lose some of their deposits. 'Deposit protection' relates to the second risk and has several common approaches:

The status quo – no formal protection

There is currently no formal or automatic depositor protection in New Zealand: depositors are 'general creditors' and, after shareholders, stand to lose money if their banks fail. This encourages people who deposit money in banks to do so responsibly, since neither the banks nor the Government is promising to protect them from the consequences of their decisions. It also encourages banks to manage their risks properly. The status quo is designed to promote a sound and efficient financial system through 'market' and 'self' discipline.

In the unlikely event of a bank failure, there are certain **resolution** options (see Box 4B) with attached functions that may protect depositors from loss (and protect their access to banking services). The resolution approach used, and the protections applied, would depend on the circumstances of the failing bank and prevailing market conditions.

Protecting depositors with a preference

Under a depositor **preference** regime, some or all of protected depositors' claims on a bank would be paid out before the claims of other general creditors. This would be achieved by permanently altering the legal framework of claims to rank depositors preferentially. Depositors with a preference would be less likely to lose money, but would by no means be immune from loss.

Protecting depositors with insurance

A deposit **insurance** scheme (sometimes called a guarantee or compensation scheme) would pay eligible depositors up to a pre-set maximum or 'coverage limit' (e.g. $50,000 per depositor per bank) if their banks failed. Insurance could be stand-alone or combined with a preference. It would be available to any eligible depositor who was exposed to loss, no matter which resolution method was used for their bank. Depositors who did not qualify for insurance, or whose deposits sat above the coverage limit, could still lose money. Insurance would be compulsory, and depositors could need to pay premiums to fund the scheme through their bank fees.

Protecting depositors' access to critical banking services is a separate bank resolution issue (see Box 4B). Depositor protection and resolution methods are different, but they interact. For example:

- without well-designed resolution methods, in some crises governments have decided to bail-out failing banks even when depositor protection schemes are in place. If this happens, any pre-planned depositor protection is not necessary or used
- having pre-planned and well-designed depositor protection may make it more credible and feasible to resolve failing banks without bail-outs, by making it easier for governments to use resolution methods to impose losses on the banks' owners and other creditors.

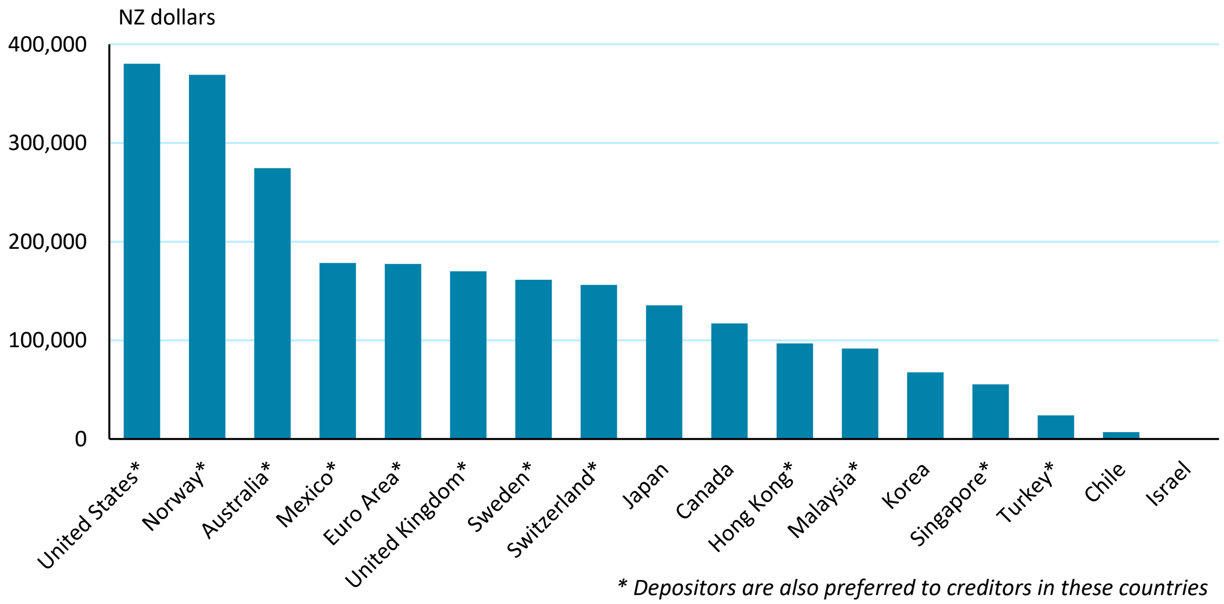
The international experience

Almost all advanced countries provide depositor protection of some sort, most often through insurance, also sometimes with a preference. Deposit insurance is part of the Financial Stability Board's Key Standards for Sound Financial Systems, which recommend a limited (i.e. capped) insurance scheme "to maintain financial stability by protecting depositors and preventing bank runs".

To give an idea of the level of protection available internationally, Figure 4C compares insurance coverage limits (the maximum protection someone can have at any one bank) in some key countries.

New Zealand and Israel are the only OECD countries without depositor protection, and Israel has indicated that it will introduce deposit insurance. In the 2016/17 FSAP, the IMF recommended that New Zealand reconsider the merits of deposit insurance, and that if it were not adopted a small level of depositor protection should be provided in Open Bank Resolution (OBR) (see Box 4B).

Figure 4C: Depositor protection scheme limits for select countries



Source: International Association of Deposit Insurers Annual Survey (2017).
Notes: Protection limits represent the maximum payout per depositor per institution. Depositor protection levels have been converted to New Zealand dollars at market exchange rates on Friday 21 September 2018.

Box 4B: Open Bank Resolution (OBR) and other bank resolution tools

Outcomes for depositors should a bank fail depend on the depositor protection approach as well as the **bank resolution** method. Bank resolution deals with a failed bank's financial problems (in contrast, depositor protection is about shielding depositors from those problems). Below are some resolution options that will be looked at more closely in the second round of consultation.

OBR – a Reserve Bank policy aimed at allowing a distressed bank to remain open for business. Under OBR, a failing bank closes temporarily and a portion of creditors' claims are frozen. The bank re-opens the next day under 'statutory management', when customers can access a non-frozen portion of their deposits. The frozen portion may be used to absorb the bank's losses. To restore public confidence in the bank in OBR, it is expected that unfrozen deposits (and the continuing operation of the bank) would receive a Government guarantee. Once the bank's problems were resolved, any unused portion of frozen deposits would be returned to customers.

It is possible for some deposits below a level called the 'de minimis' to be exempted from the OBR freeze (offset by a larger freeze of other creditors' claims). The de minimis is optional, and is set and applied bank by bank. Messaging to date has indicated that it would probably be low – perhaps as little as $1000 – fully protecting around 50 percent of deposit accounts. Formalising the de minimis at some higher, pre-announced level, perhaps around $10,000, has also been considered.

OBR is based on the idea that those who invest in or lend to a bank (i.e. shareholders, depositors) have a role in monitoring the bank's risks, so should also share in the bank's losses. Like bail-in and liquidation (below), OBR envisages that losses will be imposed on owners first and then creditors, rather than taxpayers. However, there are some differences between OBR and bail-in (e.g. OBR lacks 'bail-in' powers to recapitalise the bank) that will be examined in the next consultation.

There are currently 10 banks pre-positioned for OBR, which together hold more than 97 percent of retail deposits in New Zealand. However, OBR is not a default solution and requires Government approval to be used. No banks have failed since it was implemented, so it has not yet been used.

Bail-in – when a failing bank is restored to financial viability using the resources of the bank's shareholders and creditors. Depositors' and creditors' claims are written down or converted into capital, making them part-owners of the restored bank. Other countries (particularly in the EU) have developed bail-in regimes since the GFC, but they remain largely untested.

Bail-out – when a failing bank is rescued by external parties, usually a Government using taxpayers' money, and usually in exchange for part ownership of the bank. It was commonly used in the GFC, prompting work on 'bail-in' alternatives to protect taxpayers in any future crises.

Liquidation – when a failed bank is wound up by a court-appointed liquidator. The bank's remaining assets are sold and the proceeds allocated to creditors, according to a ranked queue of claims. As with OBR, depositors are around the middle of the queue to be paid out, so may suffer losses if there is a shortfall between creditors' claims and asset sales. It can be a long process, particularly for large and complex banks, so it is likely that only small banks would be liquidated.

Potential reasons to protect deposits

Without protection, depositors are treated like any general bank creditor. With protection, they have better financial outcomes than other creditors. Keeping depositors safe from loss (up to a limit) after a failure **can only be achieved by shifting losses onto someone else**. This kind of special treatment for protected bank depositors may be motivated by several public policy objectives that reflect the unique nature of depositors as investors and deposits as investments:

a) Protecting bank customers from loss

This objective might address:

- **information asymmetries and financial capability barriers** – ordinary retail depositors may be less aware than other investors of the risks of placing their money in a bank. Under current regulations, bank deposits are exempt from some of the customer disclosure requirements that apply to other financial investments. While public tools such as the Bank Financial Strength Dashboard are helpful, there is limited evidence to suggest that ordinary New Zealanders have the financial literacy necessary to interpret bank risk metrics and assess the safety of their deposits or manage their exposure to 'risky' banks. A 2011 Government inquiry into finance company failures during the GFC found that depositors often had no understanding of the risks they were assuming, and the FMA's 2018 investor attitudes survey found that only 42 percent of New Zealanders understood the trade-off between investment risk and return.

  ⇨ It may be unrealistic to expect **retail depositors** to be able to identify bank risks accurately, and unreasonable to hold them to account by exposing them to loss if those risks eventuate

- **special needs of certain depositors** – some deposits are special types of investment. Everyday (transactional) accounts, in particular, are an important part of modern life, helping people in daily activities like doing the shopping, paying bills, and receiving wages. No other investment offers these functions, and transactional services in New Zealand are largely accessed through banks.[17] Transactional bank deposits may be seen more as a 'public utility', helping New Zealanders to participate in the financial system, than as an investment choice.

  ⇨ It may be unrealistic and unfair to treat **transactional depositors** in the same way as other bank investors in a bank failure. (Most insurance schemes internationally protect term deposits as well as transactional accounts; this could raise equity issues, as other common retail investments such as property and retirement funds are not insured.)

b) Mitigating bank instability and wider economic costs of failure

This objective might address:

- **the risk of bank deposit runs** – while deposits are normally slow to respond to emerging bank risks, many deposit account types can be accessed at any time and money freely withdrawn. This means that when depositors **do** react to risks – generally only after wholesale investors and supervisors have become aware of the problems and the bank is nearing the point of failure – they can do so quickly, running to withdraw all the money they have deposited and triggering a sudden loss of liquidity at the bank. Run risks could increase with FinTech developments

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[17] Developments in financial services technology ('FinTech') and digital payments platforms may open up new ways for New Zealanders to access transactional services outside of the traditional channels provided by banks.

enabling 'real-time' retail banking. While the Reserve Bank can offer emergency funds to illiquid banks as LoLR, a severe run would likely lead to a disorderly bank failure – particularly in an environment of distressed markets and falling asset prices.

⇨ Giving **on-call depositors** confidence that they will be repaid rapidly if their banks fail can reduce their incentives to join bank runs. It cannot **stop** a bank failure, nor deal with all potential failures – particularly at large banks or across multiple banks. If protecting depositors means larger losses will fall on other creditors, they may be less likely to renew (and more likely to withdraw) their lending to a bank once they become aware of problems, accelerating its failure.

- **risks to depositor trust and confidence** – the way that bank customers are, and expect to be, treated can profoundly affect their trust and confidence in banks. Public confidence is crucial in a stable and efficient financial system. The GFC showed that distress at one bank can rapidly spread through the system as 'contagion', eroding confidence in other banks and market participants. While LoLR can help, a general loss of confidence following a bank failure could trigger widespread financial distress and dislocation, and threaten to lead to sustained adverse effects on businesses, employment, public trust, and financial inclusion.

  ⇨ Giving **all depositors** confidence that their deposit funds are safe and accessible could support public confidence in the financial system and protect economic and social capital if a bank fails

- **the fiscal challenges of an implicit guarantee** – the GFC demonstrated that governments are reluctant to see the losses of a bank failure imposed on depositors and may tend towards taxpayer-funded bail-out solutions when either deposit protection or resolution methods are lacking or bank distress is widespread. An example of this is the Crown Deposit Guarantee Scheme (CDGS), an emergency taxpayer-funded measure put in place to support New Zealand's financial sector in the GFC. Having a formal deposit insurance scheme can help governments to manage their fiscal objectives and risks by pre-allocating and potentially pre-funding (through scheme levy collections) some of the costs of a financial crisis.

  ⇨ Pre-allocating and potentially pre-funding a portion of the costs of a financial crisis can help governments to better manage fiscal objectives. However, building up a formal deposit insurance fund through premiums charged to members could take many years, even decades.

These objectives present important choices and trade-offs for the design of any depositor protection scheme – for example, what protection limit should apply, and what account types and institutions should be covered? An insurance limit that protects most New Zealand depositors from loss (around $10,000 would protect 80 percent of people with deposits) may not be enough to shore-up depositor confidence in times of stress and prevent bank runs and contagion; many protection schemes proved inadequate in preventing distress during the GFC. The increased coverage limits ($100-300,000) that many countries have since adopted might promote depositor confidence, but could cause unintended consequences for financial stability and, if called on, generate payout costs so high that they are infeasible unless backstopped by the Government.[18]

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[18] The government is a key insurance provider in New Zealand, with personal injury compensated by the Accident Compensation Corporation (ACC), and natural disaster damage for residential land and buildings partly compensated by the Earthquake Commission (EQC). Both the EQC and ACC are Crown entities. The EQC currently has $300 million in investments (down from $6.4 billion before the Christchurch earthquakes), and ACC has $36.8 billion.

These issues are explored further below, and Box 4C identifies some high-level design principles for a depositor protection scheme. However, detailed scheme design is not a focus of this consultation round, and would only be undertaken if the results of this round suggest it should.

Box 4C: The importance of scheme design

While this consultation round does not consider design details, as a starting point for any future design phase there are 16 international core principles of insurance scheme design (International Association of Deposit Insurers, 2014). Four in particular provide a guide to the design of a potential insurance scheme:

- Membership in a deposit insurance system should be compulsory for all banks (and other deposit-taking institutions).
- The deposit insurer is able to reimburse most insured depositors quickly (ideally within seven working days, a condition that many countries do not meet but are working towards. New Zealand would be well placed to address this challenge, as the OBR policy has already pre-positioned a possible payout mechanism for most banks).
- The insurer should be part of a broader crisis management framework (including resolution tools) that provides for the early detection of, and timely intervention in, troubled banks.
- Insurance coverage should be limited (i.e. up to a pre-announced set level), be credible, and cover the large majority of depositors, but leave a meaningful value of deposits at risk.

The final point may be feasible because many deposit accounts are low in value, leaving a minority of high-value accounts holding a substantial share of total deposits (in New Zealand's case, around 80 percent of all accounts hold under $10,000, but these make up only around six percent of deposits by value). The last two points are designed to make a bail-in of a failed bank's owners and other creditors a feasible way to limit the costs faced by the insurance fund (or the taxpayers backing it). This again illustrates how resolution and depositor protection are interrelated.

Many countries have strengthened their depositor protection frameworks since the GFC. In general, more weight is now placed on promoting depositor confidence than limiting moral hazard for depositors, for example through higher coverage limits, a move away from risk-sharing arrangements, rapid payouts, and clearer public messaging. These new schemes have not been tested though, so whether they would prove effective in another crisis is unclear.

Potential reasons to not protect deposits

Risk may encourage banks and depositors to act prudently

Depositor protection has an inherent trade-off. On the one hand, it can reduce the severity and impact of a single bank's failure on its depositors, the financial system, and the economy. On the other, it may encourage poor behaviour. This is because depositor protection, like any insurance arrangement, can distort the incentives and behaviour of those who benefit from it. Reducing depositors' incentives to run may also reduce their incentives to monitor and manage risks properly. At the same time, banks shielded from deposit runs may have less incentive to act prudently.

This is known as 'moral hazard', and can give rise to excessive risk-taking by protected depositors (who may invest in less financially sound banks than otherwise) and their banks (which may invest in higher-risk ventures). The risk of moral hazard when protecting depositors is particularly acute where bank supervision is not very intense or intrusive, as in New Zealand.[19] If not carefully managed, moral hazard could mean that depositor protection put in place to help in times of crisis also causes a build-up of risks during normal times that crystallise a crisis.[20]

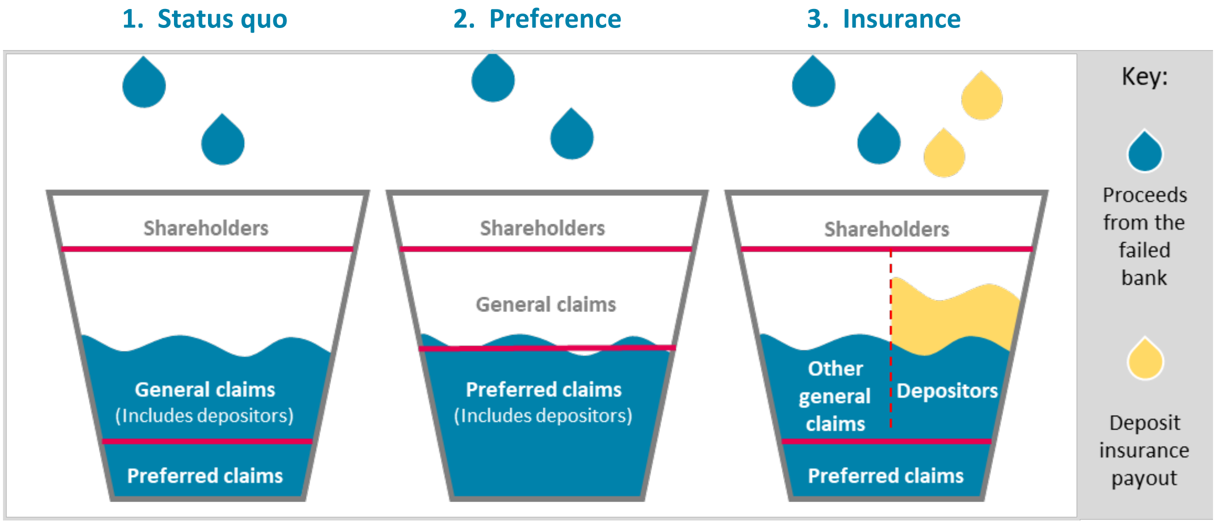
The experience with the CDGS is an example of moral hazard allowing troubled and unviable investment firms to grow their insured deposit bases before ultimately failing.[21] Depositor protection does not need to be explicit to create moral hazard. Depositors, bank managers, and New Zealanders more broadly may expect a CDGS in another crisis, which could be limiting their incentives to act prudently now.

Depositors might be saved, but everyone pays

As with any insurance-type scheme, depositor protection can alter the magnitude, distribution, and timing of the risks and costs of failure. The impact and costs of depositor protection will probably extend far beyond depositors.

Depositor protection will redistribute the risks and costs of bank failure. Figure 4D shows liquidation outcomes under the status quo and two depositor-protection options. Proceeds recovered from sales of the failed bank's assets flow to creditors and shareholders according to their positions in the bucket (which represents their rank in the legal framework of claims). Proceeds (and losses) are distributed proportionately amongst each layer. Preferred creditors, at the bottom of the bucket, are paid first, with anything left being used to meet the claims of general creditors above them, and so on. Shareholders would be paid last, and only if all creditors have first been fully repaid.

Figure 4D: Who might bear losses in a bank failure?



[19] New Zealand's supervisory and crisis management arrangements will be reviewed in the next consultation round in 2019.

[20] A lot of theoretical work has been done on the drawbacks of deposit insurance in terms of moral hazard. Real-world studies (e.g. Anginer et al, 2014) also find evidence that deposit insurance has a negative impact on the monitoring incentives of bank investors, which can be associated with riskier banks and increased crisis risk. These studies also find that the distortions of deposit insurance on risk taking can be alleviated by a strong political and legal framework, good bank supervision, and robust insurance scheme design.

[21] The CDGS was implemented in October 2008 and matured in December 2011. At its peak the scheme covered 96 institutions, including 12 banks, 60 NBDTs, and 24 investment firms. The government paid out $2 billion to 42,000 depositors under the scheme. The largest single payout was for South Canterbury Finance ($1.6 billion), one of nine failures under the scheme.

- **A depositor preference** moves depositors lower in the bucket of claims. Depositors become the first creditors to get paid from proceeds from the failed bank, and would lose money only if all shareholders and general creditors have lost all of their money first. But this means the bank's general creditors, such as wholesale investors, are exposed to greater losses, and may become more alert and sensitive to bank risks as a result.
- **Deposit insurance** tops up insured depositors, up to a coverage limit. Depositors' insured losses are moved to an insurance scheme, which would look to recover the money it pays out to depositors from the failed bank's assets. Any shortfall between insurance payouts and asset sales would fall on those funding the scheme. These could be other banks and depositors, via an insurance levy, and taxpayers if the scheme is backstopped by the Government. A public backstop would probably be necessary for the scheme to be credible in handling a large bank's failure. Insuring depositors (whether through a pre-planned arrangement or a crisis guarantee such as the CDGS) may prove very costly for taxpayers, particularly if system-wide issues meant multiple banks failed simultaneously. The resulting fiscal costs could take a long time to recover.

Protecting depositors could also add to everyday operating and funding costs in the following ways:

- Depositor **preference** could increase banks' wholesale funding costs (reflecting the increased risk of loss they bear), particularly small, deposit-focused local banks.
- Deposit **insurance** will likely create membership, administration, and compliance costs, which would be passed on to depositors as higher fees or lower returns.

Under both approaches, costs may be offset by clearer risk pricing and a transfer of risk away from depositors to those better able to hold and manage that risk, so a well-designed protection scheme need not impose additional costs on the system overall.

Lessons from the GFC

The effectiveness of depositor protection was severely tested during the GFC. As countries with pre-planned protection arrangements were forced to intervene and bail out banks using taxpayers' money, it became clear that poorly designed regimes that were not credible, well understood, or could not pay out depositors quickly would not stop banks runs.[22]

The GFC demonstrated the difficulty of managing the depositor confidence effects and moral hazard risks of depositor protection. Schemes that get the balance wrong can create incentive structures that promote risk-taking and undermine financial stability. On the other hand, a well-designed scheme complemented by robust supervision and sound crisis management (both of which will be reviewed in the next consultation round) should reduce the risks that come with protecting depositors. Indeed, at least in theory, by explicitly capping expectations of official support, formal protection might lower risk-taking among New Zealand banks and investors (Allen et al, 2011).[23]

New Zealand has chosen to operate without explicit depositor protection, and since the Reserve Bank was first tasked with prudential supervision 30 years ago it has emphasised the role of

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[22] The run and nationalisation of Northern Rock in the UK in 2007 is an example of a failure of deposit insurance. A 2008 parliamentary inquiry found that poor scheme design – a complex, co-insurance arrangement with low limits and slow payouts – contributed to depositors' incentives to run. The UK's deposit insurance framework has since been strengthened, with faster payouts (within seven days of failure), higher coverage limits, and the elimination of depositor/insurance scheme loss sharing.

[23] Deposits, more than any other retail investment, are associated with a guarantee of repayment. The FMA's 2014 investor attitude survey found that 52 percent of New Zealanders, and 75 percent of term deposit holders, thought that term deposits were guaranteed. The investment next most commonly associated with a guarantee was KiwiSaver (42 percent of New Zealanders, 49 percent of holders).

depositors in keeping banks safe (Fiennes, 2016). This approach to deposit protection was a deliberate choice made on the balance of benefits and risks, but it has become unusual relative to similar countries where, increasingly over time, the perceived advantages of well-designed depositor protection have been seen to more than offset the disadvantages (IMF, 2017).

With this in mind it is timely to review New Zealand's depositor protection framework. This consultation is the first stage of that review. Whether deposit protection achieves the policy objectives and/or generates the costs outlined above depends on scheme design and context, so any recommendations that result from this consultation would be subject to detailed design work.

The options compared

The tables below look at how the status quo and the depositor protection options discussed in this Chapter might perform against policy aims and costs.[24] The options do not include an approach that is increasingly common internationally, which combines option 2 (a depositor preference) and option 3 (deposit insurance). This approach would be considered as part of any scheme design phase.

Option 1: Status quo - no protection as default; resolution-based protection may apply	
Protects depositors from loss?	**Not consistently.** – In insolvency, losses are spread equally among general investors, including depositors. Depositors may lose their money and access to banking services. – Depositors will get uninterrupted access to their funds and banking services if their bank is put into OBR, but may still suffer losses. – Outcomes for depositors are uncertain and unpredictable, and may vary across large and small banks, potentially creating an uneven playing field.
Prevents deposit runs?	**No.** – OBR may allow depositors to access a portion of their funds, but whether and how it would be applied is uncertain. Without prompt and certain repayment, depositors have incentives to join bank runs.
Supports depositor confidence?	**No.** – If used, OBR protections apply only to depositors at the banks in OBR. Confidence in surviving banks may be undermined, triggering wider distress.
Impact on incentives to monitor risks	– The status quo does not interfere with depositors' incentives to monitor risks. – Depositors may be ill-equipped to assess bank risks from available information. – Expectations of implicit support may be distorting depositors' and banks' incentives to monitor risk. – A lack of predictability and certainty may make risks hard to price and manage.
Impact on distribution of costs and losses	– The allocation of losses in OBR and liquidation are likely to be aligned. However, the distribution of losses may be altered in OBR for the purposes of maintaining financial stability and public confidence. – The actual distribution of losses is uncertain and unpredictable. – Imposing losses on depositors may be difficult in a crisis. In the GFC, governments used public funds to support depositors and stop banks failing. Poorly targeted emergency measures may be costly to taxpayers.

[24] This is not a comprehensive list of depositor protection options. There are other ways to protect depositors, such as through zero-interest transactional accounts secured by government bonds, that have been contemplated in academic literature.

Option 2: Depositor preference regime – depositors get paid ahead of other unsecured creditors	
Protects depositors from loss?	**Partially.** – Relative to the status quo, a legal preference improves depositors' chances of repayment in liquidation and the chance of full repayment in resolution. – A preference is legislated, formal, non-discretionary, and consistently applied. – Actual outcomes ultimately depend on the troubled bank. Protected depositors might still lose money, particularly where banks are largely deposit funded. – Depositors face long repayment delays in liquidation.
Prevents deposit runs?	**Unlikely.** – A preference alone does not give depositors an assurance of prompt and certain repayment. Actual outcomes depend on the circumstances of the failing bank. – Without certain outcomes, depositors may still have incentives to run. – Increases the cost of bank failure for non-deposit (i.e. wholesale) creditors, who may become more alert and sensitive to emerging signs of bank stress. The risk of 'wholesale runs' might increase relative to the status quo. This could possibly be mitigated through revised liquidity requirements to reflect the increased risk of wholesale outflows.
Supports depositor confidence?	**Unlikely.** – May not give depositors sufficient confidence to address wider contagion risks. – May increase the risk of a single bank's distress being spread throughout the wider market via wholesale participants.
Impact on incentives to monitor risks	– Gives non-deposit creditors (i.e. wholesale investors) stronger incentives to monitor and manage their risks relative to the status quo, particularly if accompanied by credible resolution options that impose losses on creditors. – As non-deposit investors are likely to be more sophisticated and better able to respond to emerging bank risks than depositors, could increase banks' overall vulnerability to funding and liquidity stress relative to the status quo.
Impact on distribution of costs and losses	– Non-deposit creditors will suffer greater losses than under the status quo. – May have adverse effects on banks' funding arrangements via higher wholesale funding costs, shorter loan periods, and increased collateral demand. – The Government may find it difficult to impose losses on non-deposit creditors.

Option 3: Deposit insurance scheme – insured deposits repaid up to a set coverage limit	
Protects depositors from loss?	**Yes**, up to coverage limit. – Depositors are protected from losses up to a pre-announced limit. – Repayment may be uncoupled from insolvency outcomes and timeframes. – Deposits above the insurance limit are still exposed to loss.
Prevents deposit runs?	**Yes**, depending on scheme design. – Deposit insurance can reduce incentives for protected depositors to join bank runs by ensuring timely access to funds up to a known limit. – Achieving this objective may require a high coverage limit (e.g. >$50,000).
Supports depositor confidence?	**Yes**, depending on scheme design. – Deposit insurance supports depositor confidence at surviving banks, so mitigates the risk of a disorderly and widespread withdrawal of deposit funds. – Achieving this objective may require a high coverage limit (e.g. >$50,000).
Impact on incentives to monitor risks	– Insurance could create the most moral hazard of all three options. By shifting costs externally, insurance could cross-subsidise riskier firms and investments (particularly at smaller banks subject to less-intensive supervision). – Any insurance scheme would require careful design to mitigate moral hazard and support the incentives of non-deposit stakeholders to monitor risks. – For a one-off bank failure, deposit insurance could enhance the credibility of resolution options that impose losses on creditors (e.g. OBR, bail-in), particularly if accompanied by depositor preference. – If multiple banks are failing at the same time, deposit insurance could be very costly, increasing the risk of a taxpayer-funded bail-out of the banking system. This risk is reduced if insurance is accompanied by depositor preference.
Impact on distribution of costs and losses	– Depositors' costs are shifted to an insurance scheme. Insurance payouts could be costly, possibly causing financial stress among those funding the scheme (i.e. surviving banks, depositors), or threatening the credibility of the scheme itself. May need to be explicitly underwritten by taxpayers. – Payouts could be reduced, and the chance of the scheme recovering all of its costs from the failed bank improved, if insurance is combined with preference. – Insurance may necessitate more intensive and costly bank supervision.

Questions for consultation

Your views are sought on the following questions:

5. Have the key benefits of the status quo and the identified depositor protection options been correctly identified?
6. Is the high-level assessment of the risks and costs under the status quo and the identified depositor protection options reasonable?
7. On balance, do the arguments support a case to progress work on depositor protection in New Zealand? Why or why not? If yes, which protection approach do you prefer and why?
8. (To the extent possible) what are the potential implications of your preferred approach to depositor protection, for depositors, other bank creditors and investors, banks and other financial firms, taxpayers, and the operation of the New Zealand financial system?
9. Are there any alternative protection options, design principles, or complementary policies that could improve outcomes for the stakeholders identified above?

Chapter 5: Should prudential regulation and supervision be separated from the Reserve Bank?

The aim of this Chapter

A number of stakeholders have suggested that it may no longer be appropriate to locate prudential regulation and supervision alongside monetary policy and other functions in the Reserve Bank. This Chapter explores the merits of transferring some of the Reserve Bank's current financial policy responsibilities to a separate agency. It is supported by a more detailed background paper.

Note that while institutional separation is being fully considered as part of the Review, the Government has expressed an initial preference that prudential regulation and supervision continue to sit with the Reserve Bank (i.e. the status quo).[25] An enhanced status quo option (with enhancements to governance and resourcing for example) is also considered as an alternative to separation which may address some of the concerns raised by stakeholders.

What is separation?

For the purpose of this 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
- the transfer of those responsibilities to a new agency, or an existing agency.

The potential reallocation of responsibilities would be expected to include the micro-prudential and crisis management functions pertaining to registered banks, NBDTs, and insurers. It may also include a reallocation of responsibility for macro-prudential policy and oversight of FMIs, although the Reserve Bank could retain these functions even if other functions were carved out. The Reserve Bank would retain its role as liquidity provider in times of stress (its LoLR role).

Specifically out of scope of this Review is a formal consideration of New Zealand's overall arrangements for AML/CFT regulation and supervision (however, any form of separation will require decisions on the location of the Reserve Bank's current responsibilities in this area).[26] The 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 APRA taking sole responsibility for regulating and supervising the large Australian-owned banks operating in New Zealand.

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[25] See paragraph 22, Cabinet Economic Development Committee paper, 21 May 2018.

[26] 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.

In addition, this Chapter does not consider whether the responsibility for certain aspects of regulatory policy should rest outside the Reserve Bank (as is the case with the FMA and MBIE). This is covered in Chapter 7, which considers the extent of the Reserve Bank's 'operational independence' and the role of the Minister of Finance and their agents in the regulatory framework.

The Reserve Bank's role in New Zealand's regulatory architecture

The Reserve Bank has a number of financial system-related responsibilities whose nature and scope have evolved over time.[27]

As described in Chapter 1, today's twin peaks model of financial regulation emerged as a result of the RFPP in the mid-2000s, which addressed gaps in the regulation and supervision of non-bank financial institutions. One outcome of the review was the decision to make the Reserve Bank responsible for insurers and NBDTs, in addition to undertaking its longer-standing role of regulating and supervising registered banks. The Government at the time considered the pros and cons of placing the responsibility for these sectors on a single agency and whether this single agency should be the Reserve Bank. At that time the benefits of co-locating these prudential functions and the Reserve Bank's responsibility for monetary policy were considered to outweigh any potential costs.

Stakeholder feedback during the scoping for Phase 2 of the Review

In early 2018 the Treasury and the Reserve Bank engaged a number of stakeholders to help determine the issues for consideration in Phase 2 of the Review. Some stakeholders stated that the institutional separation of the Reserve Bank's prudential function would be appropriate. The most commonly raised reasons included the following concerns about the current arrangements:

- Actual or perceived conflicts of interest (e.g. between monetary policy and prudential policy) in the Reserve Bank's policy functions that might not be adequately managed within the current governance arrangements. Separation was seen as a way to avoid these conflicts.
- The lack of resourcing for the Reserve Bank's financial system responsibilities. Some stakeholders thought that separation would lead to a better-resourced, efficient and responsive prudential authority (see Box 5). In addition, some thought that a specialist agency would have a more appropriate mix of skills in prudential regulation and supervision.
- A culture within the Reserve Bank that, coupled with a lack of resourcing, was seen to have led to a lack of focus on prudential regulation. There was a sense that financial policy had historically been treated as a 'poor cousin' to monetary policy. A separate agency was seen to offer better prospects for developing a new organisational culture more appropriate for a modern prudential regulator.
- A sense that the Reserve Bank's current financial system objectives are unclear, and that separation would provide an opportunity for greater clarity.

Many of these arguments echo those in international literature related to the design of institutional arrangements for financial sector regulation.

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[27] See Hunt (2016) for an overview of the history of prudential regulation and supervision in New Zealand.

Box 5: 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 Government). A five-year funding agreement between the Governor of the Reserve Bank and the Minister of Finance specifies the amount of income that can be used to cover operating expenses.

The Governor, in consultation with the senior management group, decides how to allocate this funding 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 5: 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
	76	**68**

Source: Reserve Bank of New Zealand Annual Report 2017-18, p. 90.

The Reserve Bank's prudential functions account for just over 30 percent of total operating expenses, compared to 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 the current 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 currently apply the intrusive and higher-cost model of supervision seen elsewhere (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 below).

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.

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 minimise the effects of market failures that impede this growth.

The first step in designing a regulatory system that is fit for purpose is to create an architecture that:

- ensures comprehensive coverage of the main **financial entities and sectors** operating in a jurisdiction
- identifies **clear objectives** for financial sector regulation that reflect desired public policy outcomes
- assigns **functions and powers** (or activities) to an agency to achieve these objectives
- ensures a degree of **independence** from the political process for the agency tasked with a financial system-related role.

While all models of financial regulation attempt to address these issues, there is no single 'optimal' institutional model that can guarantee effective regulation and supervision. The institutional models used in other countries 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. All models have advantages and disadvantages and all involve trade-offs.

Nevertheless, institutional structure can certainly influence the effectiveness of financial sector regulation, as a poorly designed architecture can result in regulatory gaps (some financial institutions or markets falling between the cracks), create inefficiencies through regulatory 'overlaps' and duplication, and create conflicts within and between agencies if financial sector objectives are poorly specified.

A typology of institutional models

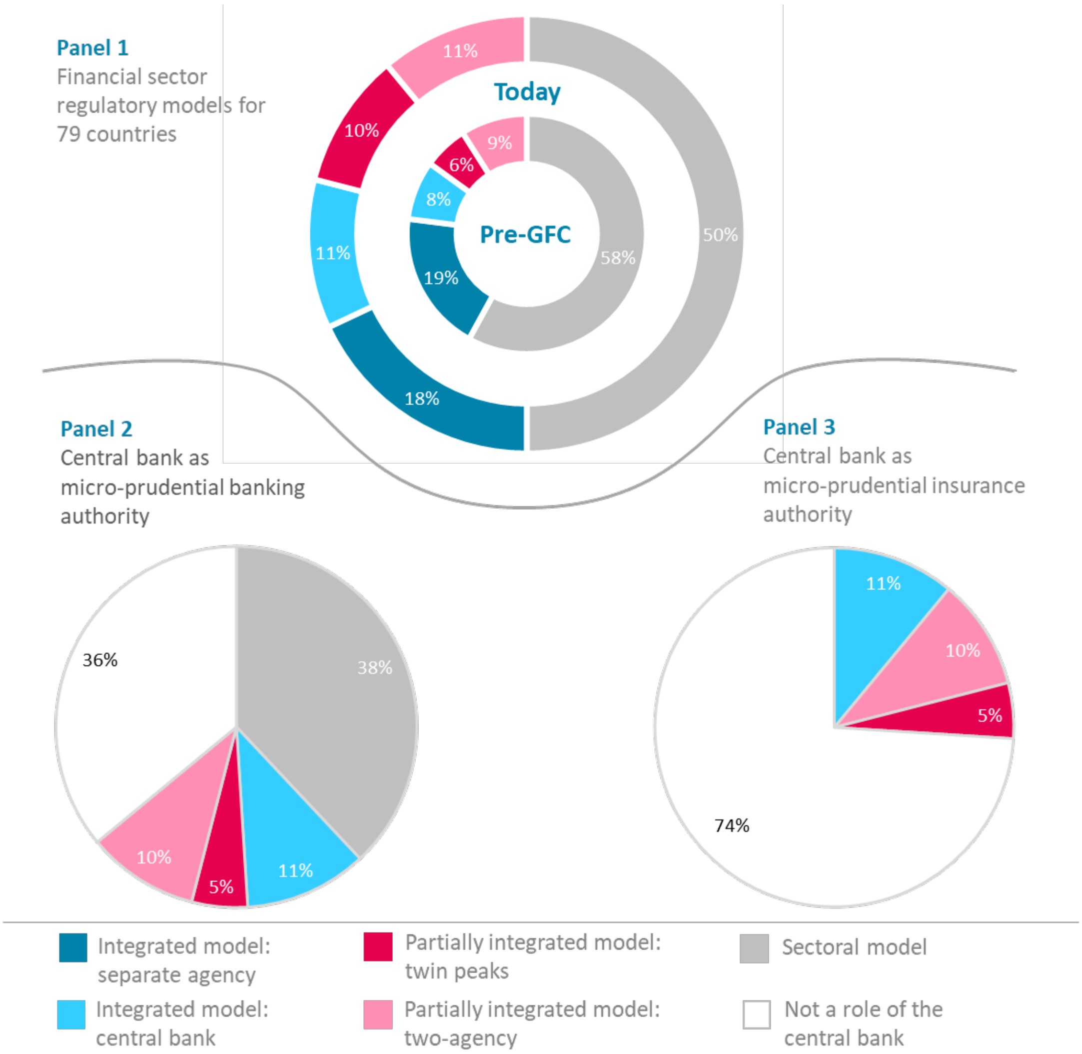
The BIS recently released the results of a survey of financial sector regulatory models in 82 countries, which included New Zealand (BIS, 2018a). It identifies three general models that are compatible with a central bank's narrow role, focusing on a currency function, monetary policy, and LoLR, and an expanded role as a financial sector regulator and supervisor. The models, which are explained in more detail in the accompanying background paper, are:

- **sectoral** – there are specialist agencies for each financial sector (e.g. banking, insurance, securities firms), combining both a prudential and a financial market conduct mandate. This model leverages off synergies between prudential and financial market conduct mandates. In countries with sectoral models, bank regulation and supervision may sit in the central bank or a separate agency. Advanced country examples include Hong Kong SAR, Israel, and Spain
- **integrated** – a single agency combines prudential and financial market conduct regulation and supervision for all key sectors. This agency may or may not be the central bank. The rationale for this model is that there are synergies in the supervision of banks and insurance and securities firms across both the prudential and financial market conduct mandates. Advanced country examples include the Czech Republic, Germany, Ireland, Singapore, and the Nordic countries

- **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 split between separate agencies. The 'solvency peak' (the prudential mandate) may be situated in the central bank (as in New Zealand and the UK) 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 regulation of banks and insurers, and the other for securities firms. Examples include France and Italy.

As shown in Figure 5, the sectoral model is the most common internationally, although it has lost ground since the GFC (see Panel 1). Across the various models described above, the central bank is now responsible for the prudential regulation and supervision of the banking sector in close to two-thirds of cases (see Panel 2), and for the insurance sector in a quarter of cases (see Panel 3).

Figure 5: Institutional models and the role of the central bank



Source: BIS (2018a and b).
Note: The BIS was unable to classify three countries: Cyprus, Kyrgyz Republic, and Timor-Leste.

Trends since the GFC

Of the 79 countries classified by the BIS, 11 have changed their institutional arrangements since the GFC, with a further two in the process. In seven of the 11 countries, this has involved a shift away 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. the UK).

Across these model changes central banks have generally assumed more responsibilities. This includes the reassignment of micro-prudential responsibility for banks and insurers, alongside new macro-prudential and crisis management and resolution functions. For example, the BIS survey identifies seven cases where the specific location of prudential supervision for the banking sector has changed. In five of these cases this responsibility has moved from separate agencies to central banks and in one case from a government department to the central bank. The other case involved reallocation from a central bank to a separate agency.

There are 11 examples of the location of insurance supervision changing. In eight cases the central bank has become the prudential authority, taking over from a separate independent agency in seven cases and from a government department in the other. In the remaining three cases, a separate agency has taken responsibility for the sector from a government department.

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

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.

The central bank is the primary crisis management and resolution authority for deposit-taking institutions in close to 60 percent of 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 architecture have gone hand in hand with reassessments of the costs and benefits of housing additional functions within central banks, with an increasing emphasis on the benefits of co-location (see the next section).

The pros and cons of a prudential role for the central bank

Any institutional arrangements for financial system regulation will involve the 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 their LoLR role
- promoting the stability of payment and settlement systems, often reflecting the central banks' direct role in providing inter-bank overnight clearing and settlement services.

In addition to having a 'natural interest' in financial stability, many central banks have responsibilities for prudential regulation and supervision (and in some cases a market conduct mandate). Arguments from the literature examining the merits and drawbacks of locating these additional financial sector responsibilities in a central bank are summarised in Table 5B, and detailed more fully in the accompanying background paper.

Table 5B: Pros and cons of having a prudential mandate within a central bank

Arguments for a prudential mandate	Arguments against a prudential mandate
Complementarity between monetary and financial policy roles – Financial stability is a precondition for the effective implementation of monetary policy; price stability is a precondition for financial stability. – The realisation of systemic risk is costly for a central bank (e.g. balance sheet costs from LoLR). – Improved coordination across prudential and monetary policy.	**Potential conflicts between monetary and financial policy roles** – Management attention stretched across a number of functions; internal allocation of resources may prioritise one function over the other. – Price and financial stability objectives may be blurred. – Trade-offs between inflation and financial system outcomes could be managed in suboptimal ways (e.g. the Reserve Bank's price stability role may be prioritised as it is easier to measure).
Synergies between monetary policy and prudential supervision – Informational (e.g. economic analysis needed for monetary policy may be helpful for financial system risk assessment), analytical perspectives, and skillsets.	**Reputation risks to monetary policy from failure of a supervised entity** – Additionally, poor monetary policy outcomes could undermine the integrity of the prudential framework.
Synergies between LoLR role and prudential supervision – Information on individual institutions. – GFC showed there was a premium for acting quickly and decisively and managing exposures. – Supports role as resolution authority.	**Use LoLR role to hide supervisory failures (delaying resolution actions)** – Regulated entities may become less risk averse.
Synergies between systemic oversight and macro-prudential policy	**Systemic focus may underweight other prudential objectives (e.g. focus on smaller institutions)**
Economies of scale (cost savings) – Merging administrative functions and sharing overheads: human resources, information technology, and data collection (important for a small country).	**Dis-economies of scale** – 'Christmas tree effect': too many functions start to weigh down an organisation.
Independence of financial system responsibilities reinforced by well-accepted notion of central bank autonomy for price stability	**Compromises to monetary policy independence from potential politicisation of financial system role**
Powerful agency able to inform and influence wider economic and financial policy settings (if seen as credible)	**Excessive concentration of power**
Ability to attract and retain staff given varied career opportunities	**Enables central bank to focus on narrower human resource needs and capability**

Options and questions for consideration

Based on the above discussion, three models are being considered for New Zealand and evaluated relative to the baseline (the status quo in the absence of any changes from Phase 2 of the Review). Note the baseline itself is not being considered as an option, as the Review will likely deliver various changes to 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, with the Reserve Bank retaining its prudential role, but could include a number of changes to arrangements within the Reserve Bank that would potentially address some of the concerns of stakeholders who have advocated separation. Changes could include developing clearer objectives for the Reserve Bank, changing 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, with the Reserve Bank's prudential role transferred to a separate agency. The Reserve Bank would retain responsibility for monetary policy and LoLR
- **a New Zealand Financial Services Authority (NZFSA)** – this separate agency would assume responsibility for the Reserve Bank's prudential role and the FMA's market conduct mandate. This is similar to arrangements in the UK before the GFC, and arrangements currently in place in all Nordic countries. The Reserve Bank would retain responsibility for monetary policy and LoLR.

The models' strengths and weaknesses are assessed against four general evaluative criteria:

- **Focus** – the emphasis given to an agency's mandate(s). This is linked to the number and clarity of objectives and the degree of management and decision-maker attention paid to each.
- **Synergies** – the nature of the interactions between an agency's mandates. This has both policy and operational dimensions: policy outcomes improve through sharing data and analytical perspectives, and staff capabilities are enhanced through the cross-fertilisation of skillsets and greater career opportunities.
- **Conflicts of interest** – the nature of any trade-offs and how they are managed.
- **Costs** – the regulatory costs for the system as a whole, including the transition costs associated with changes to the baseline (set-up costs, impact on productivity etc.). Note all models are compatible with the allocation of more resources to the prudential function (increasing overall costs for the regulatory system).

Given these criteria, there are trade-offs in selecting an institutional model, and how these are managed would be important in any model in practice.

Assessing the options against the criteria

Option 1: Enhanced status quo	
Focus	– Potential to clarify focus by re-specifying high-level objectives or adding new lower-tier objectives. Any additional financial sector objectives might require a potential refocus of the regulatory and supervisory approach. – Increased funding and governance changes (e.g. a statutory Financial Policy Committee) could increase focus on financial system responsibilities. But there is still a risk of management distraction, given the broad range of responsibilities.
Synergies	– Pre-existing synergies across three policy domains (micro/macro-prudential and monetary policy) preserved. Reserve Bank still gets to internalise outcomes across three policy domains. – Additional funding and some internal organisational changes could help to further exploit potential benefits from co-locating these functions.
Conflicts of interest	– Separate formal decision-making bodies could mitigate any perverse outcomes, while preserving benefits of coordination via overlapping membership.
Costs	– Could increase from increased resourcing of prudential function, servicing the collective decision-making bodies, or more intensive approach to supervision. – Funding model changes (e.g. industry levies) could accommodate cost increase.

Option 2: New Zealand Prudential Regulation Authority (NZPRA)	
Focus	– 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. – Opportunities for appointment of senior management with industry experience and/or greater familiarity with prudential issues. – NZPRA will still need to decide which sectors to focus on within its remit. – Mandates are potentially clearer (unless NZPRA and the Reserve Bank are both given financial stability objectives, creating some confusion for stakeholders). – Not clear where macro-prudential policy or oversight of the payments system would sit in this model.
Synergies	– Retain synergies associated with cross-sectoral approach to prudential regulation, and those between policy and supervision/enforcement. But lose synergies between prudential, and monetary policy and systemic oversight roles. – 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.
Conflicts of interest	– Internal Reserve Bank conflicts reduced by design. – Policy trade-off management will require establishment of external coordination mechanisms with the Reserve Bank, FMA and Treasury.
Costs	– Loss of economies of scale and transition costs from setting up the new agency. – Question of whether New Zealand can sustain three agencies (NZPRA, FMA and Reserve Bank) in terms of overall regulatory costs (and capabilities). – Some cost increases could come from generally better resourcing of prudential function that comes with greater focus, relative to the baseline. – Funding model would need to be considered (e.g. industry levies).

Option 3: New Zealand Financial Services Authority (NZFSA)	
Focus	– Narrower focus for the Reserve Bank, broad focus for NZFSA. Potential for management distraction within NZFSA across its prudential and conduct mandates. – Less scope for regulatory underlap in prudential and conduct functions. – Depending on specification, mandate could blur prudential and conduct functions. – Not clear where macro-prudential policy or oversight of the payments system would sit in this model.
Synergies	– Retain synergies associated with cross-sectoral approach to prudential regulation, and those between policy and supervision/enforcement. – Exploit complementarities between prudential and conduct roles. – Lose synergies with monetary policy, systemic oversight role of Reserve Bank. – Reduced development opportunities for Reserve Bank staff, but enhanced for NZFSA staff.
Conflicts of interest	– Internal Reserve Bank conflicts reduced by design. – Potentially new conflicts created between prudential and conduct (e.g. looking after consumers versus the soundness of the financial institution, and confidentiality v. transparency). – Need for external coordination with Reserve Bank and Treasury.
Costs	– Steady-state costs for regulatory system are not clear. – Transition costs high – this option would be disruptive to both Reserve Bank and FMA. The new authority would need to be established quickly to avoid this disruption and to ensure that the Reserve Bank and the FMA are not undermined while carrying out their existing functions. – Funding model would need to be considered (e.g. industry levies).

Questions for consultation

Your views are sought on the following questions:

10. In your view, have the key conceptual arguments both **for and against** assigning a prudential role to a central bank been considered? If not, what other important arguments are there?
11. In the New Zealand context, are there any significant problems associated with locating monetary and prudential policy within the Reserve Bank (i.e. the status quo)? If so, how would 'separation' address these problems?
12. Do you agree that the three alternative models for institutional arrangements (NZPRA, NZFSA, and 'enhanced status quo') are the correct options to consider? If not, please suggest any alternative options of institutional arrangements not discussed here. Please indicate your preferred option, and your reasons for preferring it.
13. What do you consider would be the main impacts on relevant stakeholders (industry, ordinary depositors etc.) arising from each option?
14. Do you agree with the evaluative criteria and the assessment of the three options? If not, please suggest any evaluative criteria and/or alternative assessment you think should be included here.
15. If the 'enhanced status quo' is your preferred option, what features of this option are likely to be most important in addressing any problems you might see with current arrangements?

Part B: How should the Reserve Bank be governed?

Key topics covered in Part B

The governance arrangements of the Reserve Bank have an important role in determining how the Reserve Bank pursues its objectives. Governance encompasses the system by which an organisation is controlled and operates, and the mechanisms by which it, and its people, are held to account. Governance captures who makes policy and regulatory decisions, who makes organisational decisions, and how decision-makers are held to account. The focus of this Part is on whether any of the Reserve Bank's governance arrangements could be enhanced. A key part of the Bank's operational independence is being able to decide its own operational procedures, within a coherent legislative framework. This Part is structured as follows:

Chapter 6 summarises governance features commonly found in State sector organisations, describes the Reserve Bank's existing governance arrangements and how they have evolved over time, and sets out some specific areas that Part B considers. The Chapter also proposes some features of an effective governance regime that are used to guide the analysis in the rest of Part B (Chapters 7, 8, and 9).

Chapter 7 discusses the Reserve Bank's independent status from government, including its relationship with the Minister of Finance and the Reserve Bank's role as a regulatory steward.

Chapter 8 focuses on two aspects of the Reserve Bank's organisational structure that could be set by legislation: whether the governing body of the Reserve Bank should be a single decision-maker or a board; and whether a Financial Policy Committee should be introduced alongside the new Monetary Policy Committee being established from Phase 1.

Chapter 9 focuses on how the Reserve Bank is held to account for its decisions, including who should monitor the Reserve Bank and what transparency requirements the Reserve Bank should have to abide by.

Chapter 6: Introduction to the governance arrangements at the Reserve Bank

The aim of this Chapter

As discussed in Part A, the Reserve Bank has an important role in safeguarding New Zealand's financial system. The Reserve Bank's governance structure is an important element in this process. Strong governance underpins robust decision-making by ensuring that responsibility sits with the individuals who are most capable of making decisions, and by providing sufficient checks and balances on those individuals to hold them to account.

This Chapter sets the scene for the following Part B Chapters. It begins by describing the governance arrangements in the wider State sector, then summarises the Reserve Bank's existing governance arrangements, how they have evolved over time, and the outcomes that Part B aims to achieve. The Chapter also proposes some features of an effective governance regime that are used to guide the analysis.

Additional details on governance are provided in an accompanying background paper.

Governance arrangements in the State sector

New Zealand's machinery of government includes the set of organisations within government, their functions and governance arrangements, and how they work together to deliver results for Ministers and the public. The Reserve Bank is part of the machinery of government.

There are three branches of government – legislative, executive, and judicial. Most State sector organisations are part of the executive branch of government. Within the executive branch, departments are part of the Crown, with most other agencies being legal entities in their own right and 'instruments of the Crown'. The Reserve Bank is part of the executive branch and a legal entity in its own right. It is an instrument of the Crown, but not part of it.

Crown entities comprise the most numerous collection of State sector organisations (approximately 80) that function as instruments of the Crown (although the Reserve Bank is not one of them). As Crown entities cover a large part of the machinery of government, they require a coherent governance and accountability framework. The Crown Entities Act 2004 provides that framework; given its wide coverage, it is used here as a useful reference point for reviewing the Reserve Bank's governance framework. The Crown entities framework includes the following key elements:

- Responsible Ministers have a statutory role to oversee and manage the Crown's interests in, and relationships with, the statutory entities.
- Every Crown entity has a board whose members are appointed either by the responsible Minister or by the Governor-General on the recommendation of the Minister.
- The board is the 'governing body' of the entity. The board generally appoints a Chief Executive Officer (CEO) to oversee the entity's management and day-to-day operations.
- The board has statutory collective duties as the governing body, and every board member has statutory individual duties.

- Board members are accountable to the responsible Minister for the performance of their duties.
- Every Crown entity has a 'monitor', recognising that performance monitoring should be carried out by a body independent of the entity and that responsible Ministers are generally not well placed to evaluate entities' performance on their own. A Crown entity's monitor works on behalf of the Minister and is usually the responsible Minister's policy department.

Governance arrangements at the Reserve Bank

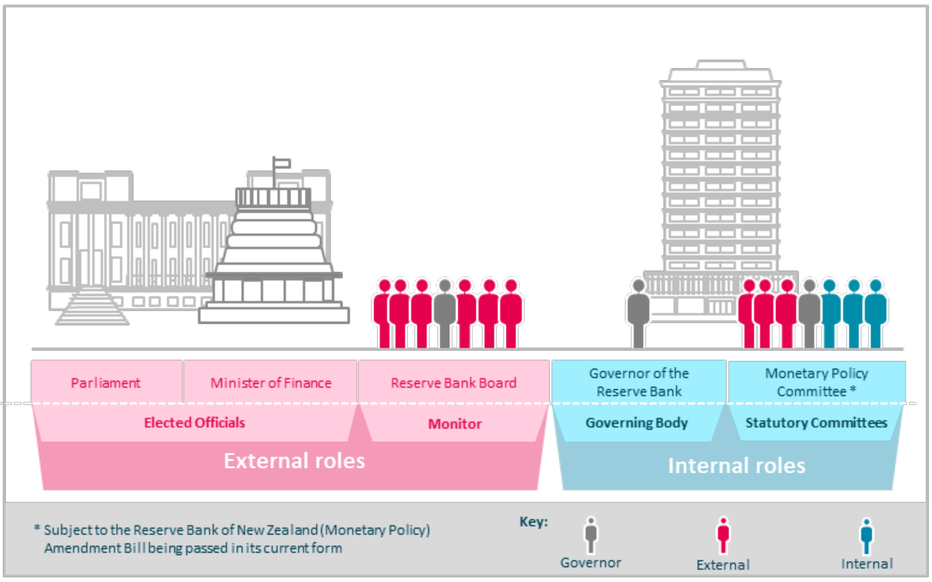
Although the Reserve Bank is not a Crown entity, it shares important features with them. For example, formal accountability document requirements are almost the same across them, and each has a Minister responsible for their performance. Their respective legislation indicates that they should undertake their functions at some degree of 'arm's length' from the Government.

However, the Reserve Bank's governance arrangements, set out in the Reserve Bank Act, differ from those for Crown entities in three key areas:

- The Reserve Bank Board is the principal monitoring agent, not the governing body, but it also makes recommendations to the Minister on persons to be appointed to key positions in the Reserve Bank.
- The Reserve Bank's governing body – the Governor – also serves as the CEO.
- The Minister's policy department – the Treasury – provides advice to the Minister but is not the principal monitoring agent.

Figure 6 illustrates the Reserve Bank's governance arrangements, on the assumption that the Bill implementing Phase 1 decisions will be passed in its current form. It shows the distinction between governance actors external to the organisation (where the focus is on the Minister's and the Reserve Bank Board's roles and responsibilities) and those internal to the organisation (where the focus is on delivering against statutory functions and objectives). This distinction is relevant to Chapter 7's discussion on the independence of the Reserve Bank from the external governance actors, Chapter 8's discussion of organisational structure, and Chapter 9's discussion of the monitoring agent.

Figure 6: Current governance arrangements for the Reserve Bank



Reserve Bank governance drivers

An organisation's governance arrangements need to reflect its functions and legal form. As the Reserve Bank is an entity with a variety of major regulatory functions, the demands on its governance arrangements are complex. These demands can be seen in Table 6, which summarises the governance areas with reference to the key players in Figure 6. Again, for simplicity, it is assumed that the Bill implementing Phase 1 decisions is passed in its current form.

Table 6: Governance areas for the Reserve Bank

Governance area	Description	Who has responsibility
Appointments (and dismissals)	The appointment and dismissal of statutory roles within the Reserve Bank, which is a key source of influence in the Reserve Bank's governance model.	The Minister of Finance appoints the Governor, Deputy Governor, MPC members, and non-executive Board members, on recommendation of the Reserve Bank Board. The Governor-General may remove these individuals on the advice of the Minister.
Organisational strategy and corporate functions	Setting the Reserve Bank's strategy and the performance of corporate functions, such as capability and performance planning, operational risk management, and compliance.	The Governor has responsibility. The Minister has influence through the Reserve Bank's *Statement of Intent* and approving the Reserve Bank's five-year funding agreement.
Monetary policy	Formulating and implementing monetary policy as required by the Reserve Bank Act.	The MPC will be responsible for formulating monetary policy and the Governor will be responsible for implementing it. The Minister will issue a remit for the MPC setting out operational objectives for monetary policy.
Prudential regulation, supervision	Developing the approach to prudential regulation setting (including risk appetite setting) and the approach to supervision.	The Governor has primary responsibility. The Minister may require the Reserve Bank to have regard to a Government policy.
Crisis management	Approach to avoiding financial system disruption from the failure of a regulated financial institution. Crisis management can be distinguished from prudential regulation and supervision given the existence of more significant fiscal risks for the Government.	While the Governor has the lead role in policy development, the Minister has more influence in the deployment of crisis management tools, such as directions (Minister's consent required) and the appointment of a statutory manager (Minister's recommendation to the Governor-General required).

Governance area	Description	Who has responsibility
Macro-prudential policy settings	Policy settings on macro-prudential tools such as loan-to-value ratios, which are an important influence on bank credit policy and loan availability to borrowers.	The Governor has responsibility, but has agreed a Memorandum of Understanding with the Minister governing the use of macro-prudential tools.
Foreign exchange, balance sheet management, and 'other functions'	Policies and processes relating to foreign exchange dealing, issuing currency, and other functions such as LoLR and providing settlement account services.	The Governor has responsibility. The Minister can set guidelines for the Reserve Bank's dealings in foreign exchange, the exchange range, and the level of foreign reserves.
External monitoring	Monitoring and reporting on the Reserve Bank's performance in carrying out its functions and the performance of the MPC, Governor, and Deputy Governor.	The Reserve Bank Board has responsibility.

Evolution of the Reserve Bank's governance framework

The Reserve Bank's governance arrangements were set in the Reserve Bank Act in 1989. Their design largely reflected the Reserve Bank's then primary function of monetary policy, alongside a relatively narrow prudential role focused on registered banks. The features considered paramount at the time were clear independence from government and a focus on the Governor's individual accountability via a single-decision-maker model.

Since 1989 the Reserve Bank's role in the financial system has expanded substantially, and the financial system itself has evolved. The Reserve Bank's operational structure has evolved too, through a number of changes to its internal management structure, such as establishing a Macro-Financial Committee in 2010 and a Governing Committee in 2013.

However, the statutory governance arrangements and the broader legislative framework that is the subject of this Review have remained largely intact, aside from changes in 2008 to accompany the expansion of the Reserve Bank's responsibilities in relation to NBDTs and later to insurers.[28]

Phase 1 of this Review introduced the first major legislative changes to the Reserve Bank's governance structure in almost three decades. The Bill implementing these decisions will, if passed in its current form:

- establish the MPC

[28] The 2008 changes included rebalancing the Reserve Bank Board's monitoring role explicitly to include the Reserve Bank's performance in promoting the maintenance of a sound and efficient financial system, requiring the Reserve Bank to have regard to directions about government policy objectives in relation to financial policy, and changes to the Reserve Bank's accountability documents.

- transfer responsibility for monetary policy decisions from a single decision-maker (the Governor) to the MPC of seven members (the Governor, three other Reserve Bank staff, and three external members)
- change the way the Reserve Bank's operational targets for monetary policy are set, from a model where the Governor and Minister of Finance reach a 'policy targets agreement' to a system where the Minister of Finance issues a remit for the MPC. The Minister's role in issuing the remit is to set the operational objectives for formulating monetary policy, with the Reserve Bank retaining independence in deciding the approach to achieving those objectives
- shift the Reserve Bank Board's role in monitoring monetary policy from monitoring the Governor to monitoring the MPC and its members (including the Governor).

Aims for Part B

This review of the Reserve Bank's governance arrangements aims to:

- **ensure an effective governance framework for the Reserve Bank's functions** – ensuring that the Reserve Bank has a governance framework that helps it to achieve its objectives effectively and efficiently
- **ensure the public has trust and confidence in the Reserve Bank's performance** – the level and nature of stakeholder engagement during the scoping of Phase 2 suggested that governance is a priority for ensuring greater trust and confidence in the Reserve Bank's performance
- **ensure institutional legitimacy** – the governance framework needs to support the accountability and transparency that New Zealanders expect and require in a powerful regulator operating at arm's length from government. This requires clearly defined roles and responsibilities that conform to well-understood governance and accountability concepts.

Phase 1 of the Review was a first step in reviewing the Reserve Bank's governance arrangements. In reporting on Phase 1, the Independent Expert Advisory Panel recommended that several broader governance matters be explicitly considered in Phase 2, including:

- whether the Reserve Bank Board should be the governing body of the Reserve Bank
- whether a statutory committee for financial policy should be introduced
- assessing the position of the Governor on the Reserve Bank Board if the Board's role remains related primarily to monitoring and appointments
- achieving a clearer separation between governance and policy/operations roles in the Reserve Bank.

Features of effective governance

Drawing on corporate governance principles and literature, several features of effective governance have been identified to guide analysis in Chapters 7-9:[29]

- **Balanced composition** – ensuring a breadth of expertise, experience, and perspective at the governing body level

[29] The literature that informed the features outlined here includes Committee on the Financial Aspects of Corporate Government (1992), IMF (1999), Perry (2001), FMA (2014), OCED (2014, 2015), Office of the Auditor-General (2016), and Institute of Directors in New Zealand (2018).

- **Efficient decision making** that balances timeliness with quality to enable the organisation to discharge its responsibilities and to meet its objectives
- **Simplicity** in legal and operational structure, to avoid unnecessary costs and keep processes manageable and flexible
- **Consistency in behaviour**, facilitating coherent decision-making over time that is not dependent on the views of any one individual and is well understood by stakeholders
- **Strategic leadership** by the governing body, ensuring that the organisation's strategy and direction are clear with a sufficient focus on all governance responsibilities
- **Appropriate independence from political authorities** to avoid the politicisation of the regulatory function and manage conflicts of interest, while helping to promote a stable and consistent regulatory environment
- **Accountability and transparency** in the performance of the organisation's functions and the achievement of its objectives, sufficient for effective monitoring by a monitoring authority so that the organisation can be held to account for its performance.

These seven features cannot on their own ensure effective governance outcomes. The calibre of individuals appointed to governance roles is, of course, fundamental. Other elements of the Reserve Bank's legislative framework also need to provide critical support for effective governance arrangements. For example:

- clarity of mandate is a prerequisite for any effective governance regime
- the legislation establishing a regulator and regulatory regime needs to be clear on the regime's purpose and the regulator's objectives (see Chapter 2)
- regulatory powers and funding levels need to be sufficient to enable an organisation, operating efficiently, to perform its functions effectively and meet its objectives.

Regulatory powers and resourcing will be covered in subsequent consultation rounds.

Links to other State sector reforms

Parallel to this Review, a State Services Commission review of the State Sector Act 1988 is underway. The State Sector Act review is considering the merits of extending the scope of the New Zealand Public Service with particular reference to public entities' governance arrangements (notably the Minister-entity relationship). The Reserve Bank's inclusion in a widened definition of the New Zealand Public Service will be considered by this Review in subsequent consultations.

Chapter 7: What should be the scope of the Reserve Bank's operational independence?

The aim of this Chapter

It is one of the guiding principles of this Review that the 'operational independence' of the Reserve Bank should be retained. However, while the meaning of this term is well understood in relation to the Reserve Bank's monetary policy functions, there is less clarity around the meaning of the term in relation to financial policy. This Chapter identifies areas where amendments to the existing regime may provide for a more clearly scoped and more durable definition of operational independence in that context.

Why is independence important?

The past 30 years have seen significant growth in the delegation of policy and regulatory functions to 'independent' agencies. This has occurred both in financial regulation and in other parts of the state sector. An agency is typically defined as independent when it has been created by statute and operates at arm's length from government.

When is there a case for independence?

Governments create independent agencies for two primary reasons:

To 'credibly commit' to a policy or regulatory regime

For some decisions, government faces a 'commitment problem'. Even where government recognises the benefits of a particular approach, short-term political imperatives may make these benefits difficult to achieve or sustain in the long term. Delegating decisions to an independent agency can allow a government to commit to a particular policy or regulatory regime. The benefits of this type of pre-commitment are most significant where:

- decisions require a long-term approach that transcends electoral cycles
- decisions involve weighing a politically powerful private interest against a dispersed public interest
- the regime requires a consistent approach over a long period of time to create a stable environment
- public confidence that the regulator is impartial is important.

To ensure that decisions are made by technical experts

Where a policy or regulatory regime is complex, there are benefits in shifting decisions to independent agencies. These agencies are then able to develop the technical expertise and focus necessary to support robust decision-making. While it is possible to achieve these outcomes within government (e.g. through the use of 'expert advisers'), this approach carries risks relating to the politicisation of technical advice.

While there are benefits associated with delegation to independent agencies, the transfer of functions or powers from democratic institutions (Parliament or the executive) to unelected bodies can undermine democratic accountability. A key principle here is that Parliament or the executive should set the goals – leaving this to the agency itself ('goal independence') is not appropriate in a democracy. A strong accountability framework can also help build legitimacy by ensuring that the agency is seen to be making decisions in a way that is fair and transparent.

Principles to help determine when governments should delegate policy responsibilities (see Tucker, 2018 and New Zealand Productivity Commission, 2014 for more detail) include the following:

- The policy goal can be specified.
- There is a problem of credibly committing to a settled policy regime (as outlined above).
- The policy instruments are confidently expected to work, and there exists a relevant community of experts outside the agency.
- The independent agency will not make big choices on distributional trade-offs (or alternatively, those trade-offs are an accepted by-product of the policy).
- Parliament and the executive have the ability to hold the agency to account and assess whether the regime is working adequately.

In addition to decisions involving big choices on distributional trade-offs, it is accepted that there is a case for greater political involvement (and therefore less independence) where:

- decisions have significant fiscal implications
- decisions involve the significant exercise of coercive state power (e.g. taxation)
- flexibility is needed to take account of political imperatives.

Operational independence

Even once goals are set, independence is never absolute, as an independent agency's powers are derived from Parliament. In terms of considering the degree and nature of independence, the IMF has prepared a framework noting four dimensions of independence in financial policy (Box 7A).

Box 7A: Four dimensions of independence

Regulatory independence *The ability to autonomously set prudential rules and regulations within the parameters set by the relevant legislation.*	**Supervisory independence** *The ability to exercise judgement on matters such as licensing, the nature of inspections of financial institutions, sanctions, and enforcement.*
Institutional independence *The agency's status outside the executive and legislative branches of government.*	**Budgetary independence** *The role of the executive and legislative branches of government in determining an agency's budget.*

An agency can be said to be 'operationally independent' when it has sufficient discretion across all four dimensions to meet its statutory objectives effectively. The level of discretion required will differ between regulatory systems. This Chapter primarily considers regulatory and supervisory independence. Institutional and budgetary independence will be considered in more detail in the second round of consultation, once preliminary decisions have been made on the Reserve Bank's objectives and governance arrangements.

The Reserve Bank has significant powers to take financial policy actions without Ministerial consultation or consent – for example, when registering banks, setting prudential regulation through conditions of registration, supervising, and taking several types of enforcement action.

When considered against the case for agency independence noted above, there is a strong argument that this discretion is appropriate. Providing discretion to the regulator in relation to financial policy is also consistent with international views on good practice, such as the Basel Core Principles for Effective Banking Supervision. There is empirical evidence that a high degree of operational independence (e.g. in setting capital requirements) has been associated with good outcomes.

While the case for operational independence is strong, it is nonetheless more challenging for financial policy than it is for monetary policy to both define the limits of this independence and design the accountability mechanisms necessary to support long-term legitimacy (Masciandaro et al, 2011).

Table 7A: Differences between financial policy and monetary policy

Role	Financial policy	Monetary policy
Specification of goals	Goals can be challenging to specify with precision, and monitor. 'Stability' will primarily be measured through the absence of failures, and through an assessment of process. It would be difficult for the Minister to define a 'standard of resilience' that balanced stability and efficiency, and for the Reserve Bank to demonstrate that its rule making achieved that standard.	Goals can be specified and measured. Parliament has provided for an overall objective of price stability, subject to clarification through a policy targets agreement. The Reserve Bank is then provided with clear operational independence to deliver the objective.
Providing for independence	Issues relating to regulatory and supervisory independence are complex. Regulating for financial stability involves the use of significant coercive powers and the application of a complex set of rules to regulated institutions.	Operational independence is relatively straightforward, with policy not involving regulation or coercion. While implementation has taken place through the Official Cash Rate (OCR) since March 1999, it is not necessary for the OCR to be referred to in the Reserve Bank Act.

These challenges have become more significant in New Zealand in the period since the Reserve Bank Act was passed in 1989. The checks and balances in the Reserve Bank Act (and the Reserve Bank's governance processes) were designed when conditions of registration were a less significant regulatory instrument and the Reserve Bank did not regulate NBDTs or insurers. Financial policy has also expanded beyond traditional prudential policy areas such as capital and liquidity, to include a greater consideration of areas such as crisis management and macro-prudential policy.

In parallel to this the Minister has been given influence and approval powers. Some of these existed in 1989, while others have been added as the Reserve Bank's regulatory scope has broadened. These powers range from high-level abilities to comment on strategy to much more specific approval powers for certain directions.

Together, these factors blur the boundaries of operational independence in financial policy to a greater extent than for monetary policy – an issue identified during the IMF's 2016/17 FSAP. Specifically, the IMF recommended "clarifying the responsibilities of the Treasury and Reserve Bank for financial sector issues", noting that "unclear boundaries could potentially compromise Reserve Bank independence and limit its ability to fulfil its supervisory role". At the same time, others suggest that the current safeguards may be insufficient, potentially leading to more limited accountability in relation to prudential regulation (Every-Palmer, 2017).

The remainder of this Chapter explores three issues specific to the Reserve Bank's operational independence in financial policy:

- The Minister's role in clarifying objectives
- The Minister's role in approving policies or decisions
- The administration of primary legislation.

Issues of clarity around the scope of independence

Ministerial role in clarifying objectives

As noted above, financial policy goals should be set by the Minister and/or Parliament. Under the Reserve Bank Act, the Reserve Bank is responsible for "promoting the maintenance of a sound and efficient financial system" – two objectives that it must balance and that can require difficult trade-offs (Bloor and Hunt, 2011).

The high-level nature of the objectives, and the expanding role of the Reserve Bank, can lead to a critique that the Reserve Bank has too much latitude in giving definition to its own goals. The ambiguity of the existing and any future objectives resulting from this Review may justify further tools to allow the Minister or Parliament to clarify those objectives. If appropriately specified and managed transparently, this additional Government influence on policy objectives could potentially enhance the resilience of the Reserve Bank's operational independence. Poorly specified tools risks the opposite, particularly if informal mechanisms need to be relied on to channel legitimate government interest in policy making.

The Minister has an existing power to direct the Reserve Bank to have regard to Government policy in discharging its financial stability functions. The direction is not structured explicitly around the Reserve Bank's objectives, as it is for autonomous Crown entities, and this potentially limits its effectiveness. Nor has the provision ever been used.

A different balance could be addressed in a number of ways, including by utilising one or more of the following:

- **Specifying additional detail in primary legislation** – objectives could be more explicitly defined in the Reserve Bank Act and weights could be prescribed using a legislative hierarchy (see Figure 2B in Chapter 2). Further detail could be added through elements such as regulatory principles. There is an inherent trade-off between breadth and focus. Narrow objectives are more specific and create clearer accountability, but may create regulatory gaps over time. In contrast, strategically broad objectives will inevitably mean more discretion and flexibility for the regulator.
- **Empowering or requiring the Minister to issue a risk appetite statement or remit** – the Government could set the weightings it expects the Reserve Bank to put on each objective and endorse a strategy for achieving it via a regular statement. For example, the Bank of England receives two statements: one to the Financial Policy Committee and one to the Prudential Regulatory Committee. The statements outline the Government's policy objectives and are for the relevant committees to have regard to when formulating their own policies. In the UK these statements must be issued regularly (so the power is always in use). There are, however, practical challenges in defining objective standards for regulatory policy statements (e.g. the probability of financial crisis) and in monitoring adherence to the standards. While the use of risk appetite statements has been proposed by a number of commentators (Gai, 2017; Tucker, 2018), this is not a model that is currently in practice internationally.
- **Requiring the Reserve Bank to issue its strategy in advance in more detail** – the Reserve Bank could be given discretion to decide what weights to put on its objectives and its strategic approach to achieving them, but required to publish its approach in advance. This could be achieved by requiring a more detailed *Statement of Intent*, or through a new strategy document.

Each option offers a choice between durability and flexibility, and between Government involvement and Reserve Bank discretion.

Ministerial role in approving policies or decisions

We consider there is a strong case for the Reserve Bank to have operational independence in relation to its prudential policy functions, provided appropriate accountability arrangements can be put in place. The Reserve Bank's prudential policy functions include, for example, setting capital and liquidity requirements, and registering and supervising regulated entities.

In practice, however, the Reserve Bank's operational independence for prudential policy is neither complete nor consistent. For example:

- while the Reserve Bank can impose substantial prudential requirements on registered banks through conditions of registration, disclosure requirements need Ministerial approval
- the Reserve Bank must obtain consent from the Minister before issuing a direction against a bank or seeking to cancel a bank registration. Similar actions applying to NBDTs and insurers do not require Ministerial consent.

Table 7B details these differences in legislative regimes.

Table 7B: Key features of the banking, NBDT, and insurance regimes

Role	Reserve Bank Act	NBDT Act	IPSA
Policy instruments controlled by the Reserve Bank	Conditions of registration	Conditions of licence	Standards Conditions of licence
Policy instruments controlled by the Minister	Disclosure regulations	Credit rating, capital ratio and related party exposure regulations	None
Does the Minister need to approve licence/registration cancellations?	Yes	No	No
Does the Minister need to approve directions/enforcement actions?	Yes	No	No

Note: Blue-shaded areas denote areas where the Minister of Finance currently has a role.

Reducing the Minister's role in approving bank directions and cancelling bank registrations would see a more consistent approach across the regimes. It would also be consistent with the IMF's 2016/17 FSAP recommendation that Ministerial consent for these areas be required "for resolutions with fiscal or systemic implications only".

Concerns around this increased independence could be mitigated by other changes, including:

- more guidance on goals (discussed above)
- additional due process around the development of delegated policy (e.g. scope for Parliamentary review) – this was raised by Every-Palmer (2017) and will be considered in the second round of consultation. Similar changes may also be possible in relation to the enforcement regime (e.g. Merits review)
- greater external monitoring and stewardship of the Reserve Bank, including stewardship of primary legislation (discussed below)
- enhancements to the governance of the Reserve Bank – see Chapter 8.

This consultation seeks feedback on this broad approach, allowing for more detailed proposals to be developed and explored during the second consultation.

The case for operational independence is not as clear outside prudential policy. In the criteria for independence it is noted that there is a case for Government involvement in decisions that have significant fiscal implications, or that involve significant coercive or distributional powers. There is also a case for Government involvement when policy instruments extend the existing regulatory framework into new areas. This is relevant to crisis management and macro-prudential policy. These areas will be considered in the next round of consultation.

Stewardship of primary legislation

Regulatory stewardship is a responsibility of government regulatory agencies.[30] It involves adopting a whole-of-system, lifecycle view of regulation and is designed to ensure that the regulatory system remains fit for purpose.

The Reserve Bank currently has primary responsibility for the regulatory stewardship of financial policy, and acts as the lead adviser to the Minister. Regulatory stewards are expected to act collaboratively and enable other interested agencies to contribute to system oversight. The Treasury's role in relation to financial policy is acknowledged in a 2012 Memorandum of Understanding with the Reserve Bank.

As part of its current stewardship role, the Reserve Bank is responsible for administering the Reserve Bank Act, IPSA 2010, and the NBDT Act.[31]

Administering an Act involves:

- being the lead policy agency in reviewing the legislation
- developing proposed changes to the legislation and managing the associated processes, including:
  - managing stakeholder and industry engagement in the policy development process
  - instructing the Parliamentary Counsel Office in drafting legislation
  - supporting the Minister in taking the draft legislation through the House of Representatives.

It is unusual, both in New Zealand and internationally, for an independent agency to administer primary legislation, particularly when it specifies its own powers. It is also inconsistent with OECD best-practice guidance (see Box 7B).

Box 7B: OECD best-practice guidance

The responsibility for setting or advising on Government policy, particularly relating to the nature and scope of the regulator's powers and functions, should not principally sit only with the regulator even though the regulator has the most up-to-date knowledge of the issues in the regulated sector. The principal responsibility for assisting the executive to develop Government policy should sit with the responsible executive agency and the regulator should have a formal advisory role in this task. In all cases such policy should be advanced in close dialogue with affected regulatory and other agencies, and there should be specified mechanisms for regulators to contribute to the policy-making process.

OECD (2014), *The Governance of Regulators: OECD Best Practice Principles for Regulatory Policy*

The usual approach to the stewardship of legislation is for the responsible Minister's policy department (the Treasury in this case) to exercise the role on behalf of the Minister as part of a broader role overseeing the regulatory regime. This makes the independence of the regulator clearer and reduces potential conflicts of interest. However, there are also important advantages of the Reserve Bank acting as steward. These arguments are noted in the boxes below.

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[30] More information about regulatory stewardship can be found at https://treasury.govt.nz/information-and-services/regulation/regulatory-stewardship.

[31] It is also intended that the Reserve Bank administer the legislation relating to FMIs, once this has been finalised.

Benefits of the Reserve Bank continuing as the Reserve Bank Act administrator

- **Aligning technical expertise with policy development** – the Reserve Bank's extensive technical expertise makes it well placed to contribute to regulatory framework development.
- **Synergies** – Reserve Bank staff can operate across both primary and delegated legislation.
- **Transition costs** – shifting the function to the Treasury would require it to reallocate or seek additional resources, assuming that no resources move from the Reserve Bank.

Benefits of the Treasury becoming the Act administrator

- **Closer constitutional relationship with the Minister** – as the Minister of Finance's policy department, the Treasury is constitutionally an extension of the Minister and is therefore best placed to serve the Minister's interests.
- **Avoids conflict of interest** – the Reserve Bank has a conflict of interest in acting as the principal adviser on primary legislation. At both an overarching level and within the regulatory regimes it oversees, the Reserve Bank is required to assess the appropriateness of its objectives, functions, and powers. In assessing the effectiveness of regulatory regimes, the Reserve Bank must also make judgements about its own performance as regulator. This can be perceived as reducing accountability.
- **Protects independence** – having the Reserve Bank as principal adviser to the Minister on primary legislation risks blurring the boundaries of its independence.

Shifting the administration of the Reserve Bank's legislation to the Treasury would move a notable stewardship responsibility from the Reserve Bank to the Treasury. This would give the Treasury an increased responsibility for ensuring that the financial policy framework is fit for purpose, and clarify that MBIE and the Treasury share an oversight role for the financial system more broadly. The Reserve Bank would retain an important advisory role, including providing independent advice where appropriate. A decision regarding the stewardship of primary legislation would not affect the role of the Reserve Bank in administering delegated instruments (e.g. conditions of registration).

A hybrid option could also be considered where the stewardship of those elements of the Act relating to the Reserve Bank's governance, objectives, and functions shifted to the Treasury (by creating a separate institutional Act for the Reserve Bank, similar to the FMA Act 2011), but the Reserve Bank remained the steward for legislation covering the regulatory regimes themselves.

Questions for consultation

Yours views are sought on the following questions:

16. Do you consider there is a case for a Ministerial role in clarifying the Reserve Bank's financial policy objectives?
17. If the Reserve Bank's objectives are to be clarified:
    a) what should the Minister of Finance's role be?
    b) what other mechanisms could be used to clarify the Reserve Bank's objectives?
18. Do you think there is a case for making the Reserve Bank's operational independence more explicit, for example by removing the requirement for Ministerial consent for certain policy instruments and direction powers? If so, will this require any process or governance changes?
19. Should the administration of the Reserve Bank Act (and other Acts creating regulatory regimes operated by the Reserve Bank) remain with the Reserve Bank or transfer to the Treasury?

Chapter 8: How should the Reserve Bank be structured?

The aim of this Chapter

This Chapter focuses on two aspects of the Reserve Bank's organisational structure that could be set in legislation:

- **The governing body** – whether the Reserve Bank should be led by a single decision-maker (as it is now) or by a board.
- **A Financial Policy Committee (FPC)** – whether a new statutory committee should be created to make decisions on financial policy.

What form should the Reserve Bank's governing body take?

The Reserve Bank's governing body is responsible for all the legal powers and functions that have been granted to the Reserve Bank (except those conferred on a statutory committee), and is accountable to the public (through Parliament and the Minister of Finance) for the Reserve Bank's performance. All decisions about the Reserve Bank's operation are made by or under its authority.

As noted in Chapter 6, the Reserve Bank has responsibility for an extensive range of functions including organisational strategy, decisions pertaining to its own balance sheet, foreign exchange interventions, policy development, and regulatory decisions. Its governing body is responsible for all these functions except those that are conferred on a statutory committee (e.g. the proposed MPC).

The role of the governing body is often distinct from management, especially in a corporate context. The governing body sets the organisation's strategic direction and ensures that it is being run well, while management runs the organisation's operations. **Governance** includes ensuring that systems and processes are in place that enable the organisation's strategy to be given effect to and that direct, shape, enable, and oversee an organisation's management. **Management** is concerned with carrying out the organisation's day-to-day operations. In practice, a governing body delegates many of its functions to management in order to run the organisation effectively.

Governing body options: single decision-maker or board

A key decision on the design of the governing body is whether it should be a single individual or a group. The main choice for independent institutions is between a single-decision-maker model and a collective board model.[32]

- **Single decision-maker** – in a single-decision-maker model, an individual has responsibility for all an organisation's powers and functions. They typically make the most important decisions and delegate authority to make other decisions to employees of the organisation. The Reserve Bank currently operates under a single-decision-maker model, in which the Governor is responsible for all the Reserve Bank's powers and functions that are not to be conferred on statutory committees. As the CEO, the Governor is responsible for both governance (strategic) and

[32] See OECD (2014) *The Governance of Regulators: OECD best practice principles for regulatory policy*, OECD Publishing. The OECD also identifies a commission model, which is a variant of the board model under which board members generally have direct management roles and responsibilities for the functions of an organisation.

management (operational) functions. The Governor has established a number of internal committees that help advise and carry out the Governor's decisions.

- **Board** – a board has collective responsibility for all an organisation's powers and functions. A typical board (of a medium to large-size company or a Crown entity) focuses on governance matters (e.g. oversight of the organisation's performance, strategic guidance, risk and audit, and operational policy) and important decisions relating to its functions. Management matters are largely delegated to the CEO, although certain powers and decisions may be reserved for the board. The board remains accountable for the actions of the CEO and has oversight of the CEO's performance. Board members have duties to act in the organisation's best interests. The board model is consistent with the structure of State sector organisations set up as Crown entities.

  A key consideration when designing a board is the composition of internal (executive) and external (non-executive) members.[33] An 'external' member is not an employee, has no management responsibility, and is likely to be part time. Internal members, as employees, bring more in-depth knowledge of the business to decisions, partly via their managerial responsibilities. External members are free from managerial responsibilities so can focus on governance matters. External members can provide more objective judgements on management's performance and, through that, enhance internal accountability. Both executive and non-executive members bring a wide range of skills and experience, which can reduce the risk of dominance by one person.

Pros and cons of single decision-makers versus boards

The single-decision-maker model has some obvious advantages, including clear lines of accountability and efficient decision-making processes, which are explored in more detail below. Internationally, however, there has been a gradual shift away from this model in the public and private sectors.

A number of external agencies have commented on why this might be the case. For example, the BIS (2009) notes:

> Society is reluctant to delegate state power to a single individual. One reason is probably a perception that groups will be better at understanding and representing society's interests. Policy objectives are sometimes difficult to specify precisely, and their pursuit might involve trade-offs or conflicts between different interest groups. And as circumstances evolve, they might have to be reinterpreted in ways that were not foreseen when they were initially formed. Group decision-making might therefore have greater legitimacy in the eyes of the public.

The New Zealand Productivity Commission (2014) also concluded that multi-member decision-making bodies have the potential to produce better-quality decisions, as long as the members themselves are high quality. This is because individuals have different perspectives through which they interpret information and options, and taking these perspectives into an effective decision-making process allows the group to base its decisions on a set of concerns, information, and judgements that is larger than may be available to an individual.

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[33] Boards may comprise entirely external or internal members. The FMA is a Crown entity with a full non-executive (external) board. The boards of APRA and the Australian Securities and Investment Commission are entirely executive (internal) with full-time commissioners.

A number of studies have also noted the benefits of creating a clear divide between governance and management responsibilities, which is a feature of board models. For example, a capability review of the Australian Securities and Investment Commission (Australian Government, 2015) notes:

> A dual governance and executive line management role inherently undermines accountability. Despite best efforts, individuals responsible for particular executive functions are unlikely to be consistently able to detach themselves from their concerns as an executive, to take a fully independent and organisation-wide perspective when acting in their governance role, to hold the executive team (including themselves) to account.

Nevertheless, there are strong arguments on both sides for the single-decision-maker and board models. These are explored in the tables below, with reference to six of the features of effective governance regimes identified in Chapter 6.[34]

Option 1: Single decision-maker	
Balanced composition	**Cons** – there is a risk of decision-making bias if only one individual makes decisions. This includes the risk that an individual is more susceptible to political or industry influence than a group.
Efficiency	**Pros** – a single decision-maker can make decisions more quickly than a board as there is no need to convene a group, bring individuals up to speed, deliberate, and reach a decision.
Simplicity	**Pros** – the single-decision-maker model is legislatively and operationally simpler than the board model.
Consistency	**Pros** – single decision-makers have time-limited terms, so there is scope for newly appointed single decision-makers to ensure that the institution continues to evolve and consistently delivers on society's preferences. **Cons** – single decision-makers have time-limited terms, and a new appointee's decision-making framework may be different from that of the previous decision-maker. This could potentially lead to abrupt changes in policy.
Strategic leadership	**Pros** – a single decision-maker can be an effective leader, provide clear direction, and ensure robust accountability. Having both governance and management roles, they can both steer the organisation and ensure effective operation. **Cons** – a single decision-maker may not have the time or bandwidth to oversee both governance and management, leading to suboptimal decisions or a lack of focus on the organisation's strategic direction. By merging governance and management responsibilities, there are also fewer internal checks that decisions are being made appropriately.
Accountability	**Pros:** strong external accountability with the single decision-maker directly accountable to the Minister for performance. **Cons:** inherently weaker internal accountability with less objective judgment on the performance of management due to the single decision-maker having both governance and management responsibilities.

[34] Independence is explored in Chapter 7 and it is assumed that the level of independence across the models is similar. Accountability is also explored in more detail in Chapter 9.

Option 2: Board model	
Balanced composition	**Pros** – ideally boards have a diversity of expertise, experience, and perspective in decision-making. A well-represented board with a robust decision-making process can provide a good balance of judgement, particularly if it includes external members. **Cons** – there is a potential for 'groupthink' (a tendency for individuals to prefer uniformity rather than challenge the group) and hence a bias towards favouring the status quo. This is a particular risk with homogenous groups that emphasise consensus-based decision making.
Efficiency	**Cons** – boards take time to convene, ensure members have sufficient information, deliberate, and reach a consensus or vote. Boards with external members may also have more conflicts of interest to manage.
Simplicity	**Cons** – boards add operational costs and coordination requirements to the decision-making process, increasing complexity. The organisation may find it difficult to recruit enough external members with appropriate expertise who do not have conflicts of interest.
Consistency	**Pros** – a board can provide more 'corporate memory' over time and does not depend on the views of any one individual. Consistency can be enhanced through the use of staggered board appointments, which can minimise disruptions to the board's composition.
Strategic leadership	**Pros** – boards are less reliant on the leadership skills of one individual. They also can create a clear divide between governance and management responsibilities, which can help to ensure that enough attention is paid to the organisations' strategic direction and priorities.
Accountability	**Pros:** internal accountability can be enhanced in a board model through the separation of governance and management functions, particularly if the board includes external members. Separation allows the governing body to exercise more objective judgment when assessing the performance of management. Because the governing body remains accountable for the actions of management, it has strong incentives to ensure the discharge of management functions is being conducted appropriately. **Cons:** weaker external accountability due to the board being collectively accountable to the Minister for performance. Individual accountability for performance is reduced and there is potential for 'social loafing' (where people put less effort into achieving a goal when they work in a group than when they work alone). It can be challenging to monitor the performance of individuals acting within a group.

In general, there can be a significant trade-off in the single-decision-maker and board models between efficiency and the diversity of expertise and perspectives involved in decision-making:

- Replacing the Governor with a board structure assumes that the benefits of group decision-making are greater than the efficiency costs.
- Retaining the Governor as the governing body assumes that the benefits of an efficient decision-making model with direct accountability outweigh concerns about diversity and consistency.

There are ways to mitigate these trade-offs, including:

- **external advice and internal processes** – in a single-decision-maker model the Governor has freedom to employ external advisers, use internal committees, and conduct public consultation programmes to provide for a wide range of perspectives and expertise
- **charters and codes of conduct** – decision-making efficiency can be enhanced in a board model through the use of charters and other corporate governance documents dealing with matters such as delegations, decision-making procedures, and conflicts of interest. Boards can also create smaller 'divisions' within the board with specific responsibilities.

Should a statutory Financial Policy Committee be introduced?

As a result of Phase 1 of this Review, a new statutory MPC is being established. The MPC will take responsibility for formulating monetary policy decisions away from the Reserve Bank's governing body (currently the Governor), and distribute it to a group of seven individuals: the Governor, three other Reserve Bank staff, and three external members.

This change reflects a trend among central banks, which have been gradually shifting away from single-decision-maker models towards committee decision-making – mainly to benefit from a diversity of perspectives and to make external challenge part of the monetary policy process.

This section explores whether a similar case can be made for introducing an FPC, which would be responsible for decisions on certain aspects of financial policy within the Reserve Bank's mandate. As with the MPC, decision-making power would be transferred from the governing body to a separate committee established in legislation – increasing the complexity of the Reserve Bank's governance model while bringing in more external perspectives. To date, relatively few central banks have created statutory committees responsible for financial policy, although the Bank of England is a notable exception.

The establishment of an MPC does not of itself establish the case for an FPC, because the nature of the decisions required for financial policy are different from those required for monetary policy. The case for an FPC should be established on its own merits. Monetary policy typically involves one key decision made at regular intervals throughout the year. In New Zealand, monetary policy is implemented using the Official Cash Rate (OCR), although it could also be implemented through other unconventional tools if circumstances warranted it. In practice, the OCR is reviewed seven times a year and the Reserve Bank publishes four *Monetary Policy Statements* annually. Financial policy involves multiple decisions and judgements covering a broad range of areas over different timeframes, and includes the following features:

- **Complexity** – financial policy is multifaceted and requires complex judgements regarding the risks posed by and to the financial system and how best to mitigate these risks to preserve the soundness of New Zealand's financial system while also promoting efficiency.
- **Breadth and depth** – financial policy involves judgements at different levels, including at individual firm, sector, and system levels, and around the impacts of the international context more generally.
- **Flexibility in crisis versus normal times** – a robust crisis management approach is required to address the impacts of the failure of a firm, and governance arrangements need to accommodate circumstances where decision-making is required under urgency.

These features do not necessarily mean that an FPC is inappropriate, but they do indicate that an FPC would probably need to operate at a higher level than the MPC (i.e. delegating and overseeing significant aspects of financial policy).

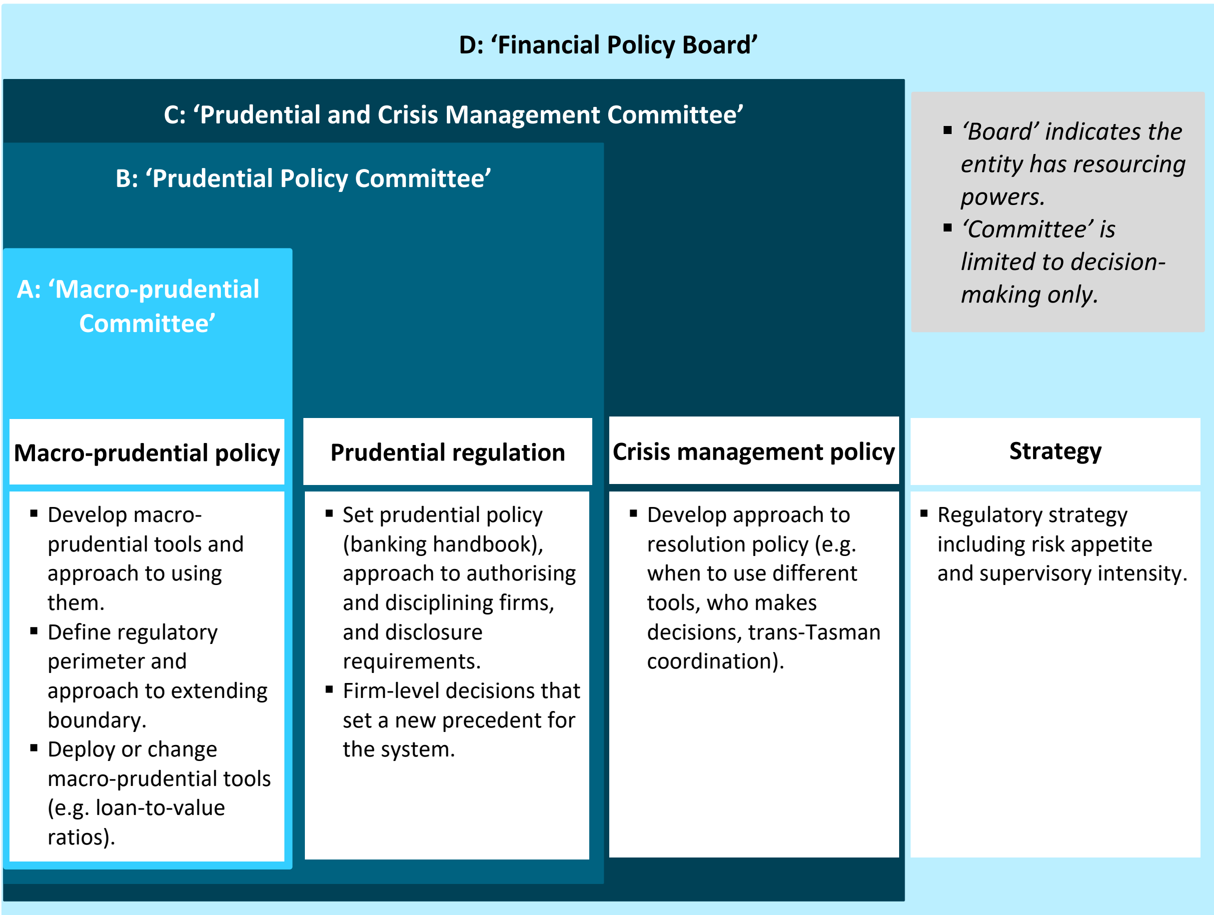
The Reserve Bank already uses a number of internal (non-statutory) committees to advise the Governor on financial policy and discharge its functions, such as the Governing Committee (for major monetary and financial policy matters), the Financial Stability Oversight Committee (for prudential and supervisory initiatives) and the Macro-Financial Committee (for systemic risk). The questions are: should such group decision-making structures be formalised in legislation, and should decision-making rights extend to external members?

What role could a Financial Policy Committee have?

Financial policy covers a broad range of areas (see Chapter 6 and the background paper for more details). A single statutory FPC could take on roles ranging from the relatively narrow (focusing on matters such as macro-prudential policy) to a wider remit covering the full range of financial policy matters (which would include macro-prudential policy, prudential regulation and supervision, crisis management, and overall prudential strategy and approach). Another option is to have multiple committees responsible for different aspects of financial policy, as does the Bank of England.

Figure 8A illustrates a range of roles for an FPC, with narrower committee options nested within broader FPC roles.

Figure 8A: Potential roles for a Financial Policy Committee



- Options A and B are limited to decision-making only, from a narrow focus on macro-prudential policy (Option A) to a broader role including decisions on prudential regulation (Option B).
- Options C and D extend the role to include crisis management policy (Option C) and a broader role in strategic decisions on financial policy (Option D). Option D is labelled a 'board' rather than a committee due to its involvement in decisions that require powers to allocate resources (e.g. supervisory intensity).

Operational matters and most firm-level decisions have not been included in Figure 8A. While the FPC would be **responsible** for these decisions, it is assumed that day-to-day decisions on these matters would be delegated to the Governor (as CEO) and employees of the Reserve Bank as part of their role in implementing the decisions of the FPC. Examples of these matters include:

- **prudential policy and supervision** – firm authorisation, disciplinary action, monitoring of firms, technical detail relating to rules and regulations, approval of risk models
- **macro-prudential policy** – systemic risk assessment and monitoring, stress tests
- **crisis management** – monitor and assess firm recovery and resolution plans, coordinate cross-border resolution tests with the Australian authorities.

The following matters are important in considering the potential case and remit for an FPC.

- **Mandate** – the more extensive the FPC's mandate, the more frequently the group may have to meet, and the more members that will be needed to cover the range of policy areas. By their nature, committees tend to be better suited to:
  - strategic policy decisions made at regular intervals, not technical policy or firm-level decisions made regularly
  - decisions where haste is not a critical factor (i.e. non-crisis situations)
  - decisions where relationship management is not a critical factor in ensuring effective implementation (i.e. not firm-level decisions).
- **Conflicts** – there is the potential for conflicts between financial policy responsibilities (which also exist in the single-decision-maker and board models). For example, if the same committee handles prudential policy and crisis management, it may have a tendency to avoid taking resolution actions to manage a troubled bank, since this could demonstrate inadequacies in the past regulation and supervision of that bank.
- **Resourcing** – if the FPC is given broad responsibilities (e.g. Option D gives the FPC power to determine the intensity of supervision), the FPC may need to have its own budget to ensure that it can deliver on its responsibilities.
- **Relationship with the governing body and other committees** – the governing body would exercise all the powers and functions of the entity that are not granted to statutory committees. However, the FPC would be affected by decisions from the governing body (e.g. on resourcing) and, more indirectly, the MPC (e.g. the loosening of monetary policy may have implications for financial stability). There is also a risk of internal dysfunction because of resource competition. This means that the relationship of the FPC with the governing body and MPC will be an important consideration.

Assessing the case for a Financial Policy Committee

The Reserve Bank has a number of core interdependent roles, which naturally raises the possibility that it may devote too much attention to one or more of these roles at the expense of others. The required skills, expertise, and perspectives differ between functions. For example, the expertise needed for corporate governance and strategy to ensure effective organisational performance is different from the expertise needed to oversee the development of prudential policy. One way to address the risk of insufficient focus and expertise on different functions is to have different groups making decisions in specific areas, as with the statutory MPC.

A potential advantage of committees is that they can enable more specialised expertise at the decision-making level and therefore better decisions. A statutory committee is considered more enduring than one formed internally as its mandate, composition, and powers are provided for in legislation. Key central bank functions may differ from each other, and in some cases conflict to such a degree that specialised governance arrangements are needed. Committees may also allow for more formal recognition of the interest of other agencies in the work of the Reserve Bank.[35] Committees have the potential to allow for a better allocation of skills and responsibilities, and dedicate more time and analysis to key policy areas.

The main disadvantages of multiple committees are the efficiency trade-offs and administrative costs. It is more difficult to extract potential synergies between different policy areas and functions if there are formal delineations, more time may be spent in meetings, and there is a need for a mechanism to ensure that multiple sets of policies are consistent and unified. The advantages of statutory committees can potentially be achieved at low cost through a well-designed board structure at the governing level, supplemented by an appropriate delegations framework. Boards routinely establish internal committees and delegation frameworks to incorporate the required expertise and perspectives for quality decision-making.

The list below briefly notes the implications of introducing a statutory FPC, with reference to six of the features of effective governance regimes identified in Chapter 6.

- **Balanced composition** – a statutory committee can allow for more specialised and focused expertise and can enhance the quality of an organisation's decision-making. A single decision-maker or board can access a diversity of views and relevant expertise through internal committees, although the decisions and responsibility remain with the individual or board.
- **Efficiency** – while the quality of decision-making can be enhanced through a committee, the introduction of a committee can make an organisation less efficient at making decisions due to the coordination, information, resourcing, and administration requirements. A committee may also be less well placed to respond where decisions are required in haste.
- **Simplicity** – committees introduce a layer of operational costs and coordination requirements to the decision-making process. A statutory committee is inherently less flexible with its mandate prescribed in legislation. Coordination challenges can be mitigated through having overlapping committee memberships and a common chair. Consideration would also need to be given to the interaction between any statutory committees and cross-agency regulatory coordination and cooperation mechanisms such as CoFR.

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[35] In the UK, for example, the CEO of both the FCA and the PRA are voting members of the FPC.

- **Consistency** – a committee can provide more 'corporate memory' over time on policy areas within its mandate. Internal committees can also provide greater consistency, although a statutory committee is considered more enduring as its mandate, composition, and powers are provided for in legislation.
- **Strategic leadership** – the governing bodies of organisations with multiple functions are often under pressure to source the expertise and perspectives they require, and there can be a higher risk of conflicts. There is also a risk that the governing body will devote more attention to one role at the expense of another. Committees focus on specific functions and can ease the decision-making burden on the governing body, enabling it to focus on all its responsibilities.
- **Accountability** – a further committee with statutory responsibilities introduces additional complexity to the governance arrangements because the committee (and its members) need to be accountable for performance. As with a board model, individual accountability for performance is reduced with a group and it can be challenging to monitor the performance of individuals acting within a group.

The case for an FPC also depends on choices made about the overall governance structure. For example:

- if a board has a broad mandate covering financial policy generally, there may be little benefit in establishing a statutory FPC. Internal committees and senior management could have delegated responsibilities for operational matters and areas requiring specialist expertise
- if a single-decision-maker model is retained, there may be merit in establishing an FPC to deal with some aspects of financial policy that would benefit from a diversity of perspectives and embedded external challenge. Similar considerations would apply if a board were established but with no policy responsibilities (i.e. a pure governance board), with policy being the responsibility of the Governor and/or statutory committees.

Other considerations

This consultation seeks your feedback on whether the Reserve Bank's governing body should be a single decision-maker or a board, and the merits of introducing an FPC. While these are broad choices, the overall effectiveness of the Reserve Bank's governance arrangements will be highly dependent on:

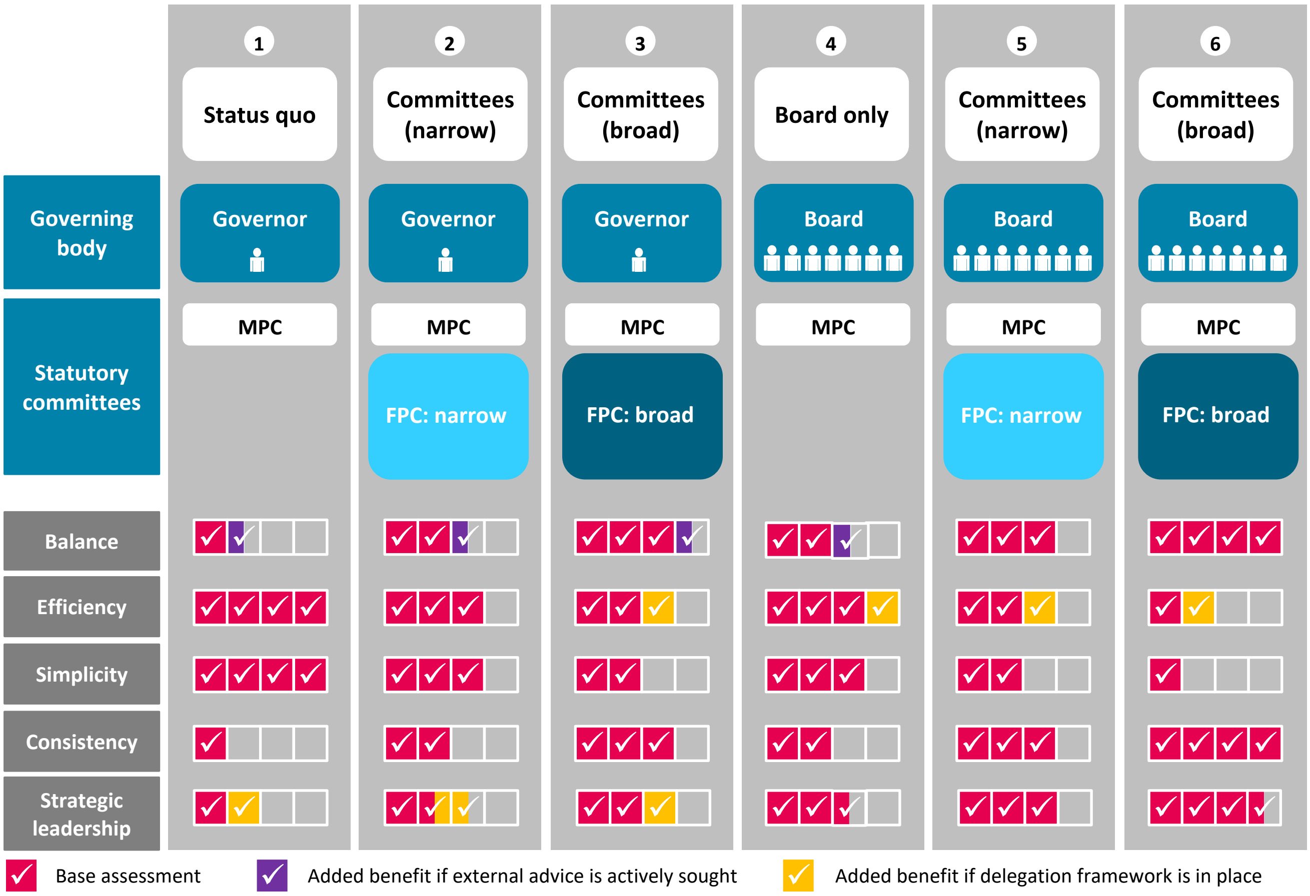
- the choice and detailed design of the internal governance model, including size (for a board model), composition of members, appointments, dismissals, term length, decision-making process, and delegations framework
- the external governance arrangements for the Reserve Bank, including the role of the Minister (see Chapter 7) and the overall transparency and accountability requirements (see Chapter 9).

Changes to governance arrangements would also affect other features of the Reserve Bank's governance model. For example, if a board structure were adopted, this would have implications for the role of the current Reserve Bank Board (see Chapter 9), including the process for appointments to the Board and statutory committees, and monitoring requirements. These aspects will be considered in detail in the second round of consultation.

Illustrative assessment of options

Figure 8B illustrates combinations of governing body and committees, with a high-level indicative assessment against some of the features of an effective governance regime.[36] With all options, the governing body (either the Governor or the Board) will have responsibility for all powers and functions of the Reserve Bank except those that are conferred on statutory committees.

Figure 8B: The Reserve Bank's organisational structure – potential legislative options



Questions for consultation

Your views are sought on the following questions:

20. Should the governing body of the Reserve Bank be a single decision-maker or a board? What are the key considerations in support of your view?
21. Should there be an FPC, and if so, what should it do? What are the key considerations in support of your view?
22. Are there any other legislative structures for the governance of the Reserve Bank's powers and functions that you think should be considered?

[36] Other features identified include independence (explored in Chapter 7) and accountability (explored in more detail in Chapter 9).

Chapter 9: How should the Reserve Bank be monitored and held to account?

The aim of this Chapter

Accountability is a fundamental principle of the constitutional conventions that govern New Zealand's independent regulators. Monitoring plays an important part in ensuring that regulatory agencies are effective, efficient, and accountable. Monitoring also provides assurance to Ministers that regimes are working as intended. The New Zealand Productivity Commission (2014) notes:

> Independent agencies need high quality governance, should be as transparent as possible about their activities, engage and consult widely and should be subject to robust and proportionate performance monitoring and accountability arrangements. Indeed, de facto independence is only sustainable with robust accountability and transparency provisions.

This Chapter focuses on how best to hold the Reserve Bank to account for achieving its objectives. It asks:

- who should monitor the Reserve Bank's performance?
- what statutory accountability and transparency requirements should the Reserve Bank be subject to?

Accountability

What does accountability mean?

Accountability mechanisms have a critical role in aligning a regulator's objectives and incentives so that objectives are met and the regulator's operations are conducted effectively and efficiently (BIS, 2009).

The following are features of good accountability mechanisms:

- The actions of the entity are regularly accounted for.
- Scrutiny is conducted by an independent body.
- There is a risk of negative repercussions if performance is considered unsatisfactory.

A regulator's accountability to Parliament and the public is fundamental in supporting the democratic legitimacy of delegating powers and decision-making to an independent agency, and thus in helping to maintain public trust and confidence in the regime.

Accountability can be provided within an organisation (via a regulator's organisational structure – see Chapter 8) and externally based on the accountability to the public through Parliament and the executive branch of government.

Ministers are also accountable for the performance of regulatory regimes within their portfolios. Monitoring helps Ministers to assess whether a regime's objectives are being achieved, and whether changes should be made to legislation or the regulator's behaviour. Transparency requirements (e.g. via documents such as *Statements of Intent* and *Annual Reports*) enable Parliament and the public to scrutinise a regulator's activity, decisions, and performance.

This first round of consultation focuses on responsibility for external monitoring at a general governance level. Subsequent rounds of consultation will focus on specific functional areas (e.g. crisis management), and will consider more specific accountability mechanisms for those functional areas (e.g. when specific powers of intervention are exercised).

The Reserve Bank's current monitoring and accountability arrangements

The Reserve Bank Board is the Minister's monitoring agent for the Reserve Bank. Each year it must deliver to the Minister a report setting out its assessment of the matters for which it is tasked. The Board's report is automatically referred to Parliament.

The existing Reserve Bank Board is similar to a supervisory body, not a governance board with strategic decision-making responsibilities.

The Board is tasked, among other things, with keeping under constant review:

- the Reserve Bank's performance in carrying out its statutory functions
- the Governor's performance in undertaking the responsibilities of that office and ensuring that the Reserve Bank achieves the policy targets agreed with the Minister.

The Board may also give advice to the Governor on any matter relating to the Reserve Bank's performance. Once the legislation implementing the decisions from Phase 1 of this Review has been enacted, the Board will also be tasked with reviewing the performance of the Deputy Governor, the MPC, and each member of the MPC.

Parliament's Finance and Expenditure Committee can scrutinise the Reserve Bank's formal accountability documents: the annual *Statement of Intent*, the *Annual Report* (which includes the Board's performance assessment report), the six-monthly *Financial Stability Reports*, and the Reserve Bank's quarterly *Monetary Policy Statements*.

Potential issues with the current arrangements

Conflicts of interest in performance monitoring

An unusual feature of the monitoring arrangements for the Reserve Bank is that the Governor is also a member of the Board. This raises potential (or perceived) conflicts of interest for the Board in reviewing the Reserve Bank's and the Governor's performance. In practice the Board seeks to manage this issue by meeting at times without the Governor's participation. The same issue will arise in reviewing the performance of the new MPC, which will include the Governor as a member.

Due to the Board's role in key appointments, similar issues arise with the independence of the Board's performance monitoring function. The Minister appoints the Governor on the recommendation of the Board, the Board determines the terms and conditions of employment of the Deputy Governor, and the Board must be consulted on the terms of employment of the Governor.[37]

[37] If the proposals for reform as set out in the current Reserve Bank of New Zealand (Monetary Policy) Amendment Bill pass into law, the appointment of a Deputy Governor will also need to be on the recommendation of the Board.

The Board has no independent resources

The current Board also lacks legislated funding or independent secretariat resources with which to conduct its monitoring function. As a monitoring agent the Board is therefore dependent on the Reserve Bank for information and resourcing, raising questions about whether it is positioned adequately to perform the public monitoring role with sufficient independence.

Accountability documents have not kept pace with wider State sector developments

The Reserve Bank's formal accountability documents were once modelled on those required of Crown entities. However, the requirements set out in the Reserve Bank Act have not kept pace with subsequent reforms to the Crown entity framework, particularly in relation to the requirement for statements of performance expectations and the form and content of annual reports.[38]

The Auditor-General has limited ability to initiate a performance audit

Finally, the Reserve Bank is excluded from the Auditor-General's scope to initiate, without a Ministerial request, a performance audit of the extent to which a public entity is carrying out its activities effectively and efficiently. No other public entity is excluded from the Auditor-General's scope in this regard.

Who should be the Reserve Bank's monitoring agent?

To be effective, an external monitor requires sufficient investigative powers, appropriate resources, and a healthy but not overly dependent working relationship with the agency's governing body.

The options for an external Reserve Bank monitoring agent fall broadly into two models:

- An independent 'supervisory council' (similar in concept to the current Reserve Bank Board)
- The Treasury, as a Crown entity-style 'monitoring department' (the Treasury being the Minister of Finance's policy department).

Monitoring functions and responsibilities under both models would include assessing and reporting on the Reserve Bank's performance (including key decision-makers such as the MPC) and advising on appointments and dismissals. The key benefits of each option include:

Supervisory council

Independent agent of the Minister, more intensive than a monitoring department. Key benefits:

- **Focus** – dedicated to monitoring one organisation
- **Intensity** – can keep performance under constant review
- **Independence** – membership and resourcing can be designed for demonstrable independence
- **Audit** – greater scope for an independent audit function.

[38] For example, since 2013 Crown entity annual reports have been required to include the information that is necessary to enable an informed assessment of each entity's operations and performance for that year, including an assessment of the entity's progress in relation to its strategic intentions. These requirements are not currently mandated for the Reserve Bank's *Annual Reports*.

Monitoring department (the Treasury):

The Minister's existing policy adviser, less intensive than a supervisory council. Key benefits:

- **Lower cost** – less intensive monitoring is lower cost and can benefit from staffing flexibility within the Treasury
- **Consistent with wider State sector practice** – strong accountability links between the monitor and the Government under an established framework
- **Synergies** – complements the Treasury's general role as advisor to the Minister of Finance.

Relationship between choice of monitor and choice of governing body

Well-designed boards can provide relatively stronger internal accountability frameworks than the single-decision-maker model, particularly if the organisation is large and complex. Strong and transparent internal accountability frameworks may imply a reduced need for intensive external monitoring. Conversely, the power concentration inherent in a single-decision-maker governance structure may imply a perceived need for greater external monitoring. The optimal choice for external monitoring is therefore influenced by the choice of governing body:

- If a board model is selected as the governing body of the Reserve Bank, the case for having the Treasury as the monitoring agent is likely to be stronger.
- If a single-decision-maker model is retained as the governing body of the Reserve Bank, the case for a well-resourced and independent supervisory council is likely to be stronger.

Transparency: enabling accountability

Transparency helps to ensure the democratic legitimacy of a regulator's activities and encourages good governance. The Reserve Bank's annual accountability document requirements reflect those that were in place for the Crown entity sector before 2013 – that is, an annual *Statement of Intent* and an *Annual Report*. In addition, the Reserve Bank is required to publish the following documents:

- *Monetary Policy Statements* (at least six-monthly)
- Six-monthly *Financial Stability Reports*
- The principles on which it acts, or proposes to act, in determining applications for bank registration and in imposing (or varying, etc.) conditions of registration
- Reports on regulatory impact assessments of policies it intends to adopt and policies it has adopted
- Notices from the Minister directing the cancellation of registered banks' registration.

In practice the Reserve Bank consults publicly and publishes more widely about banking supervision policy and other regulations than legislation requires.

This Review consultation does not seek to assess the quality of the Reserve Bank's existing accountability and transparency documents. Instead, it seeks views on whether there are any aspects of the Reserve Bank's regulatory approach and activities that should have greater legislated accountability and transparency requirements.

Greater statutory accountability and transparency could formalise many of the Reserve Bank's existing practices, ensuring that such practices are undertaken as a matter of course rather than at the Reserve Bank's discretion. Additional requirements could also increase public engagement, support regulatory robustness and legitimacy, and further encourage an open culture within the Reserve Bank.

Areas potentially requiring more statutory provisions at a general level include:

- alignment with the Crown entities' reporting framework, most notably the use of annual statements of performance expectations and a greater specification of requirements for annual performance reporting
- public consultation when developing regulatory approaches and new policy tools, or extending the regulatory perimeter (within the boundaries permitted by primary legislation)
- the publication of prudential requirements and supervision policy documents (formalising the Reserve Bank's existing practice), particularly in areas where the Reserve Bank has significant regulatory independence
- the publication of key governance decisions (or minutes in the case of board or committee meetings), which may, for example, include the weights given to competing objectives and the approaches to achieving them
- removing the exclusion of the Reserve Bank from the Auditor-General's scope to initiate a performance audit on the extent to which a public entity is carrying out its activities effectively and efficiently (although consideration may need to be given to whether the Auditor-General's audit scope should include monetary policy).

All accountability compliance carries a cost. The benefits of greater accountability requirements therefore need to be weighed against the time and resources involved, whether they might unduly slow down decision-making (especially when a quick regulatory response to emerging issues is desirable), and whether, in times of instability, too much transparency can lead to poor policy outcomes and regulatory arbitrage. In addition, accountability requirements should have value to their audience. More detailed or regular reporting is a cost if the Minister or other monitoring body does not value or need the information, or cannot use it.

Some of the above areas (e.g. regulatory approach) will also be examined in future consultation rounds.

Questions for consultation

Your views are sought on the following questions:

24. Who should monitor the Reserve Bank? What do you see as the key considerations in determining who the monitoring agent should be?
25. If the existing Board is retained as a monitoring agent only (e.g. in the form of a supervisory council), what changes do you see as necessary to improve its effectiveness?
26. Are existing statutory accountability and transparency requirements sufficient? If not, in what areas would you like to see more?

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RBNZ Act 1989: Reserve Bank of New Zealand Act 1989

RBNZ Amendment Bill: Reserve Bank of New Zealand (Monetary Policy) Amendment Bill

Glossary

Abbreviations, acronyms and key terms

ACC – Accident Compensation Corporation. A Crown entity that provides personal injury compensation.

ADI – authorised deposit-taking institution. An institution authorised by Australia's prudential regulator, APRA, to carry on banking business, such as a bank, credit union, or building society.

Agent – a party acting on behalf of someone else (the 'principal'). The Reserve Bank's Board is currently the monitoring agent for the Reserve Bank, acting on behalf of the Minister of Finance.

AML/CFT – anti-money laundering and countering financing of terrorism

Annual Report – in the context of this document, a statutory accountability document in which an agency reports on its operations and financial performance during the last year.

APRA – Australian Prudential Regulation Authority. The prudential regulator of the Australian financial services industry.

Arbitrage – where market inefficiency creates differences in the costs of similar products, allowing providers to benefit from the inefficiency. Regulatory arbitrage is where regulated entities structure themselves to minimise their regulatory compliance costs.

Asset – a resource controlled by a person or enterprise (an 'investor') from which future economic benefits are expected to flow to the investor. Cash, bank deposits, and KiwiSaver funds are common 'assets' held by New Zealanders. An instrument held as an asset by an investor is a 'liability' for the institution that has issued the instrument. For example, cash held by New Zealanders is an asset to them but is a liability of the Reserve Bank, while bank deposits are assets for the deposit holders but liabilities of the banks holding the deposits.

Basel Committee on Banking Supervision – the primary global standard setter for the prudential regulation of banks, which provides a forum for regular cooperation on banking supervisory matters. It has 45 members comprising central banks and bank supervisors from 28 jurisdictions. New Zealand is not one of these jurisdictions.

BIS – Bank for International Settlements. An international financial institution owned by central banks that "fosters international monetary and financial cooperation and serves as a bank for central banks".

Capital – financial resources held by an institution that can be easily used to bear losses without triggering a failure event. Common forms of capital include shares, other instruments of ownership, and retained earnings.

Capital ratio – a required amount of capital to exposures/investments that regulated entities must hold in order to protect against losses on those exposures/investments.

CEO – chief executive officer. The highest-ranking senior manager in a company or other institution, acting as a point of communication between the board and corporate operations. The Governor is the CEO of the Reserve Bank.

CDGS – Crown Deposit Guarantee Scheme. An emergency measure to support the financial sector implemented by the New Zealand Government during the GFC. It was put in place in October 2008 and matured in December 2011. At its peak the scheme covered 96 institutions, including 12 banks, 60 NBDSs, and 24 investment firms. The Government paid out $2 billion to 42,000 depositors under the scheme. The largest single payout was for South Canterbury Finance ($1.6 billion), one of nine failures under the scheme.

CMDT – Capital Market Development Taskforce. An industry-led taskforce appointed by the Government in 2008 to investigate issues with New Zealand capital markets. It was commissioned following the RFPP.

Collateral – an asset or commitment that is used by a borrower (a collateral provider) to secure a loan (a collateral taker).

Conditions of registration – a set of criteria that banks registered in New Zealand must meet in order refer to themselves as banks. A registered bank's conditions of registration are controlled by the Reserve Bank, and are the way prudential requirements are primarily applied. They are designed to promote banking system stability by constraining, but not completely removing, banking risk in certain key areas.

Contagion – a situation where difficulties facing one participant in the financial system spread to other participants.

CoFR – the Council of Financial Regulators. An information-sharing body for New Zealand's main financial regulatory agencies (the Reserve Bank, the Treasury, the Ministry of Business, Innovation and Employment, and the FMA).

Covered bond – a bond where the holder's right to payment is secured by specific assets, known as 'collateral'.

Creditor – someone who has lent money to a firm, which the firm has undertaken to repay. For example, a depositor is a creditor of a bank. In contrast, a shareholder is an owner of a bank.

Crisis management – a process by which authorities deal with an unexpected and disruptive event (or the risk of a disruptive event) that threatens the stability of the financial system (e.g. the failure of a major bank).

Crown (the) – the meaning of 'the Crown' varies according to the context in which it is used. Generally, it describes executive government conducted by Ministers and their departments. It does not normally include organisations that have their own corporate identities, such as state-owned enterprises. The Reserve Bank is not part of the Crown.

Crown entity – where referred to in this document, means a Crown-owned organisation, a legal entity in its own right, that has been established under legislation as "statutory entity" and is subject to the Crown Entities Act 2004. Crown entities perform functions on behalf of government at varying degrees of independence from government.

De minimis (as used in this document) – an optional function that could protect small bank deposits under OBR.

Debt instrument/security – a bond or other form of liability creating a contractual obligation on the issuing institution that the bond must be repaid. These instruments are traded in debt markets.

Democratic legitimacy – public support for, belief in, and understanding of an institution's powers and processes, which should reflect and support the will of the people.

Deposit – a credit balance in a deposit account at a deposit-taking institution.

Deposit taker – a financial institution that takes deposits, such as a bank or NBDT. Deposit takers are commercial entities that act as interfaces between lenders and borrowers, for example by collecting deposits from the general public and extending loans to households and businesses.

Depositor – someone who has money in a deposit account with a bank or NBDT, either because they have placed funds in that account or from temporary situations deriving from normal banking transactions. This person becomes a creditor to the institution holding their deposit, and the institution is contractually required to repay them.

Economic cycle – fluctuations in the economy. An economy may be in a boom, or in a downturn also known as a 'recession'. A severe downturn is a 'depression'.

EQC – Earthquake Commission. A Crown entity that compensates for natural disaster damage to residential land and buildings.

Externality – a cost or benefit affecting a third party who did not choose to incur it and that is not reflected in market pricing. For example, information asymmetries may see an investor subject to risk that is not priced into the return on their investment.

Failing bank – a bank (or financial institution) that is, or is likely to become, unviable. For example, a bank may be unviable because it is unable to honour its debts and liabilities, or because it is in breach of its conditions of registration.

Finance and Expenditure Committee – a select committee of Parliament that examines business related to economic and fiscal policy, taxation, revenue, banking and finance, superannuation, insurance, government expenditure and financial performance, and public audit.

Financial cycle – the process where financial markets fluctuate from upturns/booms to downturns/disruptions over time. The financial cycle can affect real economic activity (and the economic cycle).

Financial market – a generic term for markets in which financial instruments are issued, invested, and traded, and where those who have a surplus of funds lend to those who have a shortage. The four main financial markets trade in foreign exchange, debt or bonds, shares or equities, and derivatives. These can be broken down into subsets – for example, the 'money market' is a market for short-term debt using instruments that generally have a maturity of up to one year.

Financial policy – the approach, decisions, choices, and rules related to the regulation, supervision, and oversight of the financial system. Financial policy seeks to achieve various outcomes for the financial system, including financial stability, efficiency, and the protection of consumers. Note that in the case of the Reserve Bank, financial policy includes prudential supervision policy, macro-prudential policy, and crisis management policy.

Financial regulation – the laws and rules that govern what various participants in the financial system can and cannot do. Regulation is necessary because of the existence of various market failures that prevent the financial system achieving socially optimal outcomes on its own. Regulation seeks to achieve various outcomes outlined in policy. These outcomes for the financial system may include financial stability, efficiency, and the protection of consumers.

Financial sector – the class of financial system participants that collectively undertake a similar activity or perform a similar function (e.g. banks and insurers).

Financial Stability Board – an international body with membership comprising the G20 countries (New Zealand is not a member). It has a mandate to assess the vulnerabilities affecting the financial system, identify and oversee action to address them, and promote cooperation and information sharing among authorities responsible for financial stability.

Financial Stability Report – a six-monthly Reserve Bank report required by legislation reporting on the soundness and efficiency of the financial system and containing the information necessary to enable an assessment of the Reserve Bank's activities in pursuing its prudential purposes.

Financial system – the network of participants in an economy that collectively undertake various finance-related functions and activities. A financial system includes financial institutions (such as deposit takers and insurers), markets, market infrastructures, and the everyday people who use them. Financial systems operate at various geographical levels: regional, national, and global.

FinTech – financial technology innovations such as online and mobile payment systems.

FMA – Financial Markets Authority. The New Zealand government agency responsible for promoting fair, efficient, and transparent financial markets by enforcing securities, financial reporting, and company law as they apply to financial services and securities markets. The FMA also regulates securities exchanges, financial advisers and brokers, auditors, trustees, and issuers, including issuers of KiwiSaver and superannuation schemes.

FMI – financial market infrastructure. A channel through which financial transactions are cleared, settled, and recorded, including payment systems and trading platforms. FMIs are the 'plumbing' of the financial system, providing services critical to the smooth functioning of financial markets.

FMS – financial markets supervisor. A private sector company that supervises licensed non-bank deposit takers. FMSs are licensed by the FMA.

FPC – Financial Policy Committee, an option considered in this Review.

FSAP – Financial Sector Assessment Program. An IMF programme that seeks to identify the strengths and vulnerabilities of countries' financial systems (including regulatory frameworks, which it assesses against core principles for effective banking supervision developed by the Basel Committee on Banking Supervision). It also seeks to determine how key sources of risk are being managed. The most recent FSAP mission to New Zealand was in 2017.

GDP – gross domestic product. A measure of the value of economic production in the economy.

GFC – the global financial crisis. The GFC occurred between mid-2007 and early 2009 and was a period of extreme and widespread stress in global financial markets and banking systems. The GFC was an example of systemic risks crystallising and damaging the financial system and wider economy.

Governance – the system by which an organisation is controlled and operates, and the mechanisms by which it, and its people, are held to account. Governance captures who makes policy and regulatory decisions, who makes organisational decisions, and how decision-makers are held to account.

Governor (of the Reserve Bank) – the person appointed to perform the role of the governing body and the role of the CEO of the Reserve Bank.

Independence – in relation to a public institution such as the Reserve Bank, the provision that ensures the institution can carry out its tasks and duties without political interference.

Independent Expert Advisory Panel – a panel appointed by the Minister of Finance to provide independent and expert advice on the Review of the Reserve Bank Act.

Insolvent – when the value of a firm's assets falls below the value of the liabilities it owes, and the firm is therefore unable to pay its debts. An insolvent firm is a 'failing' firm.

International Association of Deposit Insurers – a forum of 83 deposit insurance scheme managers that was formed in 2002 to share knowledge and promote international cooperation on deposit insurance systems. IADI works with the Basel Committee on Banking Supervision to develop guiding principles for effective deposit insurance systems.

Investor – someone who has invested their money in a financial institution. Anybody providing funds to a financial institution in whatever form is an investor, from shareholders to depositors to professional investors in more sophisticated debt instruments.

IMF – International Monetary Fund. An international organisation of 188 member countries established to ensure the stability of the international monetary system. Its remit includes the system of exchange rates and international payments, as well as all macro-economic and financial sector issues that affect global stability.

Issuer – an entity that issues, and therefore becomes obligated for, a security or other financial instrument. For example, a bank that writes a debt in exchange for funding is the 'issuer' of that debt.

Leverage – a measure of indebtedness relative to asset holdings. Assets can be purchased through equity or through borrowed funds, or a combination of both. A person who takes out a mortgage to buy a house is 'leveraged'. An excessive build-up of leverage among banks and households was seen as one of the causes of the GFC.

Liability – a debt or legal obligation to be repaid, by either cash or another type of financial instrument. Examples include customer deposits held by banks, and bonds and other debt securities issued by banks. As previously noted, one entity's asset is another entity's liability.

Liquidity – the capacity to sell an asset quickly and easily without significantly affecting the price of that asset. Liquidity is also sometimes used to refer to assets that are highly liquid.

Loan-to-value ratio – a tool used by financial sector regulators to influence lenders' credit policies and the availability of loans to borrowers, by specifying the proportion of an asset's value that may be financed through borrowing.

LoLR – lender of last resort. The central bank acting in its function to provide emergency liquidity assistance to a solvent financial institution facing temporary liquidity problems in order to maintain the soundness of the financial system.

Machinery of government – includes the set of organisations within government, their functions and governance arrangements, and how they work together to deliver results for Ministers and the public.

Macro-prudential policy – the use of prudential tools (such as capital buffers and loan-to-value restrictions) to manage the system-wide (systemic) risks that can develop during boom-bust financial cycles. Macro-prudential policy aims to promote greater financial system stability by building additional resilience in the financial system during periods of rapid credit growth and rising leverage or abundant liquidity, and by dampening excessive growth in credit and asset prices. In New Zealand, macro-prudential policy is used to address systemic risks as they change over time (across the financial cycle). Systemic risks arising at a point in time are managed through 'traditional' prudential policy in New Zealand. However, internationally, macro-prudential policy is often defined as the management of systemic risk both over time and cross-sectionally.

Market failure – a situation where the allocation of goods and services by a free market is not efficient, and leads to a net social welfare loss. The existence of market failures provides the rationale for the regulation and supervision of the financial system, and its component parts (financial institutions, markets etc.).

Memorandum of Understanding – a non-binding agreement or expression of common understanding between two or more parties.

Minister – in this document, the Minister of Finance.

Monetary policy – action undertaken by a central bank to affect the cost of money and credit to meet objectives such as price stability or maximising sustainable employment. While monetary policy is generally implemented using a policy interest rate (such as the Official Cash Rate), it can also include the use of extraordinary measures such as quantitative easing/asset purchasing.

Monetary Policy Statement – a formal statement from the Reserve Bank, issued four times a year, setting out how it intends to achieve its monetary policy objectives, how it proposes that monetary policy will be formulated and implemented for the next five years, and a review of its monetary policy in the last quarter.

Monitor – a body that is responsible for monitoring the performance of an entity on behalf of a responsible Minister.

Monopoly power – when a person or enterprise is the only supplier of a particular good or service, so has control or power over the market for that good or service. Monopoly power can result in higher profits for the producer, and higher prices for the consumer, than would be the case in a competitive market.

MPC – Monetary Policy Committee. A committee that will become responsible for the formulation of monetary policy. This committee is to be established as an outcome of Phase 1 of the Review.

NBDT – non-bank deposit taker. An institution that carries on the business of borrowing and lending money, or providing financial services, or both, but is not a registered bank. Examples of NBDTs are some finance companies, credit unions, and building societies.

NDLI – non-deposit-taking lending institution. An institution that writes loans but is not funded from retail deposits.

OBR – Open Bank Resolution. A Reserve Bank policy designed to help manage a bank failure.

OCR – Official Cash Rate. The OCR is an interest rate set by the Reserve Bank. It influences all other interest rates and is, in effect, the wholesale price of borrowing or lending money in New Zealand. It allows the Reserve Bank to meet its goal of ensuring price stability for New Zealand.

OECD – Organisation for Economic Cooperation and Development. An intergovernmental economic organisation that represents industrial market countries and contributes to the economic development of less-advanced members and non-member countries.

Payment and settlement systems – a type of FMI. Payment and settlement systems support the exchange of payments for products and services. They may be cash payment systems (such as the Reserve Bank's Exchange Settlement Account System) or securities settlement systems.

Phase 1 – the first phase of the Review of the Reserve Bank Act. The outcomes of Phase 1 updated the Reserve Bank's high-level objectives for monetary policy, adding employment to the price stability objective of the Reserve Bank and providing for a committee decision-making model for monetary policy decisions (the MPC).

Phase 2 – the current phase of the Review of the Reserve Bank Act. It is primarily focused on a comprehensive review of the financial policy provisions of the Reserve Bank Act that provide the legislative basis for prudential regulation and supervision, and will also consider the broader governance arrangements of the Reserve Bank. It will be broken up into three consultations, of which this is the first.

Policy instrument – a policy tool that is available to the regulator to achieve its objective. The Official Cash Rate is a policy tool available to the Reserve Bank to effect monetary policy.

Productive capacity – the maximum output that can be produced in an economy that is working efficiently and without friction.

Prudential policy – rules that support the prudent operation of regulated financial entities. In New Zealand, traditional prudential regulation focuses on the soundness and efficiency of the financial system by imposing regulatory requirements at the level of individual institutions. Capital requirements, liquidity requirements, and disclosure requirements are among the prudential policies currently operated by the Reserve Bank.

Related party exposure – an entity's investment in another entity, where the first entity is a parent or subsidiary of the second. For example, investments in a subsidiary or parent company are related party exposures. Also known as 'intragroup exposures'.

Regulated entity – a financial service provider falling within the scope of the Reserve Bank's supervisory and/or regulatory powers. This currently captures registered banks, NBDTs, and insurers.

Regulator – a body mandated by the Government to oversee a particular industry or sector. The Reserve Bank is the prudential regulator for the financial sector in New Zealand.

Regulatory framework – a system of rules and requirements that govern the way regulators and regulated entities interact. The financial sector regulatory framework is made up of regulatory requirements, guidance, and Memoranda of Understanding.

Reserve Bank Act – Reserve Bank of New Zealand Act 1989.

Reserve Bank of New Zealand – New Zealand's central bank, established in 1934. The Reserve Bank manages monetary policy to maintain price stability, promotes the maintenance of a sound and efficient financial system, and supplies New Zealand banknotes and coins.

Retail depositors – households and small businesses with deposit accounts. Retail depositors are not professional investors or wholesale creditors.

RFPP – Review of Financial Products and Providers. A review carried out between 2005 and 2008, leading to a number of new pieces of legislation, including the Financial Service Providers (Registration and Dispute Resolution) Act 2008, the Reserve Bank of New Zealand Amendment Act 2008, and the Insurance (Prudential Supervision) Act 2010.

Risk pricing – when the amount that investors earn from/borrowers pay for a loan is calculated in relation to the risk that the loan will not be repaid. The return an investor earns on their investment is the 'risk price'. Accurate risk pricing is a key part of the risk management process. Risk mispricing is believed to have caused a build-up of systemic risks that led to the GFC.

Securities exchange – a marketplace where financial securities such as stocks and bonds are traded. In New Zealand, securities exchanges – such as the New Zealand Stock Exchange – are regulated by the FMA.

Securitisation vehicle – an instrument for pooling various types of debt instrument, such as mortgages, and selling their related cash flows to third-party investors as tradeable securities.

Shareholder – someone who has invested money in a firm to become a partial owner of that firm.

Single decision-maker – under the Reserve Bank's current governance arrangement, the Governor is the single decision-maker ultimately responsible and accountable for all financial policy decisions. An alternative model may place responsibility with a board.

Stakeholder – someone who can affect or be affected by someone else's actions and policies, etc.

State sector – a term used to cover all organisations that report to the Crown. The State sector is separate from local government (city, district, and regional councils).

Statement of Intent – a statutory accountability document setting out the strategic objectives that an entity intends to achieve in the future reporting period and other matters intended to promote the public accountability of the entity.

Statutory management – one of several legal mechanisms available in New Zealand to deal with a failing bank, set out in the Reserve Bank Act.

Statutory manager – an individual appointed by the Minister of Finance (on the advice of the Reserve Bank) to step in and run a commercial bank in the interest of the New Zealand public when the bank is failing. The statutory manager has wide powers to deal with the failing bank, such as assuming all powers of the board and management, and exercising many of the powers of a liquidator. The statutory manager may choose to suspend or make payments to creditors, or organise to sell the bank.

System/Regulatory stewardship – the responsibility for ensuring that the legislative and regulatory frameworks within which a regulator (and the sectors it regulates) operates remain fit for purpose.

Systemic risk – the risk that issues at one point in the financial system (perhaps due to operational disruption or a participant's financial difficulties) will cause issues at other points in the system, generating spill-over effects that could threaten the wider operation and stability of the system and have negative consequences for the real economy.

Treasury – the Minister of Finance's policy department and the Government's lead economic and financial adviser.

Twin peaks – a model of financial regulation where conduct and prudential regulation are separated.

Unsecured credit – funds that have been lent (e.g. to a financial institution or consumer) that are not backed by specific assets. In the event of failure, unsecured creditors will be paid out from a general pool of assets. In contrast, some funding (such as covered bonds) is secured with specific assets.

Wholesale participants – professional (non-retail) financial market players, such as sophisticated investors in capital market instruments and participants in interbank money markets.