Submission

By

THE
NEW ZEALAND
INITIATIVE

to the Independent Expert Advisory Panel

on

Phase 2 of the Reserve Bank of New Zealand Act Review

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1 INTRODUCTION AND SUMMARY

1.1 This submission in response to Phase 2 of the review (the **Review**) of the Reserve Bank of New Zealand Act (the **Act**) is made by The New Zealand Initiative (the **Initiative**), a think tank supported primarily by chief executives of major New Zealand businesses. In combination, our members employ more than 150,000 people. The Initiative undertakes research that contributes to the development of sound public policies in New Zealand and the creation of a competitive, open and dynamic economy and a free, prosperous, fair and cohesive society.

1.2 This submission focuses on three of the five key issues identified in the Terms of Reference (7 June 2018) and related consultation documents, including *Safeguarding the Future of Our Financial System: The Role of the Reserve Bank and How It Should Be Governed* (the **main consultation document**). The three issues are:

(a) Issue 1: Objectives: What high-level financial policy objectives should the Reserve Bank have?

(b) Issue 2: Should there be depositor protection in New Zealand?

(c) Issue 5: Governance: How should the Reserve Bank be governed, including who should make the Reserve Bank's decisions?

1.3 In summary:

Issue 1: We consider the Reserve Bank's existing high-level financial policy objectives remain appropriate and are fit for the future subject to the following four matters:

- Clarifying that "efficiency" refers to *economic* efficiency[1];
- Making explicit that "soundness" is subservient to economic efficiency;
- Clarifying that "soundness" refers to the resilience of the New Zealand financial system (and does not extend to attempting to dampen the economic cycle); and
- Expressly providing that the Reserve Bank's efficiency objective does not extend to promoting competition (as competition policy is the role of the Commerce Commission).

Issue 2: The material in the Review does not support a case to progress work on depositor protection.

The IMF's (2017) recommendation in favour of depositor protection was not supported by any analysis of its pros and cons. Certainly the status quo is imperfect, but the discussion paper does not make any case that there is a real problem or that more intrusive regulation would be less imperfect. A substantial empirical academic study finds that its existence internationally is commonly associated with greater systemic risk.[2]

Issue 5: The Reserve Bank's governance and monitoring arrangements should be restructured by:

- Conferring the governor's prudential regulatory powers on the board, and permitting the board to delegate those powers to the governor and hold the governor accountable for their exercise.

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[1] This economic efficiency should be productive, allocative and dynamic efficiency.

[2] See, for example, Charles W. Calomiris and Matthew Jaremski, "Deposit Insurance: Theories and Facts," *Annual Review of Financial Economics* 8 (October 2016), pp. 97–120.

- Broadening the skill set of the Reserve Bank board to increase the level of banking and insurance industry expertise. Given the systemic reservations of the Productivity Commission in relation to regulatory appointment processes, safeguards should also be introduced to ensure the selection process is informed by high-quality analysis of the skills needed.
- Creating an effective mechanism to monitor how well the board and governor collectively discharge their prudential regulatory powers.

1.4 In making our submission on Issue 5, Governance, we have drawn on the research and recommendations in our report, *Who Guards the Guards? Regulatory Governance in New Zealand* (April 2018) (**our report**). Chapter 5 of our report includes a case study on the governance and regulatory performance of the Reserve Bank. The case study incorporates results of a survey of New Zealand's largest businesses rating the performance of the regulatory agencies they interact with, including the Reserve Bank (the **survey**). The survey covered 23 separate key performance indicators, including consistency of decision-making, clarity of objectives, and accountability. The survey revealed serious shortcomings in the performance and behaviours of the Reserve Bank as prudential regulator. A copy of that case study is attached as **Appendix 1 (page 12)**. Chapter 6 of our report sets out recommendations to reform the Reserve Bank's internal governance arrangements, and makes separate recommendations to strengthen the external monitoring of the Reserve Bank's performance. We have drawn on the results of our research in our responses to Issue 5 in the main consultation document.

2 WHAT HIGH LEVEL FINANCIAL POLICY OBJECTIVES SHOULD THE RESERVE BANK HAVE?

2.1 We believe the Reserve Bank's high-level financial policy objectives require modification.

2.2 First, we consider economic efficiency – that is, productive, allocative and dynamic efficiency – should be the Reserve Bank's *primary* objective. This is to recognise the importance to the New Zealand economy of an efficient payments system and of efficient financial intermediation. As the main consultation document notes, "A sound and efficient financial system is a critical foundation for a sustainable and productive economy" (p. 27).

2.3 Second, while "soundness" is an important *attribute* of an efficient financial system, it is only important to this extent. Expressed differently, soundness, like other forms of safety, is best only pursued to the extent that the benefits to the community exceed the costs. It is not an over-riding objective. Financial markets manage risks, they do not eliminate them. It would be a serious mistake for the "efficiency" objective to be compromised by an open-ended partial objective.

2.4 Third, we propose clarifying the term "soundness" to mean the resilience of New Zealand's financial system and ensure it does not extend to attempting to dampen the financial cycle. The objectives of the Reserve Bank's financial regulatory powers should be financial system efficiency. Any powers to use macroprudential tools to attempt to dampen the financial cycle should derive from a separate monetary policy objective. Given the problems of incentives and inadequate information that enduringly confound both regulators and governments, such tools should be used only sparingly. And the Bank should have to overcome a high burden of proof the likely benefits exceed the likely costs before exercising such powers.

2.5 Fourth, while the Reserve Bank's objective in exercising its regulatory powers over the financial system should be economic efficiency, we believe the Bank's mandate should not extend to promoting competition. That is a matter for the Commerce Commission, the Crown's competition regulator. Empowering two regulators to address competition policy:

(a) would add unnecessary complexity;

(b) might contribute to regulatory confusion; and

(c) risk distracting the Reserve Bank from focusing on systemic risk issues.

2.6 Finally, we do not consider it is either necessary or desirable to extend the Reserve Bank's objectives to consumer protection, public confidence, or any other matters. In particular, we consider:

(a) Consumer's interests are protected by the Bank focusing on efficiency. An additional, or more specific, objective is not needed;

(b) A consumer protection objective would muddy the waters with the Financial Markets Authority's (FMA) regulatory responsibilities for conduct by financial markets participants; and

(c) Public confidence *is an outcome of good financial regulation, not an* objective. It is very important to be specific about what aspect of public confidence is sought. Public confidence that risk investments are not risky is not a good thing. Regulators need to endlessly exhort investors to understand that higher returns mean higher risks. *Caveat emptor* is critical for economic efficiency. As noted in the main consultation document,[3] an ill-specified public confidence objective could aggravate moral hazard.

3 SHOULD THERE BE DEPOSITOR PROTECTION IN NEW ZEALAND?

3.1 The common saying "if it ain't broke, don't fix it" applies to this proposal. Change is costly. A positive case needs to be made that there are net benefits for the community. Nothing in the consultation documents makes such a case plausible.

3.2 The main consultation document refers to a recommendation by the IMF in 2017 advocating greater consideration of deposit insurance for New Zealand.[4] On our reading, the IMF's recommendation is unsupported by any evidence in favour of that recommendation. For example, in paragraph 35 the IMF baldly asserts that:[5]

> … over time the perceived advantages and mitigating techniques of a well-designed depositor protection scheme have come to be seen as more than counterbalancing the disadvantages.

The IMF fails to identify who has these perceptions and what basis there should be for confidence in them, or to make any case that its chimerical, "well-designed" scheme is achievable or sustainable in New Zealand.

3.3 The main consultation document usefully cites a 2014 paper by Deniz Anginer, Asli Demirguc-Kunt and Min Zhu.[6] Contrary to the IMF's bald assertion of net advantages, Anginer, et al. find that in practice, net disadvantages have been the norm:

> The overall effect of deposit insurance over the full sample we study remains negative since the destabilizing effect during normal times is greater in magnitude compared to the stabilizing effect during global turbulence. In addition, we find

[3] Main consultation document, p. 31.
[4] Ibid. p. 50.
[5] International Monetary Fund (IMF), "Technical Note: Contingency Planning and Crisis Management Framework, New Zealand Financial Sector Assessment Programme" (2017), paragraph 35, p. 13.
[6] Main consultation document, footnote 20, p. 55.

> that good bank supervision can alleviate the unintended consequences of deposit insurance on bank systemic risk during good times, suggesting that fostering the appropriate incentive framework is very important for ensuring systemic stability.[7]

3.4 It goes without saying that well-designed schemes technically should produce better outcomes than ill-designed schemes, but there are compelling public choice theory reasons why political considerations can over-ride technical considerations. The empirical evidence shows that the problems of poor design cannot be assumed away. But that is what the IMF's paper seems to do.

3.5 The IMF paper is similarly cavalier about the evidence at paragraph 36, where it asserts:[8] "[r]ecent evidence from New Zealand, which is consistent with experience elsewhere, calls into question the moral hazard argument against deposit insurance." Its supposition in Box 2 on page 14 as to the government's real motivations for guaranteeing finance company deposits is ridiculous. The notion that there could have been a net outflow of funds to Australia otherwise is professionally embarrassing as the floating exchange rate made that technically impossible – and uncommercial in that depositors had much cheaper domestic options for getting a government guaranteed investment. And the IMF's assertion, again in Box 2, that the fact of no subsequent run on the banks showed the utility of the retail deposit guarantee is trite.

3.6 Given the absence of any credible argumentation, perhaps the real reason for the IMF's recommendation for New Zealand is that it currently supports deposit insurance, perhaps to keep itself onside with the vast majority of countries, and it is embarrassing for it to have New Zealand and Israel as exceptions (see footnote 3 to its paragraph 35). Such countries represent a "regulatory gap".[9] Such gaps are more likely to be found in the minds of ambitious regulators than in the minds of the lay person.

3.7 It is poor public policy to assume away real political and institutional constraints. International studies have found that depositor insurance commonly increases the risk of a banking collapse.[10] The box below reproduces in full the abstract of a recent review of the evidence and issues in an academic journal. Unlike the IMF paper, and to a lesser degree the Review, it pays due attention to the problem of political realities and rent-seeking potential.

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[7] Deniz Anginer, Asli Demirguc-Kunt and Min Zhu, "How Does Deposit Insurance Affect Bank Risk? Evidence from the Recent Crisis," *The Journal of Banking and Finance* 48 (November 2014), pp. 312–321, Abstract.

[8] International Monetary Fund (IMF), "Technical Note: Contingency Planning and Crisis Management Framework," op. cit., paragraph 36, p. 14.

[9] Paragraphs 3 and 7 in the IMF's executive summary express the absence of deposit insurance as a gap.

[10] See, for example, the 24 pages of extracts from the literature on moral hazard in banking that were attached to a 30 June 2009 paper prepared by Capital Economics Limited for New Zealand Treasury on Moral Hazard in the Financial Sector. (This is NOT a Treasury paper.)

Abstract: Charles W. Calomiris and Matthew Jaremski, "Deposit Insurance Theories and Facts" (2016)[11]

Economic theories posit that bank liability insurance is designed to serve the public interest by mitigating systemic risk in the banking system through the reduction of liquidity risk. Political theories, however, see liability insurance as serving the private interests of banks, bank borrowers, and depositors, potentially at the expense of the public interest. Empirical evidence - both historical and contemporary - supports the private-interest approach, as liability insurance has been associated with increases, rather than decreases, in systemic risk. Exceptions to this rule are rare and reflect design features that prevent moral hazard and adverse selection. Prudential regulation of insured banks has generally not been a very effective tool in limiting the systemic risk increases associated with liability insurance. This likely reflects purposeful failures in regulation; if liability insurance is motivated by private interests, then there would be little point to removing the subsidies it creates through strict regulation. The same logic explains why more effective policies for addressing systemic risk are not employed in place of liability insurance. The politics of liability insurance thus should not be narrowly construed to encompass only the vested interests of bankers. Indeed, in many countries, liability insurance has been installed as a pass-through subsidy targeted to particular classes of bank borrowers.

3.8 The reasons deposit insurance can easily exacerbate systemic risk have long been known.[12] Ash Demirguc-Kunt and Edward Kane reviewed the design difficulties given political and bureaucratic incentives in 2002.[13] Their conclusions about what is necessary to reduce the likelihood of increasing systemic risk are sobering and much more far-ranging from the transfer of risk from depositors to taxpayers that the discussion document has in mind.[14] Yet even they do not address the political economy question of why interest groups and politicians would adopt those arrangements and sustain them.

3.9 In lay terms, deposit insurance is a potential can of worms. Depositors want to shift risks to taxpayers, while banks want cheaper funding from implicit taxpayer support. Banks might also support a scheme conferring privileges and protections that are anti-competitive in practice. Scheme design choices inevitably create arbitrary boundary lines between institutions, depositors and financial instruments. Who and what is covered and who and what is not? If banks are to be charged a risk-related insurance premium through political processes, what influences will be brought to bear on premium levels and differentials? Each of those

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[11] Charles W. Calomiris and Matthew Jaremski, "Deposit Insurance: Theories and Facts," op. cit. See also Charles W. Calomiris, "Bank Failures in Theory and History: The Great Depression and Other 'Contagious' Events," NBER Working Paper No. w13597 (November 2007).
The latter paper also cites Asli Demirguc-Kunt and Enrica Detragiache, "Does Deposit Insurance Increase Banking System Stability?" Conference Paper to The World Bank (2000); Gerard Caprio and Daniela Klingebiel, "Bank Insolvencies: Cross Country Experience," Working Paper No. 1620 (The World Bank, 1996); Gerard Caprio, James R. Barth and Ross Levine, *Rethinking Bank Regulation: Till Angels Govern* (Cambridge University Press, 2006); and John Boyd, Pedro Gomis-Porqueras, Sungkyu Kwak and Bruce Smith, "A User's Guide to Banking Crises," Conference Paper to The World Bank (2000).
[12] They were succinctly summarised by then deputy governor of the Reserve Bank, Rod Carr, in "Banking on Capital Punishment", an address to the New Zealand Association of Economists Conference (27 June 2001), https://www.rbnz.govt.nz/research-and-publications/speeches/2001/speech2001-06-27.
[13] Ash Demirguc-Kunt and Edward Kane, "Deposit Insurance Around the Globe: Where Does It Work?" *Journal of Economic Perspectives* 16:2 (Spring 2002), pp. 175–195.
[14] Ibid. pp. 192–194.

boundaries will be gamed, and endlessly contested. The process will be political. Politicians will need to decide which constituencies to favour. They will ultimately decide who is in, who is out, and what the right level is for the insurance premium and the level of reserves. And will their incentives be technical or political?

3.10 In case they are useful, we end up with three more limited technical observations:

- The main consultation document espouses generalised depositor confidence as if it is a virtue. It needs to be more specific. Depositor confidence that higher return (for example, than that on government stock) is not at higher risk, is a not virtue. Those who do not want higher risk can buy government stock or deposit with a state-owned bank. Everyone else should accept a risk of default and adjust their exposures accordingly.
- The argument that many depositors are complacent about the risk of bank deposits is not an argument for shifting risks to taxpayers on an ill-priced basis.
- The main consultation document could give readers an exaggerated impression that irrational bank runs bringing down solvent banks are a serious source of instability. The empirical evidence does not seem to support such impressions.[15] The sources of systemic risk are more likely to be macro in nature and real rather than feared.

3.11 To be clear, this section is not arguing that no case for deposit insurance can be made, given the reality of politically-opportunistic decision-making. The New Zealand Initiative expresses no opinion on that matter. The case being argued here is instead that the main consultation document has not provided sufficient justification for proceeding with work on this option.

4 HOW SHOULD THE RESERVE BANK BE STRUCTURED, INCLUDING WHO SHOULD MAKE THE RESERVE BANK'S DECISIONS?

4.1 The Reserve Bank's governance arrangements are unusual and lack many of the checks and balances that are a feature of best-practice regulatory governance.[16] The Reserve Bank's governor is both the Bank's *governing body* and its *chief executive*. This means the Reserve Bank lacks the internal accountability mechanism that comes with the separation of *governance* and *management*, which is a feature of both Crown entities and private sector companies.

4.2 While the Reserve Bank has a board, as the main consultation document acknowledges, the board's role is a *monitoring* role, not a *governance* one. Even then, the Reserve Bank's board is not well-placed to perform this monitoring role as:

(a) The governor is a member of the board, with the consequence that the board is not independent of management; and

(b) The board is not independently resourced and is dependent on the governor and his staff for executive support.

4.3 Consequently, there are weaknesses in both the Reserve Bank's internal accountability mechanisms and its external monitoring.

[15] See, for example, Charles W. Calomiris, "Bank Failures in Theory and History," op. cit.
[16] For a description of best practice regulatory governance, see chapter 1 of our report, and OECD, "The Governance of Regulators, OECD Best Practice Principles for Regulatory Policy" (Paris: OECD Publishing, 2014).

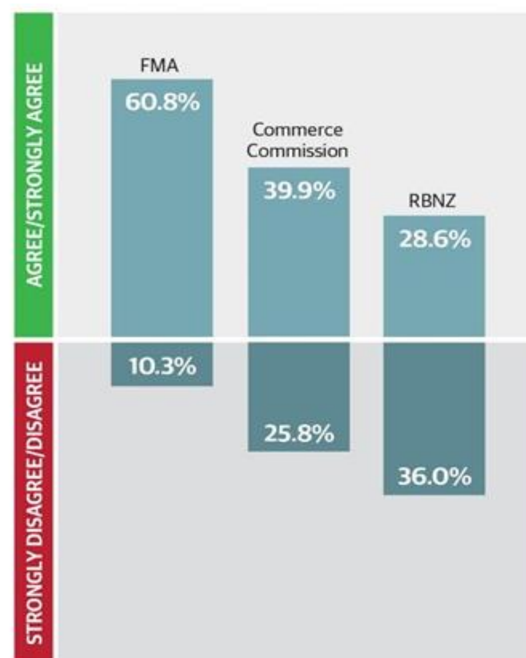
4.4 As we noted in our report, the Reserve Bank's unusual governance structure might not matter if the Bank's regulatory performance were consistently exemplary over time.[17] However, our research has found reasons to believe it is not.

4.5 Our survey results disclose that the Reserve Bank rates poorly across more than 20 KPIs covering a range of key regulatory standards of behaviour. These standards included communication, predictability and consistency, fairness and proportionality, expertise and respect, commerciality, and accountability.

4.6 We asked survey recipients to rate the performance of the three regulators most important to their business against 23 performance criteria. We also asked them to rank the relative levels of respect they had for all the regulators with whom they interacted.

4.7 The Reserve Bank's overall ratings across the 23 KPIs were poor (see Figure 1 below). On average, just 28.6% of respondents 'agreed' or 'strongly agreed' that the Bank met the KPIs, and 36% 'disagreed' or 'strongly disagreed'.[18] These figures compare very unfavourably with the average scores of the FMA of 60.8% and 10.3%, respectively. They also compare unfavourably (though less so) with the Commerce Commission's averages of 39.9% and 25.8%, respectively.

Figure 1: Average percentage responses across 23 KPIs



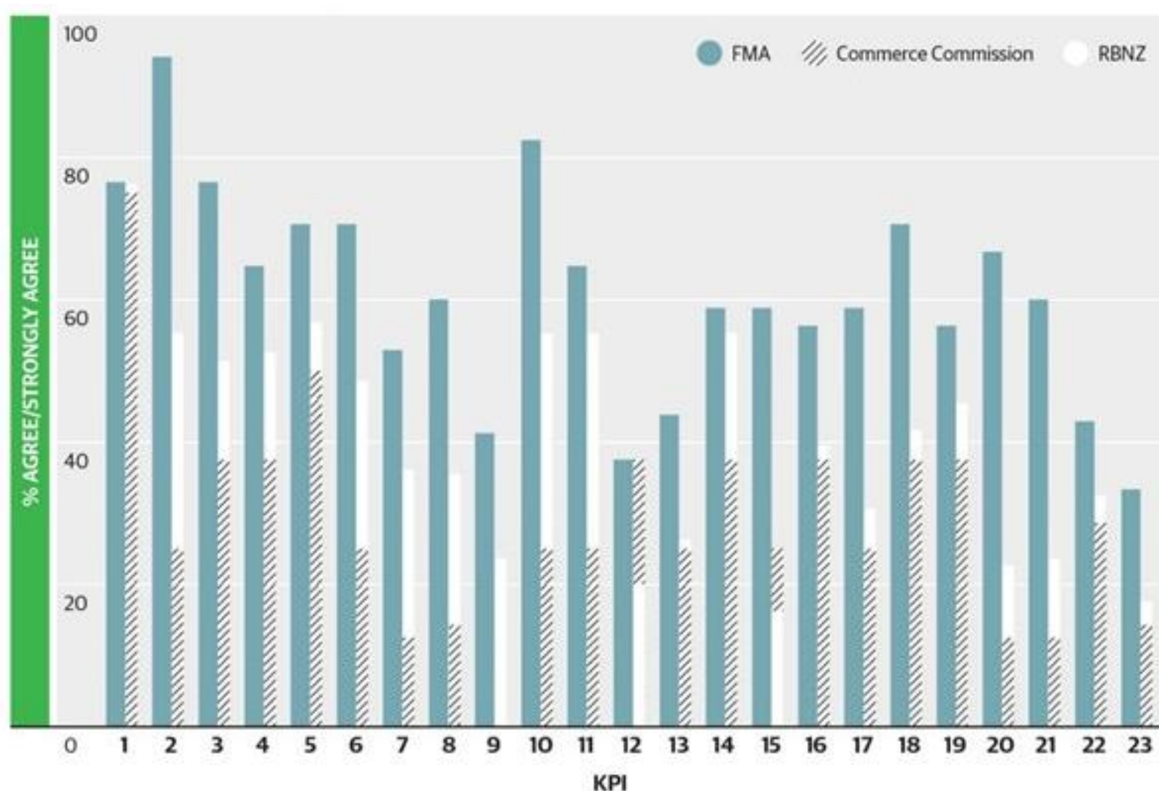
Source: The New Zealand Initiative, "Who Guards the Guards? Regulatory Governance in New Zealand" (Wellington: 2018), Figure 4, p. 46.

4.8 Where the FMA outperformed the Commerce Commission on all 23 KPIs, the commission in turn outperformed the Reserve Bank on 21 of the 23 KPIs (see Figure 2 below).

[17] The New Zealand Initiative, "Who Guards the Guards? Regulatory Governance in New Zealand" (Wellington: 2018), p. 64.

[18] This figure represents the average percentage of survey respondents who 'agreed' or 'strongly agreed' that the Reserve Bank met the 23 KPIs (see The New Zealand Initiative, "Who Guards the Guards? Regulatory Governance in New Zealand," op. cit. Appendix 1).

Figure 2: Comparative ratings for FMA, Commerce Commission and RBNZ across 23 KPIs



Source: The New Zealand Initiative, "Who Guards the Guards? Regulatory Governance in New Zealand" (Wellington: 2018), Figure 5, p. 47.

4.9 While the number of businesses rating the Reserve Bank was smaller than for either the FMA or the Commerce Commission (8 businesses as opposed to 17 and 38, respectively), this sample included some of New Zealand's largest financial institutions.

4.10 We believe a strong case can be made for linking the shortcomings in the Reserve Bank's performance with the shortcomings in its governance framework.

4.11 The Bank's single-member decision-maker model lacks the safeguards that exist with multi-member bodies. These include not just the benefit of a second (or third) pair of eyes, but also the opportunity to bring outside perspectives, including current banking and finance expertise, to bear on the exercise of discretionary power. It was just this sort of expertise Michel Prada and Neil Walter considered essential for an effective regulator of financial markets conduct like the Securities Commission.[19] This observation is equally applicable to the prudential regulator of those same financial markets. Indeed, the Reserve Bank itself recently acknowledged this, at least in theory. In its December 2017 Bulletin, the Bank noted: "… multi-member decision making bodies (cf. single decision-maker models) provide potentially greater consistency and continuity over time and a greater weight against ministerial influence."[20]

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[19] Michel Prada and Neil Walter, "Report on the Effectiveness of New Zealand's Securities Commission," op. cit. pp. 25–26.

[20] Reserve Bank of New Zealand (RBNZ), "Bulletin" (December 2017), p. 11, quoting the Bank for International Settlements' 2009 report from its Central Bank Governance Group, "Issues in the Governance of Central Banks."

4.12 Second, though the Reserve Bank has a board, the governor's regulatory policymaking and decision-making powers do not derive from that board. As a result, the board has only limited means of holding the governor accountable for either the development of regulatory policy or its implementation.

4.13 And third, the Reserve Bank is not subject to the same level of independent departmental or parliamentary review as are other regulators.[21]

4.14 The principles of regulatory governance and the experience with reforming the FMA both suggest the performance of New Zealand's prudential regulator would be improved by:

(a) Amending the Act by conferring the governor's prudential regulatory powers on the board and permitting the board to delegate those powers to the governor (and for him or her to delegate them to staff).

(b) Broadening the skill set of the Reserve Bank board to increase the level of banking and insurance industry expertise. Given the systemic reservations of the Productivity Commission in relation to regulatory appointment processes, safeguards should also be introduced to ensure the selection process is informed by high-quality analysis of the skills needed.

(c) Creating an effective mechanism to monitor how well the board and governor collectively discharge their prudential regulatory powers. We address this in more detail in paragraphs 4.16–4.18 below.

4.15 We do not recommend the formation of a separate financial policy committee, with external participants, operating at a level below the board to deal with prudential regulatory decision-making. We think that such a structure:

- would add an unnecessary layer of complexity;
- as a novel governance structure for a regulatory agency, is untested and its effectiveness as an accountability mechanism is therefore less certain and predictable;
- is inconsistent with the approach taken by other more successful regulatory agencies with board governance models, including the FMA;
- is not justified by any specific evidence or analysis; and
- would make the Reserve Bank board role less attractive to future applicants compared with the counterfactual of a board governance model.

External monitoring

4.16 If the Reserve Bank's board becomes the bank's governing body, a new external monitoring mechanism will be required. For most regulatory agencies, this role is performed by government departments, ministers and Parliament. And they have developed extensive external accountability mechanisms to support them.

4.17 Yet in its 2014 report, the Productivity Commission found that external monitoring of regulatory agencies has serious shortcomings, such as focusing too much on procedural compliance and too little on strategic performance.[22]

4.18 This should not be surprising. Many of our regulatory regimes are complex, and specialist expertise is required to evaluate them. Government departments cannot hope to replicate the

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[21] Ibid. pp. 65–66.
[22] Productivity Commission, "Regulatory Institutions and Practices," op. cit. p. 353.

expertise of the specialist regulatory agencies tasked with their enforcement. This means departments have only limited means to monitor the effectiveness of the relevant regulator's strategic approach and substantive decision-making.

4.19 The Productivity Commission's findings were supported by our survey. Despite respondents comprehensively rating the FMA ahead of the Securities Commission across the range of KPIs, the FMA's worst comparative result related to external accountability, i.e. monitoring. This was hardly surprising as none of the reforms to the governance of our financial markets regulator was aimed at strengthening external governance mechanisms.

4.20 To address concerns about the quality of external governance, the Productivity Commission recommended the government establish a peer review process through which panels of senior regulatory leaders would review the practices and performance of other regulatory agencies.[23] The government did not accept this recommendation. We doubt its effectiveness in any event. To evaluate the substantive performance of, say, the Commerce Commission, specialist expertise in competition policy and economics is required. This is a scarce skill set in the civil service.

4.21 As we outline in Chapter 1 of our report, Germany has created a specialist monitoring agency to monitor the performance of its competition regulator.[24] And other jurisdictions have called for a 'super regulator' to monitor financial regulators in the wake of the GFC.[25]

4.22 In an economy the size of New Zealand's, it would be hard to justify forming a specialist agency to monitor a single regulator's performance – even one as important as the Commerce Commission or the Reserve Bank. However, New Zealand does have an agency with deep economic expertise: the Productivity Commission itself. And it has the power to co-opt inquiry directors where a specific skill set is required.[26]

4.23 With an appropriate increase in its budget, the Productivity Commission could be tasked with undertaking, say, three-yearly reviews of the strategies and substantive performance of the Reserve Bank, the FMA and the Commerce Commission, and report to Parliament on its findings. This would create an effective external mechanism to monitor and hold to account our three most important commercial regulatory agencies. Rather than forming a new "supervisory council" as canvassed in the main consultation document, we recommend the government task the Productivity Commission with this role in relation to the Reserve Bank.

4.24 As the Productivity Commission would report to Parliament on each regulator only once every three years, we recommend the Treasury be tasked with annual monitoring of the Reserve Bank's performance – just as other government departments do for other regulatory agencies.

4.25 This would secure substantially all the benefits identified in the main consultation document of, respectively, supervision by the Treasury and an independent supervisory council.

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[23] Ibid. p. 366.
[24] Ibid. p. 19.
[25] Gerard Caprio, James R. Barth and Ross Levine, *Guardians of Finance: Making Regulators Work for Us* (Cambridge: MIT Press, 2012), p. 230.
[26] Productivity Commission, "Our team," Website.

case and the potential application of the relevant legislation."[238] The CMA board is, consequently, for the most part a governance board. It determines and guides how decisions are made, the processes involved, and the resources drawn on to analyse the evidence and inform the decisions.[239] The CMA experience suggests there is nothing in principle or in practice to preclude the Commission from operating according to the board governance model.

The conflict of interest concern arises because converting the *executive* Commissioner role to a largely *governance* role could leave the new-style board members/Commissioners retaining or seeking other outside roles to fill their time (or pay their bills). To the extent that these outside roles might be for entities regulated *by the Commission*, that creates potential conflicts of interest.

But just how real is this concern? Experience with the FMA suggests not very. Most FMA board members have other outside roles – even the FMA Chair. The same is also true of the Takeovers Panel.[240] Both the FMA Chair and CEO advised us that, in practice, conflicts of interest are readily managed through a combination of comprehensive conflicts policies and procedures and the FMA's extended board of (up to) nine members and modus operandi of regulatory decision-making through divisions of three members.

Yet because the FMA board governance role appeals to a wider range of candidates with industry expertise, the FMA had access to more current financial markets expertise than if the role were an executive one. Survey respondents suggested that was a positive. It is likely this would also benefit the Commerce Commission, with one of the key criticisms raised by survey respondents being the Commission's lack of industry knowledge.

It might be argued that either conflicts are more acute in competition regulation (compared with financial markets regulation), or the market for potential Commerce Commission governance candidates is smaller, reducing the potential for conflict-free candidates. We doubt both concerns.

- The United Kingdom's CMA itself has at least one non-executive director with outside commercial roles on its board. This suggests that, if anything, the conflict of interest is a matter of *degree*, rather than *kind*; and
- Informal soundings from competition practitioners suggest there would be as many candidates who might be willing to take on a Commission *governance* role, but who are not interested in an *executive* Commissioner role, as there are candidates who might be ruled out by potential conflicts of interest.

For these reasons, we do not think the peculiarities of the Commerce Commission's regulatory functions preclude adopting the superior FMA board governance model. And for completeness, we note that if it did, this would make it all the more important to establish an effective external governance body to monitor the strategy and direction of the Commission. We return to this issue in the final chapter.

5.2 The Reserve Bank of New Zealand

The RBNZ is best known for its independent management of New Zealand's monetary policy. And since 1989, it has had a single monetary policy mission: to maintain price stability. At times – as now – the singularity of this goal has been controversial. Yet it is a job the RBNZ has done well.

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238. David Currie, et al. "Institutional Design and Decision-Making in the Competition and Markets Authority," op. cit. 15.
239. Ibid.
240. The board of the Takeovers Panel comprises four practising lawyers, three investment bankers, two consultants, a professional non-executive director, and a corporate CEO.

But the RBNZ is not only responsible for monetary policy. It is also charged with:

- prudential regulation of banks, non-bank deposit takers, insurance companies;
- regulation of the payments system (jointly with the FMA); and
- supervision and enforcement of anti-money laundering legislation.[241]

The objective of the RBNZ's prudential regulatory role is to maintain a sound and efficient financial system.[242] With insurance companies, the RBNZ's regulatory role has the further purpose of promoting public confidence in the insurance sector.

The RBNZ's dual role is in contrast to its closest peer, the Reserve Bank of Australia, which has direct responsibility only for monetary policy. The prudential supervision of Australian financial institutions lies with a separate regulator, the Australian Prudential Regulation Authority (APRA).

Given our focus on regulatory governance, it is only the latter regulatory function of the RBNZ we address in this report. We will comment on the unique governance structures for the RBNZ's monetary policy responsibilities only to the extent they affect the RBNZ's regulatory responsibilities.

To enable the RBNZ in its prudential regulatory role, the *Reserve Bank of New Zealand Act 1989* (the Act) confers wide powers on the RBNZ. In relation to the banking sector, these include the power to:

- set and enforce conditions of registration for registered banks;
- authorise a change in ownership of a registered bank;
- recommend public disclosure requirements to the Minister;
- give directions to banks under certain circumstances; and
- recommend that a bank in financial distress be placed into statutory management.

In addition, the RBNZ monitors each registered bank's financial condition and compliance with its conditions of registration. This monitoring ensures the RBNZ is familiar with the financial condition and risk profile of each bank and that it maintains a state of preparedness to instigate corrective actions should it consider this necessary.

RBNZ's governance and accountability mechanisms

The RBNZ is a unique organisation. It has the appearance of an independent Crown entity but is not one, and therefore it is not subject to the *Crown Entities Act*. Instead, it is constituted under its own legislation and has its own, unique institutional form.

The RBNZ has a Governor (who in any other organisation would be called a CEO) and a board. However, the board does not exercise the powers of the RBNZ. The RBNZ's powers – for both monetary policy and prudential regulation – are directly vested by the Act in the Governor.

Compared with other critical regulatory regimes, this approach is unusual. But the RBNZ's governance arrangements reflect the policy objectives of the 1989 Act. At the time, achieving political independence for the RBNZ's monetary policy function was seen as paramount. It was, after all, the 1980s, and the New Zealand and global economies were still emerging from one of the most tumultuous periods of price instability in Western history.

241. In relation to anti-money laundering, the RBNZ has shared responsibilities, along with the FMA and the Department of Internal Affairs.
242. See section 1A, Reserve Bank of New Zealand Act, 1989.

Vesting the power of setting monetary policy directly in the Governor, while creating checks and balances relating to appointing the Governor, ensured the RBNZ's political independence.[243] It may have seemed only natural for the RBNZ's prudential regulatory powers to be vested directly in the Governor in the same way. And so they were, adopting what is now known as the single-member decision-maker model.

Consequently, the Governor has the sole power to determine – and enforce – the prudential requirements for all registered banks by controlling the conditions of registration and applicable prudential standards.[244] In practice, the RBNZ employs a committee-based decision-making process for regulatory policy decisions, with the Financial Systems Oversight Committee overseeing prudential regulatory strategy.[245] Nevertheless, with the ultimate decision-making power resting with the Governor, this is a remarkable concentration of both policymaking and regulatory decision-making power in a single individual.

With other policymaking powers, though, such as the prudential regulation of non-bank deposit takers (NBDTs) or bank disclosure rules, regulations are made by the executive council acting on the recommendation of the Minister of Finance (in turn, acting on the advice of the Governor).

This inconsistent approach to rule-making is unusual. Why should the RBNZ have discretionary rule-making power on significant policy issues like the *conditions of the registration* of banks, when changes to bank *disclosure requirements* must be made by the Executive Council? And why do the rule-setting requirements for banks, and those for NBDTs and insurers, differ?

This topic is beyond the scope of this report. But it is clear that at least in relation to the banking sector, the Governor's control over the banks gives him or her a level of discretionary power unparalleled in New Zealand.

Under Governor Graeme Wheeler, the RBNZ formalised diversifying decision-making by introducing a governing committee comprising the Governor, the two Deputy Governors, and the Assistant Governor under the chairmanship of the Governor.[246] However, given the committee comprises only the Governor's subordinates – and with the Governor retaining the right of veto – this arrangement does not change the fundamentally autocratic governance arrangements within the RBNZ.

There are, nevertheless, external governance mechanisms to hold the RBNZ to account.[247] The RBNZ must provide the Minister of Finance with a Statement of Intent each year.[248] And, since 2013 it has been subject to a Letter of Expectations from the Minister.[249] It is also subject to scrutiny by Parliament's Finance and Expenditure Committee and to audit by the Auditor-General. Treasury also provides a degree of oversight of the RBNZ's performance. And the RBNZ's twice-yearly Financial Stability reports also act as accountability mechanisms.[250]

However, as the RBNZ is responsible for advising the Minister on its own legislation, it is not subject to the same departmental

243. Reserve Bank of New Zealand, *Bulletin* 80:11 (December 2017), 14.
244. Reserve Bank of New Zealand, "Statement of Policy-Making Approach" (2017), 4.
245. Ibid. 5. Reserve Bank of New Zealand, *Bulletin*, op. cit. 18. The FSO is chaired by the Deputy Governor and head of financial stability. A similar committee, the Macro-Financial Committee, develops the RBNZ's macro-prudential framework.
246. Graeme Wheeler, "Decision making in the Reserve Bank of New Zealand," speech to the University of Auckland Business School (2013).
247. See section 4 of Reserve Bank of New Zealand, *Bulletin* op. cit. 2–30 for a more detailed summary of the RBNZ's accountability mechanisms.
248. *Reserve Bank Act 1989*, s 162A.
249. Reserve Bank of New Zealand, "Letters of Expectations," Website.
250. See Reserve Bank of New Zealand, *Bulletin*, op. cit. 22 and 25f.

oversight as other independent regulators. And, understandably, neither the Minister, nor the Auditor-General, nor the Finance and Expenditure Committee has the resources or expertise to evaluate the costs and benefits of the RBNZ's prudential regulatory regime.

Although the RBNZ has a board, the board's powers are much more limited than the FMA board (or, for that matter, a corporate board). This is largely because the RBNZ's regulatory powers are *vested directly* in the Governor by the Act, rather than being *delegated* to the Governor by the board.

This has profound consequences for the internal governance of the RBNZ's regulatory functions. While the board is charged with monitoring the Governor's performance, the Governor is not accountable to the board for exercising his or her powers in the way any other CEO would be. The board has no power to override a regulatory decision made by the Governor exercising a power delegated directly to him. And the Governor has no statutory duty – or need – to confer with the board before exercising the regulatory powers vested in him.

As a consequence, the board's role is primarily *ex post* monitoring of the Governor's performance, rather than *ex ante* approval of strategy (and holding the Governor to account for achieving that strategy). While the board may give advice to the Governor on any matter relating to the performance of the RBNZ's functions and the exercise of its powers,[251] the Governor is not obliged to follow the board's advice. Consequently, if the board is not happy with the Governor's use of his regulatory powers, it cannot step in and override those decisions.

And oddly, given the board's supposed monitoring role, the Governor sits on the board and supplies the board with its secretariat. Both features undermine the board's independence, and invariably compromise its effectiveness as a monitoring mechanism.

Recognising some of the oddities of the Reserve Bank's governance, in early 2017 Finance Minister Steven Joyce asked The Treasury to commission an independent report on possible changes to the governance of the RBNZ from former State Services Commissioner Iain Rennie. Following the 2017 general election, the new Minister of Finance, Grant Robertson, announced a two-stage review of the *Reserve Bank of New Zealand Act* and appointed an Independent Expert Advisory Panel to assist with the review.[252]

On 15 January 2018, Treasury released Rennie's report (the Rennie report) as background material for the review.[253]

The Rennie report recommends a move away from the RBNZ's single decision-maker model in favour of a complex 'committee-based' approach.[254] Three committees would be formed, each with external participants, to exercise the RBNZ's decision-making powers. One committee would deal with monetary policy, and the other two with micro- and macro-prudential regulation separately.[255] The RBNZ's board role would be modified to a monitoring one: It would not be tasked with the usual role of a regulatory agency's board of approving the agency's regulatory policy and strategy.[256]

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251. *Reserve Bank Act 1989*, s 53.
252. Grant Robertson, "Review of Reserve Bank Act announced as Policy Targets Agreement re-signed," (Wellington: New Zealand Government, 7 November 2017).
253. Iain Rennie, "Decision-making and Governance at the Reserve Bank of New Zealand," The Treasury, Website.
254. Ibid. 12–14 and 19–22.
255. Ibid. 22–24.
256. Ibid. 16 and 37–40.

The RBNZ's response to the Rennie report was highly critical:

> … proposals to change the governance framework of the Bank should not be made lightly and need to be motivated by evidence that changes would improve upon the current framework… Much of the analysis underpinning the [Rennie] report was insufficient, and consequently the conclusions of the report are unreliable, or would require considerable further analysis."[257]

As a report commissioned by a prior government, the Rennie report is unlikely to dictate any changes to the RBNZ's governance. However, the Rennie report will be an important resource for the Labour-led Government's Independent Expert Advisory Panel, so we will comment further on the report at the conclusion of this chapter.

RBNZ's regulatory performance

The RBNZ's unusual governance structure would not matter if the bank's regulatory performance were consistently exemplary over time. However, our research has found reasons to believe it is not.

This is not to say the RBNZ's prudential regulation of the financial system has been lax or permitted excessive risks. Indeed, the International Monetary Fund's (IMF) most recent assessment of New Zealand's finance sector found our banking system was well placed to manage the risks and vulnerabilities associated with current developments in the housing sector, the high level of household debt, and low dairy prices.[258]

At the same time, though, the IMF was not entirely happy with the RBNZ's prudential regulatory approach, and recommended rebalancing the RBNZ's 'three pillars'[259] approach to prudential regulation towards a more rules-based approach, something the RBNZ is now considering.[260]

But whether or not the RBNZ accepts the IMF's recommendations, there is more to being a good regulator than simply avoiding the harm the regulations guard against. Regulatory interventions should be proportionate to the risks being managed, with costs and benefits carefully weighed. They should not impose unnecessary costs and burdens on the regulated entities. Regulators should also exhibit appropriate *standards of behaviour* – by acting in accordance with the rule of law and principles of natural justice fairly, predictably, transparently and proportionally (see Chapter 1).

Our survey suggests that on this latter dimension, relating to standards of behaviour, the RBNZ does not perform so well. We asked survey recipients to *rate* the performance of the three regulators most important to their businesses against 23 performance criteria. We also asked them to *rank* the relative levels of respect they had for all the regulators with whom they interacted (Chapter 3).

In the ratings, the RBNZ's overall performance across the 23 KPIs was poor. On average, just 28.6% of respondents 'agreed' or 'strongly agreed' that the RBNZ met the KPIs and 36% 'disagreed' or 'strongly disagreed'.[261] These figures compare very unfavourably with the FMA's

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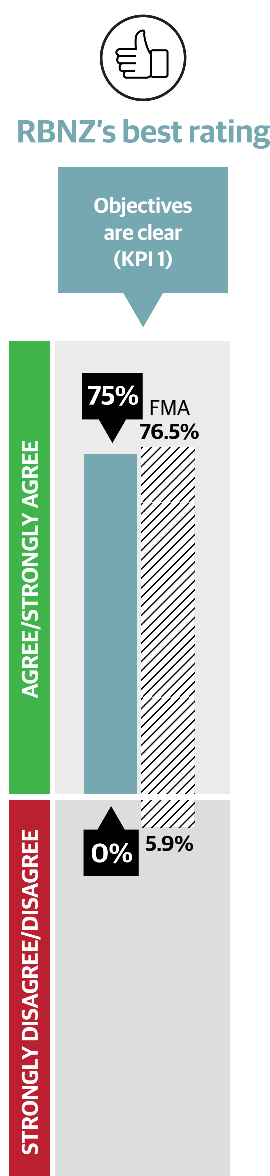
257. Ibid. 1.
258. International Monetary Fund, "New Zealand Financial System Stability Assessment" (2017).
259. The three pillars are self-discipline, market discipline, and regulatory discipline. See, for example, Toby Fiennes, "New Zealand's evolving approach to prudential supervision," Speech by Head of Prudential Supervision at the Reserve Bank to the New Zealand Bankers' Association in Auckland (2016).
260. Chris Hunt, "Outcomes of the 2016 New Zealand Financial Sector Assessment Programme" (2017).
261. This figure represents the average percentage of survey respondents who 'agreed' or 'strongly agreed' that the RBNZ met the 23 KPIs (see Appendix 1).

average scores of 60.8% and 10.3%, respectively. They also compare unfavourably (though less so) with the Commerce Commission's averages of 39.9% and 25.8%, respectively.

And where the FMA outperformed the Commerce Commission on all 23 KPIs, the commission in turn outperformed the RBNZ on 21 of the 23 KPIs.

Figure 5.4



While the number of businesses rating the RBNZ was smaller than for either the FMA or the Commerce Commission (8 businesses as opposed to 17 and 38, respectively), this sample included some of New Zealand's largest financial institutions.

The RBNZ's best rating was for clarity of objectives,[262] with 75% of respondents 'agreeing' or 'strongly agreeing' that they were readily able to understand the RBNZ's regulatory goals (see Figure 5.4). This result was comparable with the FMA's rating of 76.5%.

But on questions relating to almost all other KPIs, the gap between the performance of the prudential regulator and its financial markets conduct counterpart was cavernous.

The RBNZ's worst comparative scores related to expertise and respect, commerciality, constructiveness, proportionality, consultation and willingness to listen, learning from mistakes, and internal accountability (see Figure 5.5):[263]

- In response to Question 6, "The leaders of the regulator are skilled, knowledgeable and well-respected by businesses in your industry", only 25% or respondents 'agreed' or 'strongly agreed', and 37.5% 'disagreed' or 'strongly disagreed'. The comparative figures for the FMA were 70.6% and 0%, respectively.
- In response to Question 9, "The RBNZ understands the commercial realities facing your industry", *no* respondents 'agreed' or 'strongly agreed', and 50% 'disagreed' or 'strongly disagreed'. The comparative figures for the FMA were 41.2% and 11.8%, respectively.
- In response to Question 10, "Your interactions with the regulator are generally constructive", 25% of respondents 'agreed' or 'strongly agreed', and 50% 'disagreed' or 'strongly disagreed'. The comparative figures for the FMA were 82.4% and 5.9%, respectively.

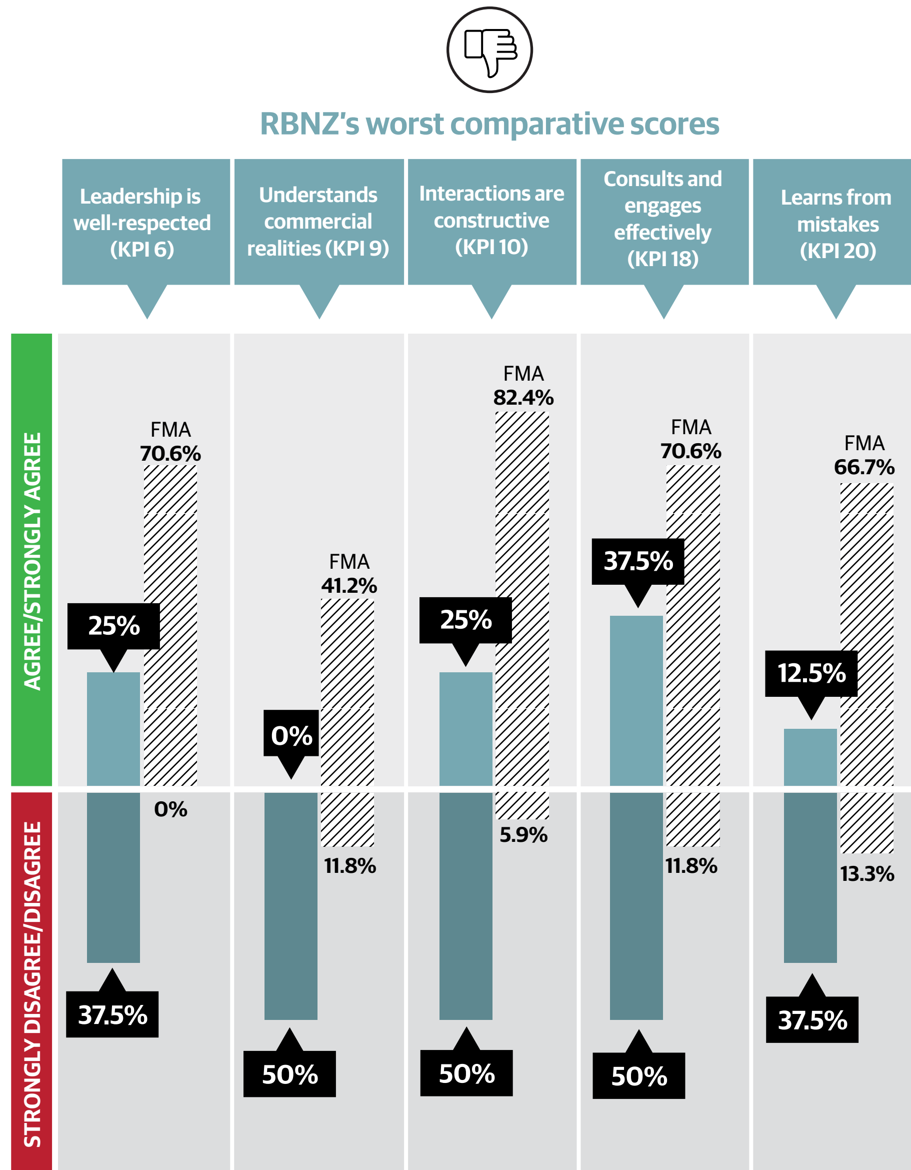
262. See Question 1, Appendix 6.
263. See comparative results to questions 6, 9–10, 12, 15, 17–18 and 20–21 in Appendix 6.

- In response to Question 18, "The RBNZ effectively consults and engages with you and businesses in your industry to ensure that good regulatory processes are being followed", only 37.5% or respondents 'agreed' or 'strongly agreed', and 50% 'disagreed' or 'strongly disagreed'. The comparative figures for the FMA were 70.6% and 11.8%, respectively.
- In response to Question 20, "The RBNZ reviews and learns from its mistakes", only 12.5% or respondents 'agreed' or 'strongly agreed', and 37.5% 'disagreed' or 'strongly disagreed'. The comparative figures for the FMA were 66.7% and 13.3%, respectively.

In relation to the accountability questions, the RBNZ's results were also comparatively poor (see Figure 5.6):

- In response to Question 21, "There are effective accountability mechanisms within the regulator to enable participants in your industry to voice concerns about mistakes," only 12.5% of respondents 'agreed' or 'strongly agreed', and 50% 'disagreed' or 'strongly disagreed'. The comparative figures for the

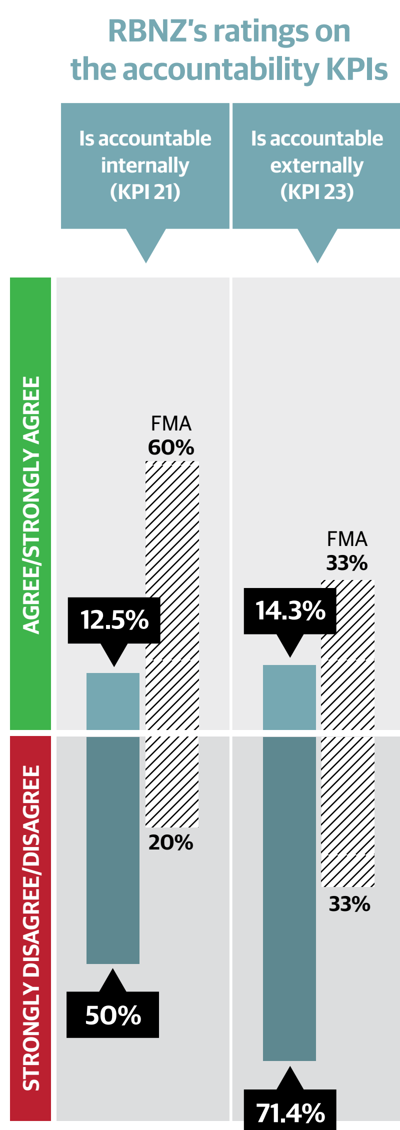
Figure 5.5



FMA were 60% and 20%, respectively.

- In response to Question 23, "The regulator is readily held to account for the quality of their work (including any mistakes) by its responsible government department, minister or some other effective external accountability mechanism," only 14.3% of respondents 'agreed' or 'strongly agreed', and 71.4% 'disagreed' or 'strongly disagreed'. The comparative figures for the FMA were 33% and 33%. While not great, these are significantly better than the RBNZ's ratings, respectively.

Figure 5.6



In the rankings, the RBNZ did not perform so poorly. It was ranked ten times by survey respondents. Of these it was ranked as the *least respected* regulator twice and the *most respected* once. But alongside the FMA's worst place ranking of once and best place ranking seven times (in each case out of 27 rankings), the RBNZ's ranking still compares unfavourably.[264]

Like the survey results, the views of interviewees were also largely negative. Some respondents were cautious to express criticism, noting that the RBNZ has been successful in achieving its financial stability goal. As one respondent said, "Significant positives, but room for improvement." Another was complimentary, noting that the RBNZ "did a good job with the resources available to it." While acknowledging that its governance structure gives rise to a potential lack of accountability, which could lead to questionable outcomes, one interviewee said the RBNZ's regulatory approach provides "flexibility and the ability to respond nimbly."

But most respondents were not so complimentary, and all expressed concerns about some aspects of the RBNZ's performance as prudential regulator.

The criticisms related both to the RBNZ's *capabilities and processes*, and the *substance* of its regulatory decision-making.

In relation to process and capability, criticisms included the following issues:

a. **Lack of consistency in process**: One respondent noted that the internal processes of the RBNZ's prudential supervision department, which is responsible for prudential supervision, can be 'random'. The

264. See Appendix 3.

respondent referred to long delays between steps in a process involving regulated entities, followed by the imposition of requirements for more-or-less immediate action from them.

b. **Lack of relevant financial markets expertise among staff**: This was a common theme. One respondent noted that until the 2000s, there was "regular interchange of staff between the banks and RBNZ," meaning RBNZ regulatory staff had first-hand finance industry expertise. But this has changed with the banks moving their head offices to Auckland and the RBNZ based in Wellington. As one respondent said, "They will always struggle to get good people [with financial markets expertise] in Wellington, especially with the banks now in Auckland… this makes interchange impossible." Another said, "RBNZ [staff are] completely divorced from the reality of how things are done." More colourfully, another said, "[RBNZ] is all a little archaic… Entrenched people don't get challenged." Another said, "On the insurance side, the level of capability is less than with the banks. There is a potential risk to policyholder protection. RBNZ ends up just focussing on the minutiae."
c. **Lack of commerciality**: This concern is allied to both the expertise issue noted above, and the materiality issue noted below. As one respondent said about the RBNZ's 'deafness' to the need for a materiality threshold before a matter becomes a breach of a bank's conditions of registration, "RBNZ says, 'If it's not material just disclose it'. But that's a regulator way of thinking. They don't understand the commercial, reputational implications."
d. **Unwillingness to consult or engage**: As one respondent said, "I would call them out for not truly consulting." Another said, "The RBNZ upholds independence to the point that it precludes constructive dialogue." Several respondents drew a contrast with the FMA, noting that the RBNZ was happy to issue hundreds of pages of "prescriptive, black letter requirements," but "without much or any guidance" for the banks on their application. One respondent did note, however, that the RBNZ "isn't resourced to spend time doing this [issuing guidance]."
e. **Lack of internal accountability:** Several respondents perceived a lack of oversight from the most immediate past Governor, Alan Bollard, in either engaging with the banks over concerns about prudential regulation or trying to resolve them. One respondent noted, "Staff are often running around doing things without serious scrutiny from above." Another said there is a group "with no accountability within the RBNZ… They favour form over substance and seem to enjoy exercising power." Another commented it was "unclear how much information flowed up to the RBNZ Board," but that if the Governor were accountable to the board for prudential regulation, then the board "could be useful in pulling up entrenched behaviour." Another noted that the RBNZ's governance structure meant it did not benefit from outside perspectives: "[t]he value of diverse thinking is to challenge, so you don't get capture by one person's view."

Two main criticisms were made in relation to substance:

a. **Materiality thresholds**: Several respondents highlighted the lack of a 'materiality threshold' before RBNZ approval is needed either for:
   - changes to banks' internal risk models in the Conditions for Registration of banks; or
   - changes to functions outsourced to related parties.

   One respondent noted that without a materiality threshold, the new requirement for a compendium of outsourced functions – and for approval of *any* change to outsourcing arrangements with a related

entity – could lead the Australian-owned banks to cease outsourcing functions to related entities, thereby increasing costs and harming customers.

Several respondents noted that the lack of a materiality threshold could be attributed to a lack of trust in the banks by the RBNZ staff responsible for prudential regulatory decisions. As one respondent put it, this led the RBNZ to "insist on approving absolutely everything."

Although this view was not shared by all banks, one respondent noted that even APRA – long regarded as a more heavy-handed, intrusive regulator than the RBNZ – was "now more reasonable to deal with than the RBNZ."

b. **Black letter approach**: Along with the lack of a materiality threshold in the RBNZ's regulatory regime, several respondents commented on the RBNZ's "black letter" approach to interpreting its rules: "If RBNZ had two or three public policy experts who could bring a 'purposive approach' to interpretation, that would be hugely positive." Another said, "[The RBNZ] has an overly legalistic approach which ignores the purpose of the legislation," and that "what they're doing undermines [public] confidence over things that are of no risk." Several survey recipients noted that this was in stark contrast to APRA's approach to public disclosure in Australia.

   Another respondent put the concern differently, saying the problem was less about the RBNZ's 'black letter' approach to its rules, and the opaqueness of the rules, and more about the lack of guidelines from the RBNZ explaining them, an issue the respondent put down to a lack of resources.

Observations and recommendations

While our survey sample size for the RBNZ was comparatively small, both the survey results and our interviews with survey recipients, raise serious concerns about the RBNZ's exercise of its regulatory powers. That is not to suggest the RBNZ's regulation of the financial system has left the financial system vulnerable to risks. Rather, the problems relate to the *standards of behaviour* of the RBNZ in exercising its regulatory powers, and also in relation to the *efficiency* of the regulatory regime the RBNZ has created.

The concerns suggest the RBNZ's regulatory function suffers from poor internal accountabilities and inadequate external monitoring. Together, these point to shortcomings in the RBNZ's governance, internal and external. This failure may be exacerbated – and perhaps even facilitated – by the unavailability of merits review of the RBNZ's exercise of discretionary decision-making power.

It is probably also influenced by the RBNZ's need for independence in setting monetary policy. As the New Zealand Bankers' Association noted in its submission to the Productivity Commission:

> [T]his culture of independence also influences the way the Reserve Bank has approached prudential policy and its role as a regulator. This has perhaps understandably resulted in a culture where at times the regulator appears reluctant to engage with the banking industry…[265]

These shortcomings should come as no surprise.

265. New Zealand Banker's Association, "Submission to the Productivity Commission on the Regulatory Institutions & Practices Issues Paper" (2013), 8.

The governance framework for the RBNZ's regulatory function lacks many safeguards. First, the single-member decision-maker model lacks the safeguards that exist with multi-member bodies. These include not just the benefit of a second (or third) pair of eyes, but also the opportunity to bring outside perspectives, including current banking and finance expertise, to bear on the exercise of discretionary power. It was just this sort of expertise Prada and Walter considered essential for an effective regulator of financial markets conduct like the Securities Commission.[266] This observation is equally applicable to the prudential regulator of those same financial markets. Indeed, the RBNZ itself recently acknowledged this, at least in theory. In its December 2017 Bulletin, the RBNZ noted that "multi-member decision making bodies (cf single decision-maker models) provide potentially greater consistency and continuity over time and a greater weight against ministerial influence."[267]

Second, though the RBNZ has a board, the Governor's regulatory policymaking and decision-making powers do not derive from it. As a result, the board has only limited means of holding the Governor accountable for either the development of regulatory policy or its implementation.

And third, the RBNZ is not subject to the same level of independent departmental or parliamentary review as are other regulators.[268] Hence, with the exception of bank disclosure requirements, its prudential policies for banks are not subject to scrutiny even by the Regulations Review Committee.

The RBNZ itself has recently acknowledged that, "[i]n the financial policy sphere the construction of robust accountability arrangements is not straightforward" and that "this warrants ongoing development and innovation."[269] We agree. The principles of regulatory governance and the experience with reforming the FMA both suggest the performance of New Zealand's prudential regulator would be improved by:

- Amending the Act by conferring the Governor's prudential regulatory powers on the board, and permitting the board to delegate those powers to the Governor (and for him or her to delegate them to staff).
- Broadening the skill set of the RBNZ board to increase the level of banking and insurance industry expertise. Given the systemic reservations of the Productivity Commission in relation to regulatory appointment processes, safeguards should also be introduced to ensure the selection process is informed by high-quality analysis of the skills needed.
- Creating an effective mechanism to monitor how well the board and Governor discharge their prudential regulatory powers (see the Conclusion).

We also recommend the RBNZ consider moving its prudential regulatory staff to Auckland to bring it closer to the financial institutions it regulates. The FMA's experience with its Auckland office suggests this would facilitate greater consultation and engagement between the regulator and the regulated. It would also facilitate the interchange of personnel between the financial market participants and the RBNZ. Both would help improve the trust and confidence of each in the other.

Our recommendations differ from those in the Rennie report in that we do *not* recommend the

266. Michel Prada and Neil Walter, "Report on the Effectiveness of New Zealand's Securities Commission," op. cit. 25–26.
267. RBNZ *Bulletin*, op. cit. 11, quoting the Bank for International Settlements 2009 report from its Central Bank Governance Group, "Issues in the governance of central banks."
268. Ibid, 65–66.
269. Ibid, 30.

formation of separate committees, with external participants, operating at a level *below the board* to deal with prudential regulatory decision-making. We think that such a structure:

- would add an unnecessary layer of complexity;
- is inconsistent with the approach taken by other more successful regulatory agencies with board governance models, including the FMA;
- is not justified by any evidence or analysis; and
- would make the RBNZ board role less attractive to future applicants.

For completeness, we note that the references in the Rennie report to the RBNZ board's role being an unusual one are correct, but not for the reasons stated.[270] What is unusual about the RBNZ board is the decision-making powers of the RBNZ's 'CEO' – the Governor – do not derive from the board, as they do, for example, for the CEO of the FMA (or for CEOs in the corporate world). As we have outlined earlier in this section,[271] this means the Governor is not accountable to the RBNZ board the way other CEOs are accountable to their boards.

The Rennie report suggests there is a "tension" between the RBNZ board's "advice role" and its role assessing the RBNZ's performance.[272] If there is such a tension, it is not an unusual one. It is an inherent feature of the board governance model, where the board both *tests and approves* the strategies developed by management – and no doubt helps shape them – and *evaluates management's performance*.

Rather than 'clarifying' the RBNZ board role, the proposals in the Rennie report would further eviscerate the board. And it would perpetuate the gap between the role of the RBNZ board and the principles of best practice for board governance for regulatory agencies discussed in Chapter 1.

We do not comment on the appropriateness of the committee model proposed in the Rennie report for RBNZ's monetary policy responsibilities. As noted earlier, the governance of the RBNZ's monetary policy responsibilities is beyond the scope of this report. That is because in exercising its powers relating to monetary policy, the RBNZ is not acting as a regulatory agency. Consequently, different accountability and independence issues arise. It would therefore be quite feasible to introduce the reforms we recommend to the RBNZ's prudential regulatory powers and either:

- leave unchanged the current arrangements for monetary policy – under which monetary policy-setting responsibilities are delegated directly to the Governor under the Act; or
- introduce a committee-based model for setting monetary policy as recommended in the Rennie report.

In its December 2017 Briefing to the Incoming Minister of Finance (BIM),[273] the RBNZ commented on the implications of involving external participants in the RBNZ's deliberations on prudential policy, suggesting that only full-time members should be considered:[274]

> Committees may also include external members to access outside perspectives, when other avenues are costly or not feasible. Financial policy decision-making generally involves extensive

270. Iain Rennie, "Decision making and Governance at the Reserve Bank of New Zealand," 16.
271. Ibid, 67.
272. Ibid. 16.
273. Reserve Bank of New Zealand, "Appendix 6: The Reserve Bank's decision-making process," in *Briefing for the Incoming Minister on the Reserve Bank of New Zealand* (2017), 54.
274. Ibid.

public and key stakeholder consultation, while monetary policy decision-making involves less formal but frequent sectoral engagement. Policy making in monetary and financial policy often involves complex considerations based on multiple indicators, analytic models and competing economic theories. Full-time members with experience and expertise are likely to be better suited to this task than part-time external participants.

Anticipating that external participants might be added to the RBNZ's governing committee, the BIM also argued that the Governor should retain final decision-making powers:[275] Provided the Governing Committee remains relatively small, we believe it should continue to make decisions by consensus, with the Governor having the final decision if no consensus can be achieved.

Furthermore, the BIM suggested any external committee appointments should be made *by the Governor*, or by the RBNZ board *on the recommendation of the Governor*.[276]

Four points need to be made in response. The first relates to complexity. Prudential policy undoubtedly involves "complex considerations," including both "analytic models" and "competing economic theories." But so too do the regulatory regimes of many other agencies, including the FMA and the Electricity Authority. And the RBNZ's BIM does not try to show that prudential supervisory issues are inherently more complex than these other regimes. The concern about complexity points merely to the need for any external participants of the RBNZ's regulatory governance arrangements to have an appropriate skill set. It does not preclude their involvement.

Second, the suggestion that any external participants should be full-time is also misguided. A full-time external participant is unlikely to be 'external' for long. Nor, in any case, is there a need for a suitably qualified external participant to commit to full-time involvement in the RBNZ's prudential regulatory function. Participation in, say, developing prudential regulatory strategy, and in periodic evaluations of the RBNZ's performance as a prudential regulator, does not require this.

Third, when the purpose of external participation is to challenge – or, at the very least, contest – the RBNZ's views, permitting the Governor to control the process for appointing external participants would compromise this objective. After all, it would be only natural for a Governor to seek external participants who share the RBNZ's views given the objective of external participation is to avoid 'group think'.

Fourth, and most importantly, external participation in a committee, with the Governor having the final decision, is not required to address concerns about the RBNZ's governance. The shortcomings in the RBNZ's governance stem from a combination of:

- the poor internal accountabilities inherent in its single-member decision-making model; and
- the lack of effective external monitoring of the RBNZ's regulatory performance.

Adding external participants to one of the RBNZ's committees will not introduce the checks and balances that are the hallmarks of a robust governance framework for the exercise of regulatory power. To achieve this, a change from the single-member decision-making model is required.

275. Ibid.
276. Ibid. 55.