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Westpac New Zealand Limited

Submission to Treasury of New Zealand on Phase 2 of
the Reserve Bank Act Review: Safeguarding the future of
our financial system

4 February 2019

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1. Background

- 1.1 This submission to the Treasury is made on behalf of Westpac New Zealand Limited (**Westpac**) in respect of the first consultation paper relating to Phase 2 of the *Reserve Bank Act Review: Safeguarding the future of our financial system*. Westpac's contact for this submission is:

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[1]

2. Introduction

- 2.1 We welcome the opportunity to provide feedback to the Treasury on the consultation document, "Safeguarding the future of our financial system: The role of the Reserve Bank and how it should be governed" (November 2018) (**Consultation Paper**).
- 2.2 We view this review as an opportunity to make New Zealand's prudential regulation regime more effective, efficient and flexible, for the benefit of all participants in the financial sector. We hope to see a regime that creates a framework for financial strength and stability, but also encourages innovation and competition. It is also essential that this regulatory framework is capable of effectively responding to new developments in this constantly evolving sector.

3. Executive Summary

- 3.1 Our key priorities in responding to this review are:
- (a) the long-term maintenance of financial stability in New Zealand through effective prudential regulation;
 - (b) the management of systemic risk in a way that does not inhibit innovation and competition in the financial sector; and
 - (c) the establishment of an appropriate governance structure and culture within New Zealand's prudential regulator so that it can effectively meet the above goals.
- 3.2 Specifically, our submissions are:
- (a) *Objectives of the Prudential Regulator*: The Reserve Bank should have an overarching objective of promoting financial stability, with secondary but mandatory objectives of efficiency, competition and public confidence.
 - (b) *Regulatory Perimeter*: New Zealand should dispense with the separate regulation of banks and non-bank deposit takers (**NBDT**), and instead adopt

an “authorised deposit taking institution” (**ADI**) regime similar to that in Australia.

- (c) *Depositor Protection*: Depositor protection, in the form of a deposit insurance scheme, should be introduced in New Zealand. This submission is subject to the outcome of a holistic review of crisis management and bank resilience policies, to ensure compatibility with the deposit insurance scheme.
- (d) *Separation of Prudential Regulation*: The prudential regulation function of the Reserve Bank should be transferred to a new New Zealand Prudential Regulation Authority (**NZPRA**). Alternatively, the prudential regulation function within the Reserve Bank should be more clearly structurally separated from its monetary policy function.
- (e) *Governance of Prudential Regulation*: The Reserve Bank should move to a crown entity-style governance model, under which it is governed by its Board and monitored by the Treasury.

4. Objectives of the Prudential Regulator

- 4.1 New Zealand's prudential regulator (currently the Reserve Bank) should have an overarching objective of promoting financial stability, which is checked and moderated by secondary but mandatory objectives of efficiency, competition and public confidence.

Financial stability

- 4.2 The current purpose of the Reserve Bank includes "promoting the maintenance of a sound and efficient financial system".¹ Within this are two objectives: financial soundness, and efficiency.
- 4.3 We propose that "financial stability" is a more appropriate objective than financial soundness, as it:
 - (a) is more consistent with the objectives of other central banks overseas;²
 - (b) may be more easily understood, and therefore more easy to measure performance against; and
 - (c) has an important additional dimension beyond just resilience (see paragraph 4.5 below).
- 4.4 Financial stability is already a key focus of the Reserve Bank in practice. The Reserve Bank website has a page dedicated to "Financial Stability", and no equivalent for "Financial Soundness".³ It also publishes regular reports on financial stability, but not soundness. This gives the impression that the Reserve Bank

¹ RBNZ Act, section 1A(1)(b); this wording is retained in the amendments to section 1A in the Reserve Bank of New Zealand (Monetary Policy) Amendment Bill section 4.

² Consultation Paper page 32.

³ Reserve Bank "Financial Stability" <<https://www.rbnz.govt.nz/financial-stability>> (retrieved 7 December 2018).

appears to prioritise stability in practice, and its primary objective should be updated to reflect this focus.

- 4.5 The definition of stability is also more closely aligned with what a prudential regulator should prioritise. Soundness goes to the resilience of the financial system. However, stability includes an extra focus on preventing and minimising harmful economic peaks and troughs.
- 4.6 A financial stability objective should therefore be the primary objective of the Reserve Bank. However, this should not be an absolute objective. Achievement of financial stability is a form of risk management exercise, and risk management of this kind involves trade-offs: financial stability is not a binary outcome (where there is either financial stability or there is not), but rather there are increasing degrees of financial stability, which can be attained at an increased cost to other factors such as efficiency. These cost increases tend to become exponential as the point of zero risk is approached. For this reason the financial stability objective needs to be balanced by considerations of efficiency and, as explained below, competition and public confidence.
- 4.7 The amount of risk the prudential regulator is able to take (and therefore the extent to which it is willing to forgo some degree of financial stability to promote efficiency and other objectives) could be determined by a third party such as the Treasury. The Treasury could set broad parameters in the form of a risk appetite statement, which would guide the prudential regulator in applying its objectives. This would also enable a series of decisions made in relation to individual components of a wider crisis management and bank resilience framework to be considered collectively for the purposes of determining efficiency. This would mitigate the risk of decisions being considered in isolation without proper consideration of their cumulative effect.

Efficiency

- 4.8 The Reserve Bank's current purpose of "promoting the maintenance of a sound and efficient financial system" gives (in theory at least) equal emphasis to financial soundness and efficiency. We submit that financial stability should be the primary objective, but that efficiency should be retained as a mandatory objective, and that it should be used to moderate the financial stability objective.
- 4.9 The scope and meaning of the Reserve Bank's efficiency objective is currently in doubt and as such it should be clarified to focus on "regulatory" and "dynamic" efficiency. The legislated efficiency objective should be explicitly limited to these concepts.
- 4.10 Regulatory efficiency concerns the minimisation of the cost and burden of regulation, both on the Reserve Bank as regulator (and therefore on taxpayers) and on the firms it regulates (and therefore the wider economy). Where it is possible to reduce the burden of regulation without compromising its effectiveness, this should be a priority. In addition, a regulatory objective to minimise risk (that is, the promotion of financial stability) without the addition of a balancing objective of efficiency could incentivise the regulator to drive outcomes to the extreme boundary of risk avoidance. As explained above, as risk minimisation approaches that boundary, the cost (to the regulated institutions and to the economy) tends to become exponential. Financial services is necessarily a heavily regulated area, and it is important that the Reserve

Bank understands the commercial context in which it operates and takes into account the consequences of its decisions on regulated entities and on the economy at large.

- 4.11 Dynamic efficiency concerns the facilitation of innovation within the financial sector. Where possible, regulation should not prevent new ways of doing things— instead it should manage risks in the financial sector regardless of the actual activities carried out. An objective of promoting dynamic efficiency will ensure that the Reserve Bank delivers "mode neutral" regulation to the extent possible.
- 4.12 A focus on dynamic efficiency is more important now than ever before, with financial technology (**Fintech**) changing the way market participants conduct their financial affairs. Fintech promises reduced costs or increased functionality for users, and the Reserve Bank should ensure that such innovations are not unfairly inhibited by regulation.
- 4.13 A "dynamic efficiency" objective has some similarity with a "competition" objective (see paragraph 4.17 to 4.20 below). However, the focus of dynamic efficiency is on new products and services (regardless of who provides them), while competition is concerned with new players in the market (regardless of what products or services they provide). These objectives therefore complement, but do not necessarily overlap, one another.
- 4.14 Two other possible meanings of "efficiency" were identified in the Consultation Paper: *competitive efficiency*, and *allocative efficiency*. Competitive efficiency is addressed by a separate competition objective (see below) and therefore no longer needs to be a part of the "efficiency" objective.
- 4.15 Allocative efficiency concerns the economically efficient distribution of resources to those who can use them most productively. As an objective this is too broad, vague and hard to measure, and does not fit neatly within the mandate of a central bank. In practice the Reserve Bank's role has not extended to promoting allocative efficiency, and there is no need for this to become an objective.
- 4.16 While the efficiency objective should be secondary to the financial stability objective, it should be a mandatory consideration. This is important to ensure that financial stability is not pursued as an absolute objective. The prudential regulator must therefore consider the actions it takes in pursuance of financial stability against the efficiency costs of these actions. Guidance on the regulator's risk appetite, and therefore the relative emphasis it places on financial stability and efficiency, could be guided by the Treasury (see paragraph 4.7 above).

Competition

- 4.17 Competition generally benefits the financial system. It has the ability to drive down costs, promote innovation, and discourage complacency from market participants. Promoting competition is not the Reserve Bank's primary role, but where the impact of regulation on competition can be reduced without compromising financial stability, this should be encouraged.
- 4.18 The Reserve Bank's regulatory decisions can have a substantial impact on financial institutions, and it is possible that some regulation may be disproportionately burdensome on new or minor players in the industry.

- 4.19 Competition objectives are already part of the mandate of overseas central banks and prudential regulators, including in Australia and the United Kingdom. The UK Prudential Regulation Authority has an objective to "act, so far as reasonably possible, to facilitate effective competition" in the markets it regulates,⁴ and the Australian Prudential Regulation Authority's objectives include "to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality".⁵ Additionally, "the need to maintain competition" is already a principle to be taken into account in the Reserve Bank's prudential regulation of insurers under the Insurance (Prudential Supervision) Act 2010 (IPSA).⁶
- 4.20 The Reserve Bank should therefore have a secondary objective not to inhibit competition. This negative objective (as opposed to a positive objective to promote competition) makes clear that the Reserve Bank should not seek to regulate with the purpose of promoting competition, but when it does regulate it should do so with as little harm to competition as possible.

Public confidence

- 4.21 Public confidence in the effective operation of the financial system is valuable in maintaining financial stability. This includes confidence not only in the financial health of market participants such as banks and insurers, but also that New Zealand has a modern, secure and effective system of financial infrastructure, facilitating the timely and reliable processing of payments and sharing of information. The Reserve Bank's mandate is being expanded to regulate financial market infrastructures (FMIs),⁷ so public confidence in this area will become even more closely aligned with the Reserve Bank's mandate.
- 4.22 Another important aspect of public confidence is confidence in the effectiveness of regulators. The public should be confident that the regulator understands its mandate, follows proper processes, acts fairly, is accountable, and exhibits a positive and inclusive culture.
- 4.23 As discussed in the Consultation Paper, public confidence is widely understood to be an implicit objective of central banks.⁸ As such public confidence should be made an explicit objective of the Reserve Bank (as it is already with respect to insurers under IPSA).⁹ Like efficiency and competition, the public confidence objective should be secondary to the Reserve Bank's financial stability objective, and should inform how the Bank pursues financial stability.

Consumer protection

- 4.24 "Consumer protection" was raised in the Consultation Paper as a potential objective.¹⁰ The protection of consumers is a useful goal in many contexts, but as an objective of the Reserve Bank it would have the potential to distract from, or even conflict with, the central objective of financial stability. For example, a focus on

⁴ BoE "Governance of the Bank Including Matters Reserved to Court" (7 February 2017) at page 4.

⁵ Australian Prudential Regulation Authority Act 1998, section 8(2).

⁶ IPSA, section 4(g).

⁷ Consultation Paper at page 40.

⁸ Consultation Paper at page 36.

⁹ IPSA, section 3(1)(b).

consumer protection may require a shorter-term outlook compared to financial stability. For this reason consumer protection is best left to other regulators.

- 4.25 As a prudential regulator the Reserve Bank should be concerned with systemic financial health and stability, and a broad goal of consumer protection would distract from this priority. It is particularly important to retain the integrity of the twin peaks model of financial regulation, and consumer protection should be within the conduct peak. This means that consumer protection in the financial regulation context should fall under the regulatory supervision of the Financial Markets Authority, to the extent that it is not within the mandate of the Commerce Commission.

5. Regulatory Perimeter

- 5.1 New Zealand should adopt an ADI regime, to unify the currently separate regulation of banks and NBDTs. This would bring our prudential regulatory perimeter in line with the Australian system.
- 5.2 Banks and NBDTs (as they are currently defined) carry on the same type of business. They are regulated differently, but that is for historical reasons rather than by design. There is no obvious reason why banks and NBDTs should be regulated differently, and it would be best if they were subject to the same regulation. This approach would be more efficient and would promote public confidence that all deposit takers are appropriately regulated. It could also eliminate the costs for growing deposit taking firms in transitioning between the existing NBDT and bank regulation regimes.

Scope of the ADI regime

- 5.3 We propose an ADI-based regime under which all deposit takers are subject to the same regulation, but the level of regulation that applies to each firm reflects the particular size and risks of the ADI. For instance, a new entrant may be subject to comparatively less regulation, but structures would be in place to easily increase regulation as the firm grows.
- 5.4 To accommodate for new developments in the financial sector (especially through Fintech), there should be scope for the definition to be extended if required. The governing body of the prudential regulator should have a power to make recommendations to the Minister of Finance that a certain sector or kind of institution be included in the definition of an ADI. This is similar to the approach taken in the United Kingdom, where the Treasury there can designate activities to be "PRA-regulated activities" upon the recommendation of the Prudential Regulation Authority.¹¹ This flexibility would allow the regulatory regime to respond quickly and effectively to new developments.
- 5.5 We acknowledge that a move from the status quo to an ADI regime would result in transition costs to stakeholders (including regulators, banks and NBDTs). However, gains in efficiency in the long term, from having only one regulatory regime for all deposit takers, are likely to outweigh these initial transition costs.

¹¹ Consultation Paper at page 45; Financial Services and Markets Act 2000 (UK) section 22A.

6. Depositor Protection

- 6.1 We support the introduction of depositor protection in New Zealand, subject to the design of the scheme and the outcome of a holistic review of existing bank failure management and bank resilience policies (discussed below). If introduced, depositor protection should take the form of a deposit insurance scheme, guaranteeing all deposits up to a predetermined amount.

Rationale for depositor protection

- 6.2 As observed in the Consultation Paper, New Zealand is one of only two countries in the OECD that do not currently have some form of depositor protection.¹² Depositor protection is useful for maintaining financial stability and public confidence in the system, and may need to be introduced in a crisis to reduce the risk of a bank run (as was the case with the Crown Retail Deposit Guarantee Scheme of 2008-2011). A depositor protection scheme makes explicit, and defines the parameters of, what may be in practice an implicit level of support from Government in the case of a financial crisis (as has been seen in the past in New Zealand), and allows a cost recovery in return for that support. In the interests of fiscal certainty, a deposit protection scheme should be costed, funded and publicised in advance of any such crisis.

Deposit insurance

- 6.3 Design of the deposit insurance scheme is key. Deposits must be protected to a high enough level to have a meaningful effect on public confidence and therefore reduce the risk of a bank run. However, a higher level of protection leads to higher costs involved in funding the scheme.
- 6.4 Our support for depositor insurance is subject to the design details of the scheme, and we look forward to engaging in further consultation on this.

Depositor preference

- 6.5 We do not support the introduction of depositor preference as it is likely to cause a material increase in the price of wholesale bank funding. A statutory preference for depositors would have the effect of subordinating all other creditors (such as investors in wholesale bonds issued by banks), and would therefore be likely to increase the cost of borrowing from these creditors.
- 6.6 Depositor protection should be focussed on maintaining financial stability. This is a key element of deposit insurance, which reduces the risk of bank runs by promising immediate payment to depositors regardless of the status of the bank. This is not true of depositor preference, which applies only after a bank is in liquidation.
- 6.7 An argument in favour of depositor preference is that it may reduce the costs of a deposit insurance regime by increasing the likelihood that the scheme could recover its payouts after a bank failure. We submit that this benefit is uncertain, and does not outweigh the likely negative effect of increased bank funding costs.

¹² Consultation Paper at page 50.

Moral hazard

- 6.8 The most common objection raised to depositor protection is the "moral hazard" created by reducing the incentive for depositors and deposit takers to limit the risk of their investments. This moral hazard exists to some extent in the system already, in that there is an expectation that the Government would be likely to intervene to support institutions or the system in the case of a financial crisis as has been seen in New Zealand in the past. The benefit of depositor protection is that it makes that support explicit and limited in scope, and its benefits to financial stability outweigh any increased moral hazard.
- 6.9 The damaging effect of moral hazard can be reduced by the design of the depositor protection scheme and by sound macro and micro-prudential policy and conduct regulation, which reduce the risk of failure of financial institutions. However, the risk of failure will never be eliminated. We accept that moral hazard is a valid cause for concern, but submit that concern regarding it tends to overlook the extent to which moral hazard already exists in the system, and that it does not outweigh the benefits to financial stability of a depositor protection regime.

Interaction with bank resilience and failure resolution

- 6.10 Depositor protection must be considered in the broader context of New Zealand's bank failure resolution and bank resilience policies and systems, including the open bank resolution (**OBR**) regime, statutory management, and minimum capital requirements. These policies and systems have been designed for an environment without depositor protection, and it is essential that the extent to which they remain relevant and effective if depositor protection is introduced is examined. It is also important that these existing systems and any depositor protection regime are designed to work together efficiently.
- 6.11 For this reason we submit that the introduction of depositor protection should occur at the same time as a broad review of the Reserve Bank's bank failure resolution and bank resilience policies. Our support for the introduction of depositor protection is dependent on the outcome of such a review. We look forward to engaging in further consultation on this, as well as on the specific design of the depositor protection scheme.

7. Separation of Prudential Regulation

- 7.1 The prudential regulation function of the Reserve Bank should be transferred to a new entity with prudential regulation as its sole focus. This New Zealand Prudential Regulation Authority (**NZPRA**) would replace the Reserve Bank as the prudential peak of New Zealand's "twin peaks" regulation structure.

Transfer of prudential regulation to NZPRA

- 7.2 The Reserve Bank is first and foremost a central bank, meaning that it is natural for its emphasis to fall on monetary policy. This may come at the expense of its other mandates, notably prudential regulation.
- 7.3 There is little or no synergy or overlap between the core functions of a central bank (the operation of monetary policy, the currency and payments systems) and prudential supervision of financial institutions.

- 7.4 A separate NZPRA would be able to focus purely on prudential regulation, and could be staffed and resourced accordingly. In addition, a dedicated prudential regulator would be able to develop a culture more appropriate to its role, and would not have to balance its prudential regulation functions with competing priorities such as monetary policy.
- 7.5 The establishment of a separate NZPRA would allow the governance of that body to be established in accordance with best practice and with the checks and balances of a modern regulatory body, including a Board, an independent monitoring agent (for example, the Treasury) and a Chief Executive, all with clearly defined powers and responsibilities. This would, in turn, greatly simplify considerations relating to the governance of the residual Reserve Bank.
- 7.6 The cost dis-synergies arising from the establishment of a new authority (largely arising from the creation of its board and the separation of its administrative functions from the Reserve Bank) would be minimal, and could be recovered by using an industry funding model.
- 7.7 The synergies between monetary policy and prudential regulation (including an overlap in relevant information, a joint interest in stability, and the use of macro-prudential tools) could largely be retained with the establishment of a memorandum of understanding (**MoU**) between NZPRA and the Reserve Bank. An MoU between APRA and the Reserve Bank of Australia facilitates the "full and timely exchange of information" between the two entities,¹³ and a similar approach should be adopted in New Zealand.
- 7.8 We would welcome further engagement on the important point of separation of prudential supervision. We would also be happy to provide further, and more detailed, submissions if this would be useful to the Review Team.

Internal separation of prudential regulation

- 7.9 As noted above, we consider the cost dis-synergies arising from the establishment of a separate NZPRA to be minimal. However, if separation is considered too costly to be justified, the Reserve Bank's prudential regulation role should be clearly separated administratively and culturally from its monetary policy functions.
- 7.10 As proposed in the Consultation Paper, this division would see prudential regulation brought under the authority of a financial policy committee (**FPC**) in the style of the monetary policy committee (**MPC**) which has already been established as a result of Phase 1 of this review.¹⁴ The FPC would be responsible for the Reserve Bank's prudential regulation function.
- 7.11 The FPC and MPC would have some overlap in membership, but would have separate mandates, separate resources, clear reporting lines and clear boundaries.

¹³ Consultation Paper at page 51; and <<https://treasury.govt.nz/news-and-events/reviews-consultation/reviewing-reserve-bank-act>> I Regulation Authority" (12 October 1998) <<https://www.apra.gov.au/file/12911>>.

¹⁴ Consultation Paper, Chapter 8.

- 7.12 An example of this governance structure has been employed by the Bank of England (**BoE**) since 2013.¹⁵ The BoE has three governing committees: the MPC, the FPC and a Prudential Regulation Committee (**PRC**). This approach divides the prudential regulation role into two subcategories: the FPC is responsible for macro-prudential policy, and the PRC for micro-prudential regulation. In New Zealand, a division between monetary policy with the MPC and prudential regulation with the FPC would be sufficient, without the further split between macro- and micro- prudential supervision.
- 7.13 If this internal division is adopted, it is important that the committees retain the benefits and resources of being part of a larger Reserve Bank without losing their independence from each other. The BoE has implemented a "One Bank" strategy to "promote the integration of work produced by different divisions and the sharing of data and analysis across the BoE," and to make clear that "all BoE officials work to support all three policy making committees".¹⁶ This approach should be followed in New Zealand.
- 7.14 This approach creates a level of independence between the Reserve Bank's monetary policy and prudential regulation roles, without incurring the costs associated with establishing a separate NZPRA. However, we note that when considering this alternative suggestion, the internal complexity necessarily created to attain the objectives sought makes the proposed creation of a separate NZPRA a simpler model.

8. Governance of the Reserve Bank

- 8.1 The Reserve Bank's current governance structure does not provide the checks and balances required for a modern regulatory body. The Bank's single decision-maker model and lack of independent monitoring should be replaced with a crown entity-style governance model. Under this model the Board would be the Reserve Bank's governing body, and the Treasury would be the independent monitoring agent.

Moving away from a single decision-maker model

- 8.2 The Reserve Bank's current single decision maker governance structure is unusual, in the context of both Government entities in New Zealand and central banks internationally. Of the seven central banks provided as examples in the Reserve Bank's background paper on this topic, only one (Canada) has a single individual overseeing prudential regulation.¹⁷
- 8.3 There is a general view that group decision making leads to better and more accurate decisions, though possibly at the expense of efficiency.¹⁸ However, the advantages of a group based governance structure outweigh the disadvantages.

¹⁵ Piers Ovenden "The Bank of England's decision making structure for macro-prudential policy and financial stability" (1 May 2017).

¹⁶ Piers Ovenden "The Bank of England's decision making structure for macro-prudential policy and financial stability" (1 May 2017) at [71].

¹⁷ Treasury "Background Paper 3: Current governance arrangements for the Reserve Bank of New Zealand" (November 2018) at Appendix 3.

¹⁸ BIS "Issues in the Governance of Central Banks" (May 2009) at page 77.

Independent monitoring

- 8.4 The Reserve Bank's performance is currently monitored by its own Board. This arrangement should be replaced with a more typical crown entity structure with an independent supervisory body. The Treasury would be a natural choice for this role, as the policy department of the Minister of Finance.
- 8.5 This change is required to eliminate perceived conflicts of interest under the current regime, deriving from the fact that the current supervisory body includes the Governor, and receives no funding from any party other than the one it supervises.¹⁹ In addition, the Board will not be able to continue in a supervisory role if it takes on a governance role instead (as we propose).

Role of the Governor

- 8.6 Under a crown entity-style governance structure, the role of the Governor would be analogous to that of a CEO. The Governor would have broad delegated authority for management and operational matters, under the oversight of the Board. The Governor would remain a member of the Board and the MPC.

¹⁹ Consultation paper at pages 96 and 97.