

The Treasury

Reserve Bank Act Review Phase 2 Second Consultation Information Release

July 2019

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Report: Phase 2 of the Reserve Bank Act Review – Feedback from ministerial consultation and final versions of consultation documents

Date:	06 June 2019	Report No:	T2019/1667
		File Number:	MC-1-7-3-1-13

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	<p>Refer this paper to your associates and Minister Twyford for their information.</p> <p>Agree to lodge the Cabinet paper and consultation documents for the DEV Committee meeting of 19 June</p>	<p>By 17 June</p> <p>By 10am on 13 June</p>

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Bernard Hodgetts	Director Reserve Bank Act Review - Phase 2	[1] (wk)	[1] (mob) ✓

Actions for the Minister's Office Staff (if required)

Refer this paper to your associates and Minister Twyford for their information.

Note any feedback on the quality of the report

Enclosure: Yes – Consultation documents (C2A and C2B)
Cabinet paper

Report: Phase 2 of the Reserve Bank Act Review – Feedback from ministerial consultation and final versions of consultation documents

Purpose of report

1. This report provides a brief response to the questions and comments that have been raised through ministerial and coalition consultation on the draft C2 consultation material for Phase 2 of the Reserve Bank Act Review. It follows meetings with Hon Jones and Hon Shaw and comments received from Hon Parker. We recommend this report be referred to Associate Ministers of Finance and the Minister for Housing and Urban Development for their information.
2. This report also notes some additional questions that the Review team has added to the consultation documents to reflect comments raised during ministerial consultation. We have attached amended consultation documents to this report. If you are comfortable with the updated consultation documents and Cabinet paper, we recommend they be lodged at the Cabinet Office by 10am on Thursday 13 June to enable them to be considered at the DEV Committee meeting of 19 June. Subject to Cabinet confirmation, we then expect for the release of the consultation to take place in the week of 24 June.

Question and comments raised on governance

3. *Under the proposed governance structure, how will the Government be able to influence the Reserve Bank's objectives and set clear performance expectations for the Reserve Bank board? [Hon Jones, Hon Shaw]*

The government has a number of levers for influencing the objectives and performance of the Reserve Bank that are consistent with operational independence. The government has the ability to set the Reserve Bank's objectives through primary legislation. Depending on choices made through the Review, government may also have the ability to provide further guidance to the Reserve Bank about its objectives through delegated instruments such as a potential Financial Policy Remit (to provide further clarification of financial policy objectives and considerations), or a Government Policy Statement (which could outline key government priorities, such as climate change). The government can also help set performance expectations and guide Reserve Bank behaviour by commenting on the Reserve Bank's Statement of Intent, or issuing a Letter of Expectation to the Reserve Bank board.

The government also designs the regulatory framework set out in primary legislation, including the powers and tools that the Reserve Bank can use to achieve its objectives. The design of these powers and tools – including their scope and the safeguards that apply to them – is an important driver of the relationship between the government and the Reserve Bank. Through the Review, consideration is being given to the appropriate role the government should have – such as decision-rights or a requirement for the Reserve Bank to consult with government – in areas such as making rules (including macro-prudential rules), using supervisory or enforcement tools such as directions, and in crisis management. In these areas, an appropriate balance needs to be struck. On the one hand the government has a legitimate interest in matters of significant policy. On the other hand, in order to effectively meet its objectives over the longer-term, it is important that the Reserve Bank has sufficient ability to exercise its powers at arms-length from government.

4. *What processes are being considered to ensure that high quality members are appointed to the board? [Hon Jones]*

For the new governance board to operate effectively, it will be critical that capable members with the right mix of skills are appointed. The upcoming consultation considers appointment processes, which must be robust and guided by a high-quality analysis of the mix of skills needed on the board. Phase 1 of the Review recognised the importance of having members on the monetary policy committee with relevant knowledge and experience, and built-in criteria targeted at the expertise required. Similar provisions would be needed for the skills and expertise required on the board, particularly in respect of its prudential policy responsibilities.

5. *Will the board have access to suitably qualified experts in order to ensure good quality advice and maintain stakeholder confidence? [Hon Jones, Hon Shaw]*

Given its role as a governance board, the board will be able to access a range of skills and experience to cover the range of its responsibilities and promote public confidence in its decisions. As noted above, board members themselves will need sufficient skills and expertise to cover the breadth of the board's responsibilities. Key decisions made by the board will often be informed by in-depth analysis provided by Reserve Bank staff, and board members will need to have a sufficient level of knowledge to understand and interrogate this analysis. Where further specialist or independent expertise is required to inform board decisions, there are options available to the board – including hiring external advisers and setting up advisory committees. Board members will also often have skills (and access to networks) that will broaden the perspective they bring to decisions.

6. *What approaches can be taken to ensure the board's discussions and decisions are transparent? [Hon Jones, Hon Shaw]*

The Reserve Bank currently releases considerable information about its outlook for the economy, and the rationale for its policy decisions, including through regular Monetary Policy Statements, Financial Stability Reports, and speeches. The way the board operates, including how it makes and communicates decisions, will not be fully set out in legislation. The legislative framework will typically provide for key parameters within which a board operates (such as responsibilities, powers, accountabilities, reporting, composition, and conflicts of interest), while the board is given flexibility to determine its operating procedure. As a matter of good practice, a board will often adopt a charter to clarify how it intends to operate, and to enhance the transparency of its responsibilities and operations. The consultation documents ask for feedback on whether there are aspects of the board's operation that would benefit from legislative clarity or guidance.

7. *Will the board have sufficient resources and be able to seek independent advice? [Hon Jones, Hon Shaw]*

As the decision makers of the organisation, the new governance board will be able to seek independent advice on any matter within its responsibilities. The board will have responsibility for resourcing decisions, including for the board's operations.

8. *Are protocols or safeguards needed to ensure that the Treasury monitoring role is carried out appropriately? [Hon Parker]*

The Review team is considering the merits of an explicit agreement between the Treasury and the Minister setting out the Treasury's monitoring responsibilities and approach. An agreement would make the Treasury's monitoring responsibilities and approach more specific, and better set expectations around the specific responsibilities, particularly with

regard to monitoring the monetary policy committee. An agreement would be consistent with the SSC's guidance for monitoring departments.

Question and comments raised on deposit insurance

9. *What are the broader considerations that should be taken into account in relation to depositor protection in order to ensure policy balance? [Hon Shaw]*

Depositor protection is one part of a 'financial safety net' that makes society more resilient to financial shocks like banking crises. The financial safety net works to do this in two ways:

- At the 'top of the cliff', **regulation** and **supervision** make banks less vulnerable to failure.
- At the 'bottom of the cliff', **emergency liquidity support**, **depositor protection**, and orderly **resolution** protect society from the damage caused if banks do fail.

All five elements of the safety net interlink. Tools at the bottom of the cliff that contain the damage from failing banks can alter the way banks and their investors behave during normal business and help to provide confidence to the public in times of bank distress. At the same time, tools at the top of the cliff influence the way banks and investors behave during normal business and alter the chance, and severity, of bank failures.

There is a two-way interaction between capital requirements and depositor protection:

- A robust depositor protection scheme can reduce the reliance on higher capital requirements to protect society from the damage caused by failing banks.
- Higher capital requirements can lower – but not eliminate – the risk of banks failing, and reduce the severity of losses facing investors if and when they do. By reducing the chance that a depositor protection scheme will have to be used in the first place, and by making it more likely that the scheme will recover its costs from the failed bank, tighter capital requirements can reduce the costs of protecting depositors.

Getting the balance right between failure prevention and protection requires all elements of the safety net to work well in their own right, and to fit well together.

10. *What happens to depositors that may not be protected by the scheme, for example because they are holding temporary high balances above the protection limit? [Hon Shaw]*

Future work will consider options for the detailed design and calibration of the depositor protection scheme. This work will address, amongst other things, the types of deposit accounts that should be eligible for protection and the extent to which eligible accounts should be protected. While the proposed protection limit is \$30,000 - \$50,000, there may be circumstances where depositors' balances are temporarily forced above this range. Examples include households in the process of buying or selling property, or farmers and small businesses with volatile cash flows. Detailed design work on the scheme will consider options to protect depositors holding these kinds of 'temporary high balances'. Other depositors who are likely to hold balances in excess of the protection limit on a regular basis will be able to minimise their exposure to loss by diversifying their deposits across different banks.

11. *How was the coverage limit of \$30,000-\$50,000 arrived at and does discussion of this range need to be made more explicit? [Hon Shaw]*

International best practice for effective depositor protection system guides that the vast majority of individual depositors should be fully protected from loss, whilst leaving a large share of deposit funds exposed to risk (and thus market discipline): it is widely accepted that covering the vast majority of depositors strengthens the role of deposit insurance systems in the safety net.

An insurance limit of \$50,000 would fully protect about 90 percent of individual deposit accounts in New Zealand, while leaving 60 percent of deposit funds exposed to loss. This coverage is broadly consistent with modern international averages – especially keeping in mind that the share of depositors that would be fully covered is likely to be higher in practice, as depositors split their accounts to take advantage of the protections. Discussion of these points is included in the C2A consultation document.

Question and comments raised on climate change

12. *Can additional questions be added to the Consultation papers on the issue of climate change (including questions that link to the supplementary papers)? [Hon Shaw]*

The Review team has revised the Consultation document C2B, which now includes the following additional questions on climate change:

- Chapter 2 of Consultation Document 2A (objectives): *Should the Reserve Bank be given a more explicit climate change objective? If so, what would be your preferred mechanism for achieving this?*
- Chapter 3 of Consultation Document 2B (supervision and enforcement): *Do you think that the Reserve Bank's planned approach to the supervision and management of climate change-related risks is appropriate and adequate? Do you think that the Reserve Bank's approach to climate change would be different if it was given a more explicit climate change objective, as considered in question 2B of Consultation Document 2A?*
- Chapter 6 of Consultation Document 2B (cross-agency coordination): *Do you think that a high level coordination objective would be an appropriate way to ensure that the Reserve Bank is effectively coordinating with non-financial sector agencies (for example on climate change)?*

Questions and comments raised on other Review issues

13. *What capacity improvements are needed for the Reserve Bank and in what areas? [Hon Shaw]*

Stakeholders and the IMF have previously raised concerns about the Reserve Bank's capacity in a number of areas, particularly prudential supervision. This consultation addresses the regulatory tools and powers available to the Reserve Bank (including macro-prudential policy), the approach to supervision and enforcement, and the crisis management regime. There appears to be general agreement on the need to build capacity in these areas, which may require additional resources.

The proposed changes to the governance framework will also support an improvement in the Reserve Bank's capacity. A strong board that is responsible for all outcomes should devote sufficient attention and resources to improve overall capacity. The consultation material also discusses the Reserve Bank's funding model. The funding model will determine the ability of the Reserve Bank to obtain sufficient funding over the long term, while balancing operational independence with accountability and transparency. The Phase 2 Review may result in changes in a number of areas with associated implications for the level of funding available to the Reserve Bank. In the interim, the particular level of funding available to the Reserve Bank is outside the scope of the terms of reference of this Review.

14. *Does any of the Consultation material record that the Reserve Bank used macro-prudential policy for the purposes of economic stability, not just financial stability, in the wake of the GFC? [Hon Parker]*

The Consultation material acknowledges the potential role played by macro-prudential policy in supporting economic stability. A background paper on New Zealand's macro-prudential policy framework that the Reserve Bank has produced for the Review ('Macro-prudential policy framework – mitigating the likelihood and severity of boom-bust cycles') notes that macro-prudential policy and monetary policy can be complementary. The paper notes that during an economic upturn, when macro-prudential instruments are used to curb rapid credit and house price growth, this can support monetary policy by lowering inflation pressures associated with greater household wealth and household demand. This may be advantageous if it reduces the need to raise the Official Cash Rate, where the latter could result in undesired upward pressure on the exchange rate.

Recommended Action

We recommend that you:

- a **refer** this report to your associates and Minister Twyford for their information.

Refer/not referred.

- b **Agree** to lodge the Cabinet paper and consultation papers with the Cabinet Office by 10am on Thursday 13 June to enable them to be considered at the DEV Committee meeting of 19 June

Agreed/not agreed

- c **Note** the release of the consultation is now expected to take place in the week of 24 June reflecting the change in timing of the Cabinet process.

Agreed/not agreed

Bernard Hodgetts
Review Director, Phase 2 Review

Hon Grant Robertson
Minister of Finance