The Treasury

Reserve Bank Act Review Phase 2 Submission Information Release

March 2019

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SAFEGUARDING THE FUTURE OF OUR FINANCIAL SYSTEM

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

Have your say

To have your say on these important issues, please answer the questions below and send this form by email to rbnzactreview@treasury.govt.nz

To get more information on these topics and the wider Reserve Bank Act Review, see the full consultation document at treasury.govt.nz/rbnz-act-review).

Please note that some of our responses more than fill the text boxes and scrolling is necessary to see the whole response. Empty boxes mean we have no comment.

C2

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

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?

Soundness and financial stability can be seen as two distinct and desirable objectives if more clearly defined.

From a consumer perspective, soundness is the assurance that deposits and other interactions with the financial system are as safe as possible, even through times of instability. That does not mean complete lack of risk, but it reflects the fact that particularly for financially unsophisticated individuals it is simply unrealistic to expect them to make accurate assessments of the risk in a particular institution. The regulatory environment must provide an assurance of soundness that they can rely upon in its place. The concept here is not consumer protection in the form that the Financial Markets Authority (FMA) is responsible for, but systemic. We come back to this in discussing deposit guarantees.

Financial stability reflects the systemic importance of the financial system for both its own participants, including consumers, and for the economy and society more generally. The impacts of banking crises for example can be devastating and long lasting in both economic and social terms. That is the extreme of instability, but there are less extreme examples, such as the failure of a systemically important bank or a malfunction of the payments system, that are also important.

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)?

Taking a narrow view, focusing on regulatory 'efficiency' channels efforts towards minimising regulation: that is, towards so-called light-handed regulation. The failure of that became most apparent during the Global Financial Crisis, and that failure is now recognised by many expert commentators. It is a false view of efficiency. While regulatory actions should be well-designed, the primary criteria for their assessment should be on their impacts, their outcomes. We would therefore oppose narrowing this objective to "regulatory efficiency". If it is retained, it should be efficiency in a broader sense. We agree that the Reserve Bank Act's proposed new overarching purpose statement achieves the a broader efficiency objective much more clearly and in an encompassing way: "The purpose of this Act is to promote the prosperity and wellbeing of New Zealanders and contribute to a sustainable and productive economy". A problem with a conventional "efficiency" statement is that it ignores broader views of efficiency if the four capitals of the Living Standards Framework are taken into account. Most particularly it ignores the impact on social capital of financial instability, financial failures, excessive debt and other potential impacts of a financial system: this could be regarded as inefficient use of social capital but it is more clearly expressed in the purpose statement.

c) Should ‘efficiency’ remain a high-level objective of the Reserve Bank, or should it be demoted to a lower tier of the legislation?

See answer to previous question.

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?

As the discussion paper notes, competition in the financial sector is a complex issue. In a standard market sense, more competition is good in that it helps to keep down prices, improve services and reduce excess profits. We are far from that position in the banking and insurance sectors so there is more work to be done there. But there is also the concern that excessive competition encourages individual financial entities into taking higher risks, selling more risky products, using high pressure sales techniques, and reducing capital buffers. That could reduce financial stability, soundness (in the sense described above), consumer protection and (as has been seen in New Zealand and Australia) staff morale and retention. Any competition objective should therefore make it clear how these tensions are balanced and show how it interacts with the Commerce Commission's role (it could be a systemic role, and one that mandated the Reserve Bank to use its various levers to encourage desirable forms of competition, rather than the more specific role the Commerce Commission plays).

c) Should 'consumer protection' be added to the Reserve Bank's objectives?

See the above comments regarding soundness. The Reserve Bank could play a role in systemic protection for those consumers who are in practice not in a position to make judgements about the soundness of financial institutions: principally those who are neither financially sophisticated nor institutional or professional investors.

d) Should 'public confidence (or trust)' be reinstated as a high-level financial policy objective of the Reserve Bank

Any role here should ensure that public confidence is based on reality, not on assurances for the sake of maintaining (perhaps false) confidence, which could at times be a temptation. It is better expressed as maintaining a financial system system in which the public can justifiably have confidence. It implies requiring banks (etc) to make changes if their state or behaviour risks making confidence unjustified.

e) Are there any other objectives you think the Reserve Bank should be given?

There is little discussion in the paper of the Reserve Bank's role with respect to the exchange rate. An objective of maintaining a stable exchange rate at an appropriate level could be considered.

C3

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

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?

The perimeter should be broad.

Firstly, the rapidly changing form of financial service suppliers (if they can all be called that) has the potential to challenge the ability of the Reserve Bank to carry out its role in both financial and monetary stability. Crypocurrencies as alternative currency systems, systems such as PayPal as alternative payments systems (merging into deposit taking systems), peer-to-peer lending, and potentially further disintermediation such as through blockchain-based systems, may become alternatives to the current systems, making them more difficult to regulate, or become sources of insecurity in their own right.

Secondly as the Global Financial Crisis showed, existing finance sectors can unexpectedly become risks to the stability of the financial system, as insurers like AIG did in the GFC in the US. The failure of the finance company sector in New Zealand, had it been larger, could have been a risk to system stability. Because it is a near-substitute to parts of the banking system, it can also weaken the ability to regulate banks.

On p.40, criteria are proposed for bringing a sector inside the perimeter. We make the following comments.

* The sector poses potential risks to financial soundness that cannot be met using existing regulatory powers.
Comment: Or it has the potential to undermine the ability to regulate (such as new forms of service as described above).

* The application of prudential regulation (such as capital, liquidity, or risk management requirements) would effectively address those risks.
Comment: But the Reserve Bank should stand ready to create new regulatory tools as needs change.

* Regulatory action would not result in unintended consequences or costs in excess of the benefits.
Comment: This is a regulatory design issue, not a criterion for deciding whether or not to regulate.

Regarding KiwiSaver, a consideration is that when a member reaches 65, his or her KiwiSaver account becomes similar to a bank account as amounts can be withdrawn without notice. This will become increasingly material as the balance of KiwiSaver membership moves towards older members.

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?

Flexibility for the regulator to respond to changing technology, products and providers is important given the pace of change. This implies that requiring a legislative change to change the perimeter is not the best option. It also suggests that the Reserve Bank should have the responsibility for writing regulations.

C4

Should there be depositor protection in New Zealand?

5. Have the key benefits of the status quo and the identified depositor protection options been correctly identified?

In general, they are correctly identified. However it is also important that not only are "Everyday (transactional) accounts... an important part of modern life, helping people in daily activities like doing the shopping, paying bills, and receiving wages," (p.52) bank accounts are in practice compulsory for receiving wages and payments through the welfare system. Given that situation, there is a strong case for protection because New Zealanders have no choice but to use bank accounts. In effect they are required to hold what is for most households significant balances (such as at least a fortnightly pay) which in many cases would cause hardship if they unexpectedly became unavailable. Even loss of relatively small balances could prevent a household from paying its rent, mortgage payments, power bills or other essential payments.

As we mention below, better information on the distribution among households of bank balances, and their purposes, is needed for good policy making.

6. Is the high-level assessment of the risks and costs under the status quo and the identified depositor protection options reasonable?

There are aspects of New Zealand's regulatory regime which mean a depositor protection scheme should be favoured.

The light-handed regulatory regime (which we consider an undesirable risk in its own right) transfers risk to those who cannot control it such as small depositors.

In addition the Open Bank Resolution regime instituted by the Reserve Bank contemplates partial loss of deposits if a bank should fail, but guarantee of remaining deposits. This guarantee has never been formalised and should be. The current situation does not treat depositors in good faith and provide them with the information necessary to make decisions as to best disposition of their personal finances. They know neither the amount nor the timing of payments under the guarantee.

As the discussion paper notes, "depositors are around the middle of the queue to be paid out", and this position is gradually deteriorating as they are pushed down the queue by covered bonds and other privileged forms of bank liabilities. Given the decisions by successive governments to allow these higher ranked securities, it has a responsibility to protect small depositors.

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?

Yes. We do not consider that moral hazard (the concern that depositors will take greater risks if their deposits are protected) is an issue for small depositors. (To the extent that it exists, arguably it is no greater with explicit deposit protection given there is widespread expectation that the government would bail out depositors in a bank crash in any case.) Small depositors are not in a position to judge the soundness of a bank - something even experts can find difficult, and expert opinions at any time may differ. For those with large deposits, taking a greater responsibility to make those judgements is more reasonable, they have more ability to spread risks, and they are probably in a better position to either have the expertise or pay for expert advice. The policy question is therefore what is a "large deposit". The discussion paper provides little information on the distribution of deposits. Much better information should be provided when further work is progressed on depositor protection.

From the information provided, insurance/guarantee of up to $10,000 would protect 80 percent of people with deposits (p.53). This is much less than other countries, and does not take into account differing distributions by age: people who are retired or close to retirement are likely to have accumulated much larger sums to provide for retirement income. This will become more common as Kiwisaver matures as a scheme and savings may be moved to bank accounts for use in retirement.

These factors need to be carefully considered in the design of the scheme. It may be worth considering a design incorporating a mixture of compulsory insurance/guarantee paid for by bank levies for smaller deposit levels, and optional government-provided and guaranteed deposit insurance for those wishing to protect larger sums (up to a higher threshold). We do not support simply raising the preference for depositors ahead of other creditors as it does not give sufficient assurance of timely payout. However, preference is still a consideration and any work on depositor protection should also review depositors' deteriorating ranking for repayment with a view to reinstating a higher ranking.

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?

See above.

9. Are there any alternative protection options, design principles, or complementary policies that could improve outcomes for the stakeholders identified above?

See above.

C5

Should prudential regulation and supervision be separated?

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.

In general we support the enhanced status quo option. An important consideration is that the Reserve Bank's general powers to oversee and regulate the financial sector gives it credibility. A separate authority is unlikely to have as broad a range of powers.

We support moving away from the "light-handed approach" to supervision (e.g. p.62) which has failed in other jurisdictions, and failed here in the case of the finance company sector. The risks inherent in the financial system are too high to continue with this approach.

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?

C7

~~Should prudential regulation and supervision be separated?~~

16. Do you consider there is a case for a Ministerial role in clarifying the Reserve Bank's financial policy objectives?

We do not have detailed comment on these matters. However we make the following two points:

1. As the Bank makes increasing use of instruments such as loan-to-value ratios which have social and distributional consequences, and which in general must be supported by fiscal or regulatory action by the government (such as housing policies), the Bank must work much more closely with the rest of government, inevitably implying that autonomy is lessened and indeed from a whole-of-government viewpoint, autonomy is inappropriate. These matters will only get more complex, and negotiation of the changes needed in a changing environment further illustrate the difficulties in an autonomous model.

2. On the separation of policy advice to the Government, including the development of legislation and regulation, from the regulator's (the Bank's) exercise of its powers: we have seen recurrent failures of this model (such as in workplace health and safety) if only because the expertise and the experience in operating the current model lies heavily with the regulator. It is very difficult for a small unit in a separate agency to maintain convincing and up to date expertise, especially to the level of ministerial advice and drafting legislation.

In this case, because of the importance of the Bank's role in economic and fiscal policy, Treasury will maintain general expertise in many of the Bank's areas of responsibility. There is therefore always likely to be contestability in the advice given to Government in its areas of responsibility and that should be a significant check on the quality of the Bank's decision making.

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?

C8

How should the Reserve Bank be structured?

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?

We do not have detailed comment on these matters. However we support a governance model that is a board rather than single decision-maker. The board should be more broadly representative of society, as well as including specific relevant expertise. It should include representation from workers (through the CTU) in addition to business, which is in practice already well represented.

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?

C9

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

~~How should the Reserve Bank be structured?~~

23. Who should monitor the Reserve Bank? What do you see as the key considerations in determining who the monitoring agent should be?

The Board should monitor the Bank. The Bank should be brought within the scope of the Auditor-General.

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?