

The Treasury

Reserve Bank Act Review Phase 2 Review Update Proactive Release

March 2020

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Report: Phase 2 of the Reserve Bank Act Review – preview of upcoming decisions

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|--------------|----------------|---------------------|---------------|
| Date: | 15 August 2019 | Report No: | T2019/2498 |
| | | File Number: | MC-1-7-3-1-13 |

Action sought

| | Action sought | Deadline |
|--|--|--------------------------|
| Minister of Finance (Hon Grant Robertson) | Note the contents of this report for discussion at a meeting on 22 August | Thursday, 22 August 2019 |

Contact for telephone discussion (if required)

| Name | Position | Telephone | 1st Contact |
|------------------|---|--------------|----------------|
| James Haughton | Acting Manager, Reserve Bank Act Review Phase 2 | [39] (wk) | [39] (mob) |
| Bernard Hodgetts | Director, Reserve Bank Act Review Phase 2 | [39] (wk) | n/a (mob) ✓ |

Minister's Office actions (if required)

Return the signed report to Treasury.

Enclosure: No

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Executive Summary

The Review Team will be seeking final decisions on matters necessary to allow drafting of an Institutional Bill to begin later this year. Cabinet decisions will be required on most key components of the Institutional Bill in November. These decisions include:

- Financial policy objectives – replacing the Reserve Bank’s existing soundness and efficiency objective with a single high-level objective to protect and enhance financial stability, together with any secondary objectives or principles.
- Governance and institutional form – the governance and monitoring arrangements, whether the Reserve Bank should become a Crown Entity.
- Funding – the source of funding (self-generated revenue and financial industry levies), and the role of the Minister of Finance in the funding mechanism.
- Coordination – how the Reserve Bank should coordinate with other financial sector agencies.
- Balance sheet matters – how the Reserve Bank uses its balance sheet to support its objectives and the governance arrangements for balance sheet functions.
- Residual matters – updating existing provisions relating to the Reserve Bank’s non-regulatory functions.

We will also be seeking in-principle decisions on a range of matters necessary to progress work on a Deposit-Takers Act and depositor protection. These decisions will form the backbone of a third consultation package, which we would expect to release in November. These decisions include:

- Depositor protection – decisions on the purpose and form of the scheme including objectives, governance arrangements, coverage, and funding.
- Regulatory perimeter – the proposed regulatory perimeter following your in-principle decision to combine the bank and non-bank deposit taker regimes.
- Prudential regulation powers – the primary tools used to implement prudential regulation and the enforcement regime.
- Supervision and enforcement – the approach of the bank to supervision and enforcement, and supervisory powers available to the Reserve Bank.
- Macro-prudential policy – how macro-prudential policy is empowered, and the manner in which the Reserve Bank is required to consult with other agencies when making macro-prudential decisions.
- Crisis management and resolution – decisions sought will focus on ensuring that the resolution regime can support the quick, credible and reliable resolution of failed deposit-taker without recourse to taxpayer funds.

Recommended Action

We recommend that you:

- a) **Note** the issues for which the Review Team will be seeking decisions in order to progress drafting of an Institutional Bill for the Reserve Bank and to progress work on a Deposit Taker and Deposit protection legislation, and
- b) **Note** that you are meeting with the Review Team and Chair of the Independent Panel on 22 August to discuss the contents of this paper.

Bernard Hodgetts
Director, Reserve Bank Act Review Phase 2

Hon Grant Robertson
Minister of Finance

Report: Phase 2 of the Reserve Bank Act Review – preview of upcoming decisions

Purpose of Report

1. The purpose of this report is to provide you with an overview of the decisions the Review team will be seeking from you later this year in order to progress the Reserve Bank Act Review work program, consistent with your agreement to T2019/2242. We are meeting with you on 22 August, which will provide an opportunity to discuss the contents of this paper in further detail.

Background

2. The Review Team is currently working to determine its recommendations for the next stage of the Review of the Reserve Bank Act, with assistance from the Independent Expert Panel. On the current timetable, we expect to provide these recommendations in early October following preliminary discussions with you and your associates during September. Cabinet will need to confirm these decisions ahead of the release of our next public release in late November. Our recommendations will fall into two categories:
 - Final recommendations on matters necessary to begin drafting of a Reserve Bank Institutional Bill for introduction in 2020.
 - Recommendations for in-principle decisions relating to as many matters as possible that would be included in a deposit-takers bill. We would expect to undertake further consultation on many of these in-principle decisions.
3. The submission process to the second Consultation on the Reserve Bank Act Review formally closes on 16 August. A number of submitters, including the banks, have sought extensions to this date and we believe the bulk of submissions will be received in the week ending 30 August. While it is not possible to provide a comprehensive summary of themes at this stage, during July and August, the Review Team has undertaken substantial engagement with stakeholders, many of whom are expected to make formal written submissions. This paper notes the themes that have arisen during our interactions with these stakeholders, which will give you a flavour of what we expect to see in written submissions. We will provide a full summary of written submissions in early September.
4. The remainder of this paper sets out the nature of the decisions we expect to seek from you and Cabinet as part of the next consultation package.

Crown Entity Model

5. The Reserve Bank currently sits within its own category in the wider state sector. This is unlike other independent institutions with functions inside the Executive Branch, which are subject to the Crown Entities Act 2004. As a result, the current legislative framework for the institution and its operations does not fit within public sector norms. This is likely to have contributed to a lack of clarity regarding the Bank's independence; its relationship with both the Minister and the Treasury; and the application of some state sector standards. In-principle decisions to establish a new governance board with statutory responsibility for the Reserve Bank and to appoint the Treasury as the monitor mean that the Reserve Bank will look relatively similar to a Crown entity. The Review Team has considered the merits of classifying the Reserve Bank as a Crown entity and its preliminary position is that a Crown entity classification would be sensible.
6. The Review Team thus expects to provide advice for decision on the Reserve Bank becoming a Crown entity and the type of statutory entity it should become (section 7 of the Crown Entities Act provides for three types of statutory entity). The Crown Entity Act is a flexible framework allowing adaptations as appropriate.

Financial Policy Objectives

7. We will be seeking final decisions on a complete financial policy objective set for the Reserve Bank. You have agreed, in principle, to replace the Reserve Bank's existing soundness and efficiency objective with a high-level objective to protect and enhance financial stability. We expect to recommend a fuller 'objective set' (including secondary objectives or regulatory principles) to complement this high level objective. The expanded objective could include aspects of financial efficiency, preserving competition, functional objectives for the Reserve Bank's currency function and the use of its balance sheet, and other behavioural goals for the Bank such as using its resources prudently, acting transparently and coordinating with other agencies.
8. Support for the proposed shift to a high-level financial stability objective backed up by secondary objectives or regulatory principles has generally been positive. Some stakeholders are keen for the term 'financial stability' to be further defined in legislation. In addition, some stakeholders have reiterated that references to financial system efficiency need to be retained in the objective set as a qualifier on the financial stability objective. Stakeholders have noted that it is important that the Reserve Bank does not pursue financial stability at all costs and that the effects of financial policy initiatives on the efficiency of the financial system are properly taken into account. We expect to provide recommendations on how best to achieve this requirement.
9. Phase 1 of the Reserve Bank Review established a remit for the Monetary Policy Committee that clarifies the operational objectives of monetary policy. The Review Team will provide advice on whether to establish a financial policy remit. A remit would help to guide the Bank on how to weight the secondary objectives and regulatory principles when undertaking its regulatory role.

Governance

10. In light of your in-principle decision to establish a governance board for the Reserve Bank, we expect to seek decisions on a broad range of legislative provisions for the new board, including appointments, removals, duties, conflicts, remuneration, and other matters. Provisions relating to the appointment of the governor – and the issue of whether the governor will be on the board – will need to be agreed. Two key issues include the potential use of a nominations committee for Board appointments and the role of the Minister of Finance in appointments.
11. Two further decisions we will be seeking are whether the board or the Minister will appoint the Governor (as the Reserve Bank's CEO) and the process involved and whether the position of Deputy Governor should be retained in legislation.
12. We also expect to make recommendations on the Reserve Bank's general reporting requirements (e.g. annual report, statement of intent, financial accounts) along with the potential role of the Auditor General in undertaking performance audits of the Bank.
13. Following the in-principle decision to establish the Treasury as the Reserve Bank's monitor, decisions will be required on the role of the monitor and any requirements on the Reserve Bank to supply information necessary for the Treasury to undertake this task.
14. Stakeholder support for a board model has generally been positive. There is considerable interest in the design details including composition, expertise on the board, delegations, the appointments process, and the role of the Governor.

Coordination

15. We will be seeking decisions on how the Reserve Bank should coordinate with other financial sector agencies in respect of financial sector regulation, banking crisis management and resolution and business cycle management. A key focus in the consultation paper has been on the role of the Council of Financial Regulators (COFR), which is an informal inter-agency body comprising the Reserve Bank, Treasury, MBIE, FMA and Commerce Commission. The role of COFR could potentially be given legislative backing or its informal role could be strengthened in various ways (such as through letters of expectations issued by Ministers, an approach favoured by the Independent Panel).
16. Stakeholder engagement has revealed support for the Reserve Bank's legislation to set an expectation for coordination with Ministers issuing additional guidance on what coordination would be expected to deliver. Some stakeholders are concerned that current coordination arrangements are not working very well and should be improved. Our recommendations in this area will take into account COFR's recent initiative to refresh its own vision and approach.

Funding

17. The way the Reserve Bank receives its funding will have a key influence on how and whether it can achieve its statutory objectives. A well-designed funding mechanism combines a significant amount of budgetary independence with accountability checks that ensure that the public is getting good value for money. Recommendations around the basis of the funding mechanism are expected to fall into two general areas.
18. The first area relates to the Reserve Bank's sources of funding. The Bank currently receives its funding from a combination of self-generated revenue (through its balance sheet operations) and fees for providing certain services (such as registering banks). Alternatively, some of the Reserve Bank's functions (such as prudential supervision) could be funded by a financial industry levy and it is likely that we will recommend the capacity for industry levies be included within the Institutional Act. While this would make the funding model more complex, it would mean that the financial firms that benefit from the Reserve Bank's supervisory service would also potentially pay for it. Levies would introduce a more formal role for the Minister of Finance if a levy and appropriation model were used (similar to the FMA).
19. We also expect to make recommendations around the role of the Minister in the funding mechanism. The Reserve Bank's funding is currently set out in a five-year agreement between the Minister of Finance and the Reserve Bank Governor. Legislation could continue to require that the Minister 'agree' the funding with the Reserve Bank. Under a stronger role, the Minister could instead 'approve' the Reserve Bank's funding. Alternatively, a softer requirement to 'consult' the Minister on how much the Reserve Bank plans to spend would give the Reserve Bank more independence to determine its own funding level.
20. It is possible that different Reserve Bank functions could be funded differently – for example, prudential supervision could be funded using a levy and appropriation model, providing the Minister a similar level of involvement as other domestic regulators. The Reserve Bank could 'consult' the Minister regarding spending on its core central banking functions, providing for more budgetary independence for these functions in line with international practice.
21. Stakeholders have not generally expressed strong views about the Reserve Bank's funding model but many support a material increase in the Reserve Bank's funding directed at increasing its supervision capacity and intensity. There has been some support for levies and some support for greater budgetary independence.

Balance sheet matters

22. The Reserve Bank uses its balance sheet to support its objectives, with some balance sheet activities, such as lender of last resort, potentially undertaken during unusual market conditions such as a financial crisis. Recommendations around the governance of the Reserve Bank's balance sheet are expected to centre on clarifying the range of activities the Reserve Bank can undertake independently, and the further range of activities that are possible but should have more ministerial input. For example, lending to a solvent institution (lender of last resort) is likely to remain an autonomous duty of the bank, while lending to an institution in resolution should be possible but should probably require ministerial approval.

Residual matters

23. The Institutional Act will contain provisions relating to the monetary policy functions, non-regulatory functions (including currency), and other activities undertaken by the Reserve Bank. Many of the provisions relating to these functions in the existing Reserve Bank legislation would be carried over into the new Institutional Act. However, these provisions need to be reviewed and updated, as clearly in some cases they are out of date or are no longer relevant or appropriate. In other cases provisions should be modernised to reflect best practice or to better enable the Reserve Bank to discharge its functions.

In-principle decisions to support development of deposit-takers legislation

The Regulatory Perimeter

24. We expect to seek further decisions on the proposed regulatory perimeter following your in-principle decision to combine the bank and non-bank deposit-taking regulatory regimes into one unified regime. The proposed definition of 'deposit-taker' is likely to be framed around the taking of 'retail deposits' with that definition aligned to the proposed depositor protection regime.
25. We expect to make a distinction between deposits and debt securities, which would have implications for those entities deemed to be inside or outside the perimeter. An issue for decision will be how we regulate entities (such as finance companies) that fund themselves through retail issues of longer-date capital markets products like bonds, debentures, medium term notes. Options may include maintaining a level of prudential regulation of these entities, or relying solely on conduct and disclosure regulation under the FMC framework.
26. We also expect to make recommendations on two other aspects of the regulatory perimeter. The first would be around the inclusion of a designation regime, which would set out the mechanism under which the perimeter could be extended to include an entity or class of entities if these were deemed to pose financial stability risks. The second aspect relates to the macro-prudential perimeter, which would define the group of entities that may be subject to specific macro-prudential rules. A possible option that we may recommend would be to make certain lending standards (like LVRs) apply to all lenders to help promote competitive neutrality and reduce the risks of regulatory arbitrage.

Prudential Regulation Powers

27. A key issue for decision around the Reserve Bank's regulatory powers will include whether the primary mechanism currently used to implement prudential regulation – i.e. conditions of bank registration – should be replaced with standards, which are more commonly used to implement regulation. Such a model would provide Parliamentary oversight and other procedural benefits (such as the right to be heard and be given reasons in writing).

28. We will also be seeking decisions on whether the supervisory enforcement regime should move to a more graduated model with less emphasis on criminal liability: arguably criminal sanctions should be limited to deliberate or reckless breaches of regulatory requirements, while less serious breaches should be grounds – at most – for a civil pecuniary penalty. For breaches of Standards it is very important that the Reserve Bank gains the ability to direct without Ministerial consent – this is the most obvious and immediate response to breaches. In practice, direction powers are unlikely to be used often but they become the formal power that underpins moral suasion.
29. The enforcement powers and level of sanctions will need to dovetail with any changes to bank executive and director accountability. In particular, the Review Team will make a recommendation on whether to follow Australia and the United Kingdom in establishing a bank executive accountability regime.

Supervision and Enforcement

30. Recommendations for decisions on the supervision and enforcement framework will be focused around ensuring New Zealand's supervisory framework is aligned broadly with international 'best practice' and becomes more intrusive, sceptical, proactive and forward-looking, adaptive and comprehensive.
31. A key decision point will be whether to empower the Reserve Bank to undertake on-site inspections of any licensed deposit-taker (under the new Deposit-takers Act). Such powers would be consistent with those commonly seen for prudential regulators in most countries and would materially increase the Reserve Bank's capacity to test and examine regulatory compliance. Should this be adopted, consequential recommendations are likely for insurance legislation. In addition, we would likely recommend that the relevant on-site power for the FMA be amended to align with the new Reserve Bank power in order to facilitate cooperation between the respective agencies for future joint inspections of individual financial institutions, or joint thematic reviews.
32. Were the Reserve Bank empowered to undertake onsite inspections, the Review Team would likely recommend that the Bank consider developing an appropriately calibrated risk-based on-site inspection regime for licensed deposit-takers. In the first instance, such a regime would like include the four Australian banks along with a coordinated approach with APRA in order to minimise the impost on the NZ subsidiaries, as well as leveraging off the insights and perspectives of each regulator.
33. We will be seeking a decision on whether to remove from legislation the Minister of Finance's role in consenting to the issuance of directions to financial institutions in relation to any area of emerging concern. This would align with IPSA and the current approach under the NBDT Act.
34. On the issue of enforcement, we expect to recommend that the new Deposit-takers legislation contain a broad suite of formal enforcement tools including statutory public notices, enforceable undertakings, infringement notices and civil penalties. A more graduated approach to enforcement has been strongly endorsed by stakeholders.
35. Consistent with recommendations to deliver improvements in the supervisory and enforcement regime, the Review Team is likely to make recommendations for a significant step shift in resourcing for the Reserve Bank's supervisory function.

Macro-Prudential Policy

36. Early thinking on the macro-prudential policy framework is that macro-prudential decisions would be empowered by the Deposit taking legislation (with details on how each tool operates being established using standards if that approach is adopted more widely). Decisions would generally be taken independently by the Reserve Bank consistent with prudential regulation more broadly.
37. However, we will be seeking your decision on whether certain macro-prudential tools – mainly those affecting lending standards like LVRs or DTIs – should be specifically empowered in legislation thereby defining the range of intrusive macro-prudential tools available to the Bank. Under that model, adding tools to the toolkit or extending the perimeter would require a change via regulation. This mechanism would replace the existing Memorandum of Understanding on macro-prudential policy.
38. We will also be seeking your decision on the manner in which the Reserve Bank is required to consult with other agencies when making certain macro-prudential decisions, and the mechanism through which that consultation would be required. The nature and extent of consultation could be specified under a financial stability remit, if adopted, rather than necessarily written into legislation.

Crisis Management and Resolution

39. We expect to make a range of recommendations on the features of New Zealand's crisis management and resolution regime for banks and other deposit-takers. The recommendations will be focused on ensuring that the resolution regime can support the quick, credible and reliable resolution of a failed deposit-taker without recourse to taxpayer funds. Decisions are expected around:
 - Formally designating the Reserve Bank in legislation as New Zealand's resolution authority for deposit-takers.
 - Confirming the statutory resolution objectives that should be contained in legislation, such as maintaining financial system stability, protecting insured depositors, protecting public funds and minimising the cost of resolution.
 - Confirming the statutory functions of the Reserve Bank as resolution authority, such as pre-crisis planning, coordination with other domestic authorities, coordination with foreign authorities, implementing recovery plans and exercising resolution tools and powers.
 - Requiring the Reserve Bank to ensure structural separation within the Bank between its resolution function and its prudential supervision function.
 - Whether to remove banks and non-bank deposit-takers from the scope of statutory management under the Corporations (Investigation and Management) Act 1989 (CIMA), which is the purview of the FMA.
 - Confirming the Reserve Bank's resolution powers, including around the appointment of a statutory manager, directing deposit takers to take specific actions and writing down or converting contingent debt instruments or other unsecured liabilities to equity.
 - The nature of any creditor safeguards that are to be observed under a resolution.

- Legal protection from prosecution under New Zealand market conduct and securities regulations when directors of deposit takers have been directed by the RBNZ to suspend continuous disclosure obligations.
- Empowerment of the Reserve Bank to provide emergency liquidity assistance for deposit-takers in resolution and the conditions under which that assistance is provided.
- Possible amendments to the Public Finance Act 1989 to provide for a permanent legislative authority to make public funds available as a last resort to support the resolution of a failed financial institution if certain conditions are met.
- Powers for the Minister of Finance to recover any losses from a deposit-taker or the wider sector arising from the provision of public funds in support of a resolution.

40. The pool of stakeholders with interest and expertise in the operation of crisis resolution regimes is small. Feedback from a limited number of stakeholders has provided strong support for a bail-in regime (i.e. the facility to 'bail-in' a category of unsecured debt in order to recapitalise a failing institution). There has also been support to align with international best practice on adopting creditor safeguards in resolution.

Depositor Protection

41. Following your decision to establish a depositor protection regime for New Zealand, the Review Team is undertaking work to clarify the institutional details of the scheme. While this work is ongoing, we expect to make further recommendations on the purpose and form of the scheme. We will endeavour to make as many of these recommendations as possible during October but further work will be required on some aspects (including before we are in a position to confirm the scheme coverage limit). Areas in which we expect to seek further decisions include:

- Formally clarifying the objectives of the scheme. Specifically, the scheme's objectives are likely to be protecting depositors from loss and contributing to public confidence and financial stability.
- Clarifying governance arrangements for the scheme and who operates it.
- Clarifying coverage of the scheme – this is most likely to be on a 'per depositor, per institution' basis. Recommendations would also clarify the intended position of, for example, joint account holders.