

The Treasury

Reserve Bank Act Review Phase 2 Second Consultation Information Release

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12 May 2019

Dear Bernard,

As you are aware, the Review Team met via a conference call Sunday evening to jointly discuss the latest two consultation documents, 2A and 2B.

I am pleased to report that the Panel has found these to be good quality reports, showing a marked improvement from the earlier versions we saw. Individually, the selected topics are covered thoroughly and the treatment of the issues is balanced. The Panel believes that the selected issues and the questions being asked by the consultation are the right ones.

Overall feedback on the documents from the Panel as a whole

The Panel advises the Review Team to use the remaining time before publication to format the chapters in a way that makes the range of options stand out more clearly. Some specific areas the Team should consider include:

- **Chapter 1 of Consultation Document 2B** – This is thorough, but also dense. It is somewhat difficult to see the options, and how the chapter links to the rest of the document.
- **Chapter 2 in Consultation Document 2A** – This chapter does a better job of illustrating the options being considered. However due to the level of optionality, it is also very dense. The Panel considers that the separating out the options by formatting into descriptive tables would make it easier for respondents to engage and provide comprehensive feedback on the issues that are covered.
- **Chapter 3 of Consultation Document 2A** – Given the size of this topic, the Panel provides a more detailed response to this chapter below. In general, the Panel considers that it could include a greater level of economic impact analysis relating to the different options, and an analytical perspective on the role of the Reserve Bank in the financial system.
- **Chapter 3 of Consultation Document 2A, and Chapters 2 and 4 of Consultation Document 2B** – The Panel would like to see greater attention paid to tricky issues around macro prudential policies involving the boundaries between macro-prudential, micro-prudential, monetary policies and balance sheet actions. The discussion in the current draft is framed as if there is going to be some way found of tightly defining these boundaries, and that then each sphere of policy potentially will have distinct governance and decision-making arrangements. The Panel would encourage the Review Team to consider the efficiency and practicality of such an approach. A single unified governance approach overseen by the Board, under a remit from the government, would be more consistent with the Crown Entity model. The Panel would like to see this option put forward as a question for wider consultation.

An important aside is that the new strengthened Reserve Bank Governance suggests a different position for monetary policy which is wider than setting interest rates. It follows then that another option for the Monetary Policy Committee in the diagram on page 44 (Chapter 3 Consultation Document 2A), is to come in below the Policy Board rather than to one side as illustrated. Another option for the MPC to become part of the Monetary Policy Box but with externals.

Detailed Feedback from the Panel as a whole on Chapter 3 of Consultation Document C2A (Governance)

The Panel found that treatment of Governance in Chapter 3 was generally good. It reflects the discussions we have had with the Review Team. The panel is supportive of the inclusion of the option that the Reserve Bank is to have a structure like other Crown entities.

There are some areas that could be strengthened:

1. There is no discussion of whether/ how the Board should report to the public. Typically, a Board will issue an annual statement and hold an ASM or AGM. Options for reporting to the public could be specified by principle-based legislation. This could be a valuable point for discussion.
2. Based on the Reserve Bank of Australia's approach, there could be value in consulting on the question of the role (if any) for ministerial/government override of Reserve Bank decisions. The panel believes that this is an important question, as it determines both how independent the Reserve Bank ultimately is, and could have an impact on the effectiveness of the Reserve Bank in its financial stabilization role.
3. The Panel also raises the question of who evaluates whether the Reserve Bank has followed a potential remit, and what happens in this situation? Overall, the Panel would like to see a more focused discussion on the degree of independence we want to aim for.
4. Relating to the question is about the decision-making model (consensus or voting), the Panel encourages the Review Team to consider whether this is a binary choice. There is also a possible hybrid where decisions are by majority vote but with votes not disclosed. A hybrid option might combine attractive features of both models.

The Panel wonders too if there is an option to reconsider the role of the Treasury. Give its role advising the Minister of Finance, this suggests another option where it would be less prominent in the RB structure than as illustrated in the page 44 diagram.

The Panel agreed that an important option for public consultation is whether the RB should be given special powers in the case of an unforeseen emergency. While under the Crown Entities Act the Government can replace the Board, the Government may in an emergency choose to have an over-ride power as a last resort. The Panel thinks Chapter3 would be even more informative if it included more detail about the Crown Entities Act and added the over-ride power as an option for discussion.

Economic Impact Analysis

A general comment made by the Panel is that there is currently either no or limited analysis of the comparative economic consequences of options set out in the Consultation 2 Document. It is proposed that project management for the next round of consultation include committing the resources required to do more analysis of the economic impact. If it is a challenge to find the resources, this should be noted as a factor shaping the scope of the work while also explaining that for options such as depositor protection, the results may incur (un-necessary) costs.

Systemic Context

Some Panel Members' comments below aren't directed at the summary of the status quo, but rather at some of the suggested outcomes.

As has been commented during the earlier consultation papers and in Panel discussions, the Panel feels that a "silo-ed" approach to aspects of the review has resulted in the lack of a natural flow in the consultation papers that integrates the impacts of the various subjects addressed by the Review Team.

For example, the new Reserve Bank board will need to have greater involvement in the crisis management process as the risk to financial stability accentuates, including, ultimately, bank resolution. One option for the Review team to consider would be to see bank resolution as part of the continuum of "enforcement" tools/remedies available to the Reserve Bank following non-compliance/default by a supervised financial institution. In some cases, bank resolution may not be the preferred/required tool for dealing with a failed/failing institution.

For that reason, with more time, consideration might be given to Chapter 5 (Crisis Management) immediately following (or possibly become a part of) Chapter 3 (Supervision and Enforcement) - or vice versa. There is a grey area between BaU intervention/enforcement for non-compliance and more material intervention as envisaged by Chapter 5, and whether the intervention is required will be dependent on the materiality of the breach and most importantly on whether the non-compliance poses a threat to financial stability (which is the overriding objective of the Reserve Bank and the "litmus test" that should be applied to any action taken by the Reserve Bank). The powers/actions contemplated by Chapter 5 are just part (albeit a material part) of the enforcement tools available to the Reserve Bank.

Arguably, consistent with the above comments, there is an option for supervision and enforcement to be treated as being two separate sections on which feedback should be sought. Supervision (or compliance - which may be a better term) is very important and should stand alone. Supervision could include some initial "enforcement" measures where non-compliance is not material and the breach can be remedied to the satisfaction of the Reserve Bank within a reasonable period.

However, if there is a material breach/non-compliance then there should be a range of enforcement tools available to the Reserve Bank, which can be invoked at its discretion (with input from the Board (or a committee) depending on the severity of the breach and the risk to financial stability. The enforcement tools would include the remedies set out in Chapter 5 (Crisis Management), and when and how those tools were used would depend on the degree/measure of risk to New Zealand's financial stability.

The current timelines limit the extent to which the silo-ed work of by the Review Team can be worked into a framework for more systemic analysis of the options.

The Panel has asked for a longer Panel meeting prior to the next round of consultation. It also sees benefit in preparing an independent paper focused on the systemic impact of the Review findings at the end of the final consultation period.

Comments from individual panel members:

While members of the Panel may have commented from different perspectives below, the key point is to ensure that the options they describe are included in the Consultation Documents.

One Panel Member noted that: “I am happy with what has been presented, as a ‘consultation document’ – I believe it covers all the issues very well – and the questions being asked for consultation are the right ones.”

Consultation Document 2A

1. Some language needs tightening up, for example:
 - a. On page 1 – The Treasury would be the Minister’s Monitoring agent (not the Reserve Bank’s monitoring agent)
 - b. On page 3 in the penultimate paragraph – “the Reserve Bank’s emphasis the Reserve bank places” amend to “The emphasis the reserve bank places on ...”
2. Prudential regulation remaining in the Reserve Bank – does the section respond to the issues raised by those who opposed this with sufficient robustness? The drafting should also be tightened – remove reference to minority of respondents – just say some respondents. Also, say that these concerns “will” be addressed – see page 2. Does it reflect a real commitment to ensure that despite no separation, that the effect of the review will be a Reserve Bank operating with renewed sense of engagement and pragmatism with the sector?
3. Page 5 – The Panel thinks the definition of risk-based, when seen in relation to safeguarding the future of our financial system, is wider than just risk profile of the regulated entity as described in should also refer to financial stability generally for avoidance of doubt. Page 5 also refers to insurance whilst also saying that depositor protection approach will be explored further – should this be more reflective of there being options for the different forms the protection may take?
4. Page 6 second paragraph – should this refer to enforcement along with supervision and monitoring?
5. Page 7 – order of questions – 3E should be moved up into another place.
6. Governance
 - a. Does this chapter adequately describe the governance model we envisaged? The introduction seems to conflate operational with strategic roles – see the first paragraph on page 40. This paragraph could usefully mention the points made in paragraph 3 further down: that the Board will set the strategic direction, and make strategic decisions, which will then be implemented by the Governor and staff with respect the areas the Reserve Bank oversees.
 - b. Is the illustration in Figure 3A correct (page 44)? The Policy board will still have oversight of the overall operation of the bank, with a clear carve out for the MPC – on Monetary Policy matters. A better illustration would include a Policy Board at the top with MPC out to the side with dotted line to Policy board.
 - c. Is it premature to say on page 45 that Reserve Bank staff will do most of the prudential policy work under a delegation model? This seems like a decision for the Reserve Bank board to make once it has been established. The work will be done by staff but the Board may elect to have decision making retained at Board level for some time.
 - d. We suggest moving the section on monitoring Reserve Bank performance (pages 47-52) to follow Section 2.
 - e. It would be helpful to form a Panel view as to whether we agree with the recommendation to move towards an ICE? – Discussions with the Team suggest that some members of the Team have experience in this area and could usefully assist others to understand how the ICE model operates in practice. It is a workable model that better defines accountabilities and preserves independence.

- f. Table on page 56 – Add the reporting and accountability differences between ICE – SOI, SPE and Annual Report and Board – AGM, Annual Report.
7. Depositor protection
- a. Should the list on page 81 also include further work on taking the economic impact into account alongside other regulatory levers such as capital and OBR – or do we think the work done – as described on page 90. It seems that one thing stakeholders wanted was to see the economic impact of Depositor Protection alongside cost of increased capital, OBR, LVR and other prudential/macro-prudential levers operating. The paper does not appear to address that.
 - b. On page 102 of C2A (the depositor protection regime) there could be a question asking something along the lines of “under what scenario/conditions would you consider there to be no need for a depositor protection regime?” This might help address the currently open question of where people see deposit protection fitting within the overall regulatory architecture, and the economic consequences of protecting depositors.

Consultation Document 2B

8. There is a typo in the second bullet point on page 8 of C2B - the final sentence doesn't end.
9. On page 13 there is an acknowledgement that this review of the Act is occurring at the same time as the Capital Review. It would enhance the quality of the feedback people provide if they could be encouraged to state whether their answers to any of the questions would change if capital levels end up in the place the RBNZ is proposing (the 1:200 year failure risk). It is most relevant for the depositor protection regime and the OBR questions.
10. On page 13 - this page talks about “Chapter 2” in question 1.A. Presumably, it should read Chapter 1? While the discussion in Chapter 1 is good, the options for change are quite buried in amongst the text (for example, the 3 options on page 9 and the “spectrum of options” referred to on page 12). Respondents are being asked (in question 1.C) to comment on the “potential options proposed” but it is difficult to sift through and recall the options as a reader. The Review team should look into pulling these options out of the text so a reader knows what to focus on.
11. Supervision and enforcement
- a. This section talks about the range of tools, but does not talk about the intersection of the tools with the spectrum of possible attitudes of regulated entities – i.e. willing compliance, high levels of engagement and openness with regulator, assisted compliance. It doesn't explore the implications of regulated entities who may exhibit deficiencies in meeting standards but respond to required compliance. This type of entity can be contrasted to an entity that engages knowing in misconduct – recklessly or intentional disregards requirements. The intersection with entity behaviour is important because it dictates the types of tools that may be required or appropriate.
 - b. Crisis management follows from enforcement. Panel members differ as to whether it is important to separate supervision and enforcement, or keep them together. It is often a rolling spectrum from one to the other with tools used in each scenario.

Nevertheless, the enforcement tools discussion on pages 37-38 should follow the supervision discussion on page 43-55, with the resourcing questions coming last.

12. Crisis management

- a. There is a question as to whether there should be a separate set of resolution objectives when the Reserve Bank will already be required to operate under a financial stability objective. The financial stability objective should guide how crisis management should operate, alongside general resolution principles.
- b. This view is reiterated by multiple Panel members: There has been an in-principle decision that the primary objective of the Reserve Bank will be to maintain financial stability. As a result, some panel members disagree that additional resolution objectives are required in the context of bank resolution and Chapter 5 in general. Panel members are concerned that if there are multiple, possibly conflicting, objectives, this may lead to unnecessary litigation. If other 'objectives' are required, such as minimising the loss to insured depositors, then for consideration is whether those additional 'objectives' could be better dealt with using language such as "in exercising the powers/rights set out in clauses X to Y, the Reserve Bank will have regard to the following"

13. Co-ordination

- a. This Chapter should highlight that whichever option is pursued, this should be designed so as not cut across independence of any of the entities involved. If Reserve Bank were to become an ICE, Ministerial expectations for effective coordination and cooperation would not need legislation.
- b. Under the Crown Entities Act structure – if an ICE – coordination expectations can be embedded in the Statement of Intent and Statement of Performance Expectation – this can be noted in this section.

14. Capital review

- a. The papers notes that the Capital Review will not have material consequences for phase 2 of Review – but there is an outstanding question as to whether Deposit Protection is needed and what the Crisis Management framework becomes? This optionality could be a further protection against use of taxpayer funds? Respondents should be asked if their responses to the issues raised in 2A or 2B would be different if the Reserve Bank's capital proposal is landed.

CONCLUSION

In the short time available to provide this feedback, it has been necessary to take a high level approach. The brief summaries of some complex themes may be incomplete and unclear. Please feel free to ask Review Team members to get in touch with me or with individual Panel members where they have questions relating to their content.

Warm regards,

Suzanne Snively, Chair
Panel Reviewing RBNZ Act