Second 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 the second round of consultation on 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 Wellington-based think tank supported primarily by chief executives of major New Zealand businesses. In combination, our members provide employment to more than 150,000 people.

1.2 The Initiative undertakes research that contributes to the development of sound public policies in New Zealand which help create a competitive, open and dynamic economy and a free, prosperous, fair, and cohesive society.

1.3 Our submission focuses on four issues raised in consultation documents 2A and 2B,[1] namely:

(a) What high-level financial policy objectives should the Reserve Bank have? (Chapter 2, consultation document 2A);

(b) How should the Reserve Bank be governed? (Chapter 3, consultation document 2A);

(c) What prudential regulatory tools and powers should the Reserve Bank have? (Chapter 1, consultation document 2B); and

(d) How should the Reserve Bank enforce prudential regulation (Chapter 3, consultation document 2B).

1.4 In summary:

(a) **Objectives**: The purpose of all regulation, including banking regulation, should be to make the community better off than otherwise. That can occur only if the benefits regulation confers exceed the costs for those affected. This is an efficiency test. The proposal to drop efficiency from the over-riding objective statement for banking regulation would reduce community wellbeing to a subsidiary consideration. That is not what Budget 2019 is about. The over-riding pursuit of soundness puts safety ahead of welfare-enhancing risk-taking, and thereby ahead of efficient financial intermediation. One option for restoring the primacy of net community benefit would be to include a limiting phrase in the objective statement such as "to the degree that the expected benefits to the community exceed the costs".

(b) **Governance**: We support the in-principle decision to establish a proper governance board for the Reserve Bank. We have given ongoing thought to who should be responsible for monitoring the Bank as a whole. Treasury or MBIE are two department options. *Of the two*, recent events conflating the roles of Treasury and the Bank have led us now to favour the MBIE. MBIE would then have oversight of both financial markets *conduct* regulation (by the FMA) and financial markets *prudentia*l regulation (by the Reserve Bank). Given the importance of the Reserve Bank's regulatory function, we also consider the Reserve Bank's performance should be periodically monitored by an independent statutory body. It could also monitor the performance of the Financial Markets Authority (**FMA**). This suggestion accords with the recommendations of the Hayne Royal Commission in Australia in relation to monitoring the performance of the Australian Prudential Regulatory Authority (**APRA**) and the Australian Securities and Investment Commission (**ASIC**), who perform the equivalent roles in Australia to those of the Reserve Bank and the FMA in New Zealand. For reasons of greater independence

[1] The Treasury, "Public Consultation – second round (Reserve Bank Act Review)" (Wellington: New Zealand, 24 June 2019).

from any 'Wellington group-think', we favour an external monitor with at least Trans-Tasman representation.

(c) **Tools and powers**: We favour a standards-based approach to the core prudential rule-making power. This has the advantage of both parliamentary oversight and publication while preserving flexibility. It would also formalise the need for proper cost-benefit analysis for the introduction or revision of standards. In relation to process rights, we consider introducing merits review (that is, appeal rights) for regulatory decision-making in relation to individual regulated entities. We also consider some form of "sentencing guidelines" are needed to ensure that any sanction imposed by the Reserve Bank is proportional to the alleged wrongdoing.

(d) **Enforcement**: We consider the strategic approach to prudential regulation *should be a matter to be determined by the board of the Reserve Bank.* We do not consider it should be prescribed in legislation. Nor do we consider it should be specified in instruments like a "government policy statement". We agree with the view expressed on p. 97 of consultation document 2B that a civil penalty regime would be more proportionate than criminal liability for breaches of prudential regulatory requirements that do not involve an element of dishonesty.

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

2.1 We submit that the prime goal and purpose of financial regulation, and indeed all government regulation, should be to produce net benefits for the community.

2.2 Community wellbeing/welfare is widely considered to be enhanced if the benefits to those affected exceed the costs, as perceived by those experiencing those costs and benefits.[2] This is an efficiency objective. An outcome is not efficient if other arrangements would produce greater net benefits for the community.

2.3 The proposed soundness objective is not an efficiency objective. It invites the pursuit of soundness at the expense of community welfare/wellbeing. A banking system that takes minimal if any risk might be sound, but it may not be of much use to the community.

2.4 New Zealanders need an efficient financial system, just as they need an efficient transport system, telecommunications system, and much else. People need to be able to conduct financial transactions efficiently. They need efficient financial intermediation. They need efficient price discovery, particularly in relation to risk and return.

2.5 To argue, as the discussion document does, that efficiency is "a broad and poorly defined term" is to discount the large literature of welfare economics and all cost-benefit manuals, including the Treasury's social cost-benefit guide and related tools. It also flies in the face of the government's current focus on wellbeing, as expressed in Budget 2019. The assertion that the term is poorly defined is also jarring in that the Reserve Bank has been subject to this statutory objective for the best part of the last 30 years. The Bank surely developed a good operational definition of what this statutory objective means in that time.

[2] This is a general "in-principle" statement. There are questions of due process, consistency with the rule of law, protection of person and property, protection of minors and the feeble-minded, lack of knowledge, and paternalism that may be important in particular cases.

2.6 Of course, benefit-cost analysis has well-understood limitations, particularly with respect to making interpersonal utility/wellbeing comparisons.[3] Even in such cases, it can help advisers quantify what the trade-offs must be to cause a decision to go one way rather than another.

2.7 The weaknesses in benefit-cost analysis do nothing to establish the superiority of less comprehensive approaches. It is not for nothing that the Cabinet Manual, through related documents, emphasises the central role for benefit-cost analysis in its Regulatory Impact Statement requirements.

2.8 In contrast to this mainstream efficiency criterion, we know of no theory in welfare economics that advocates the pursuit of soundness at the expense of efficiency.

2.9 The following is an illustrative alternative objective statement that would incorporate the efficiency constraint:

> Protect and enhance the stability of New Zealand's financial system, to the degree that the benefits to the community exceed the costs.

2.10 This is just one of many possible ways of accommodating the point. Probably the most straightforward way would be to keep the existing soundness and efficiency statement.

3. HOW SHOULD THE RESERVE BANK BE GOVERNED?

3.1 We support the Minister's in-principle decisions:

- To establish a new governance board with statutory responsibility for the Reserve Bank's decisions (except those reserved for the Monetary Policy Committee); and
- Not to establish a Financial Policy Committee.[4]

3.2 These decisions are consistent with the recommendations made in our April 2018 report, "Who Guards the Guards? Regulatory Governance in New Zealand".[5]

3.3 We no longer support the Minister's in-principle decision to make Treasury responsible for assessing the Reserve Bank's performance.

3.4 In our January 2019 submission, we somewhat favoured the above option [3.3]. Subsequent events have led us to change our mind. We now see Treasury as too close to the Bank to perform a sufficiently independent monitoring role.[6] While we now see the MBIE as a better option than Treasury, for reasons of independence, we do not see the MBIE as adequate on its own.

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[3] A Pareto efficient policy would make at least one person better off and no one worse off relative to the next best alternative policy. The Hicks-Kaldor criterion would allow some people to be made worse off as long as the policy produced sufficient net overall benefits to allow those made worse off to be made good in principle from a distribution of those net overall benefits.

[4] The Treasury, "Consultation Document 2A: In principle decisions and follow-up questions on: The role of the Reserve Bank and how it should be governed" (Wellington: New Zealand, 24 June 2019).

[5] The New Zealand Initiative, "Who Guards the Guards? Regulatory Governance in New Zealand" (Wellington: 2018), 65–72 and 75–79.

[6] The Secretary to the Treasury can sit on the Monetary Policy Committee's meetings, the Reserve Bank Governor is anticipating an increased blurring of monetary policy and fiscal decisions, and Treasury is working with the Reserve Bank on the proposed changes to the Reserve Bank's governance arrangements. The last of these facts compromises Treasury's ability to provide an independent evaluation of the joint proposals.

3.5 We see the need for additional periodic monitoring by an independent agency. We favour, in principle, a body with a Trans-Tasman, or wider, perspective and expertise in financial regulation. Expertise that is uncompromised by conflicts of interest is in short supply in New Zealand, and there is a need to ensure that any evolving Wellington 'group think' of accepted practice is tested by outside experts. This more independent monitor could be a Crown agency drawing on Australian expertise, if that can be done. Perhaps the Productivity Commissions in both countries could contribute to biennial or triennial assessments to Parliament.

3.6 We recommend that an independent statutory authority be charged with reporting once every three years on the Reserve Bank's performance of its prudential regulatory functions. We consider this independent statutory authority should also be charged with periodically monitoring the performance of each of the two other "all of economy" regulators – the FMA and the Commerce Commission – and with reporting its findings to Parliament.

3.7 The rationale for this recommendation is set out in our April 2018 report at pp. 76–77.[7] The Productivity Commission has found that existing monitoring of regulatory agencies has serious shortcomings.[8] These shortcomings include focusing too much on procedural compliance, and too little on strategic performance.[9]

3.8 To address concerns about the quality of external monitoring, the Productivity Commission has 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.[10] This recommendation has not been adopted. We doubt its effectiveness in any event. To evaluate the substantive performance of regulatory agencies with complex regulatory functions like the Reserve Bank's prudential regulatory functions, specialist expertise in financial supervision is needed. This is a scarce skill-set in New Zealand's civil service.

3.9 As we explained in our April 2018 report, to address a similar concern about monitoring and oversight of its competition regulator, Germany has created a specialist agency to monitor its competition regulator's performance.[11] And there were similar calls in other jurisdictions for a "super regulator" to monitor financial regulators in the wake of the global financial crisis.[12]

3.10 More recently, in February this year Australia's Royal Commission into the financial services industry (colloquially known as the **Hayne Commission** after its sole commissioner, the Hon. Justice Kenneth Hayne), recommended that ASIC and APRA should each be subject to oversight by a new, independent "oversight authority".[13]

3.11 The Hayne Commission acknowledged that both regulators were already subject to a number of existing oversight mechanisms. These include parliamentary oversight, ministerial responsibility, and annual reporting and audit.

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[7] The New Zealand Initiative, "Who Guards the Guards? Regulatory Governance in New Zealand," op. cit. 76–77.
[8] Productivity Commission, "Regulatory Institutions and Practices" (Wellington: Productivity Commission, 2014), 220.
[9] Ibid.
[10] Ibid. 366.
[11] The New Zealand Initiative, "Who Guards the Guards? Regulatory Governance in New Zealand," op. cit. 19.
[12] Gerard Caprio, et al. "Guardians of Finance: Making Regulators Work for Us" (Cambridge: MIT Press, 2012), 230.
[13] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, Final Report (Canberra: 2019), 41 and 472–480.

3.12 However, the Hon. Justice Hayne noted that none of the existing processes requires "regular and systematic reviews of how well either regulator discharges its statutory functions or exercises its statutory powers."[14]

3.13 Given the importance of each regulator to the Australian economy, the Hon. Justice Hayne concluded a new permanent oversight body is required. The role of the new watchdog would be to assess and periodically report to Parliament on:[15]

- the effectiveness of each regulator in meeting its statutory objects;
- the performance of the leaders and decision-makers within the regulator; and
- how the regulator exercises its statutory powers.

3.14 We consider a similar approach should be adopted for the Reserve Bank (along with the FMA and the Commerce Commission) in New Zealand.

3.15 In relation to other matters canvassed in Chapter 3 of consultation document 2A:

- In relation to questions for consultation 3.A relating to the factors most relevant to an effective board,[16] we consider the competence of the board members appointed will be key. The most critical factors relating to competence are relevant banking and insurance expertise and "commercial judgement".
- In relation to questions for consultation 3.B relating to "appropriate degrees of delegation",[17] we consider this matter should be left for the Reserve Bank board (as it is with corporate boards). Setting out "hard lines" within the statute are likely to reduce the board's effectiveness as a governing body.
- In relation to institutional form,[18] we consider that the Reserve Bank should be reconstituted as a Crown entity. We do not consider there are any good reasons for adopting a "bespoke" institutional structure for the Reserve Bank, and there are likely to be benefits in harmonising the Bank's institutional form with the well-understood Crown entity form.
- In relation to board composition,[19] we believe the FMA model is likely to be appropriate in relation to both the number of board members and whether the board should include executive directors. Appointing up to nine members will enable the board to avoid potential conflicts of interest. As noted in consultation document 2A, the board governance model is also inconsistent with standard practice in the New Zealand state sector.[20] Ensuring the board is fully non-executive will enhance the board's independence and effectiveness as a governance body. Having executives (including the CEO) on a board reduces independence, increases ambiguity, and undermines accountability. These are all critical requirements for a board of a regulatory agency, especially so for one with as important a role as the Reserve Bank. Of course, having a fully non-executive board will not preclude the governor and other Reserve Bank executives from attending board meetings and participating in board discussions. But it

[14] Ibid. 476.
[15] Ibid. 477.
[16] See 2A Phase 2 in The Treasury, "Public Consultation – second round (Reserve Bank Act Review)," op. cit. 56.
[17] Ibid.
[18] Ibid. 56-59.
[19] Ibid. 60-61.
[20] Ibid. 61.

will avoid ambiguity in relation to decision-making by the board and in relation to internal accountability.

4. WHAT PRUDENTIAL REGULATORY TOOLS AND POWERS SHOULD THE RESERVE BANK HAVE?

4.1 While beyond the scope of our April 2018 research report focusing on regulatory governance, we wish to make some general observations on the issues raised in Chapter 1 of consultation document 2B.

4.2 First, we support the general approach of making changes to address issues of legitimacy, transparency and proportionality identified in Chapter 1, without excessively affecting flexibility.

4.3 We do not consider that an "enhanced status quo" system of bank conditions of registration (**CoRs**) as described on p. 35 of consultation document 2B would provide adequate safeguards to ensure the goals of "legitimacy, transparency and proportionality" are met. Under such a system, the rules would not be subject to parliamentary oversight nor to publication requirements. As noted in consultation document 2B, these shortcomings are inconsistent with good regulatory practice.

4.4 For these reasons, we favour a standards-based system described in consultation document 2B as "Option 2".[21] Such a system would be subject to both parliamentary oversight and publication. Making the rule-making power subject to parliamentary oversight would also have the advantage of formalising the need for proper cost-benefit analysis. And we agree that the risk of disallowance by the Regulations Review Committee – or even by the courts on judicial review – would serve as a useful discipline.

4.5 We also agree that a system of standards should preserve the necessary flexibility to ensure that the rule-making regime is practically workable while minimising the extent to which "political risk" is introduced into New Zealand's prudential regulation system.

4.6 In relation to process rights,[22] we consider the absence of appeal rights (that is, merits review) in relation to *at least some categories of* regulatory decisions made about individual regulated entities is a serious shortcoming of the current regulatory regime. In principle, we favour the approach of the views of the Legislative Design and Advisory Committee that "the starting point should be a right of appeal if the rights or interests of a particular person are affected by an administrative decision."[23] Rule of law considerations require appeal rights *at least* where a regulatory decision relates to an alleged breach by an individual regulated entity of prudential regulatory requirements. A case can also be made for appeal rights in relation to approvals or non-objections in relation to proposed conduct by individual regulated entities. Both exist in relation to decisions made, for example, by the Commerce Commission, and we can see no good reason for depriving individual entities regulated by the Reserve Bank of the same appeal rights (even though the omission is especially egregious in relation to decisions-making findings of wrongdoing by an individual entity).

4.7 Finally, we consider there is a material omission from the matters considered in the "Responding to breaches of rules" of consultation document 2B.[24] There are currently no civil liability rules or

[21] See 2B Phase 2 in The Treasury, "Public Consultation – second round (Reserve Bank Act Review)," op. cit. 35–36.
[22] Ibid. 37–38.
[23] The Legislation Design and Advisory Committee, Legislation Guidelines, 2018 Edition (Wellington:2018), 310.
[24] See 2B Phase 2 in The Treasury, "Public Consultation – second round (Reserve Bank Act Review)," op. cit. 38–39.

standards applying to breaches of the CoRs. Consequently, in response to a finding of breach, it is possible for the Reserve Bank to impose enhanced or revised CoRs for a regulated bank that are disproportionate to the breach. Typically, regulatory agencies are unable to act as both "judge and jury". Instead, a regulator will make an allegation of breach, a court will make a finding and will then determine the appropriate penalty. Legislation may set out a penalty regime and, if not, guidelines emerge from precedents to ensure that "the punishment fits the crime" – even where the "crime" is a breach of a regulatory requirement that does not amount to a criminal offence.

4.8 Currently, the CoR regime contains no guidelines on the appropriate sanctions the Reserve Bank should impose in the form of more onerous CoR for an individual bank in response to a breach by that bank of its existing CoR.

4.9 The omission should be remedied as part of the current reform process by introducing some form of "sentencing guidelines" to ensure that any sanction imposed by the Reserve Bank is proportional to the alleged wrongdoing. The sanction then imposed should be subject to both merits review and appeal rights in favour of the individual bank.

5. HOW SHOULD THE RESERVE BANK ENFORCE PRUDENTIAL REGULATION?

5.1 We consider the strategic approach to prudential regulation *should be a matter to be determined by the board of the Reserve Bank.* We do not consider it should be prescribed in legislation. Nor do we consider it should be specified in instruments like a "government policy statement".

5.2 There are several reasons for our view:

a) First, it is standard practice for boards of regulatory agencies to set regulatory strategy. It would be unusual – and require a case to be made – for the board of a regulatory agency to be directed to take *a particular regulatory approach*.
b) Second, if board members are not responsible for regulatory strategy, this will limit the attractiveness of the Reserve Bank board role and is likely to have an adverse effect on the quality of candidates willing to perform the role.
c) Third, prescribing the strategic approach "from above" is likely to reduce the flexibility of the prudential regulatory approach taken by the Bank and the Bank's ability to respond to changing circumstances.

5.3 Finally, in relation to enforcement tools – and as we have argued elsewhere[25] – we agree with the view expressed on p. 97 of consultation document 2B that a civil penalty regime would be more proportionate than criminal liability for breaches of prudential regulatory requirements that do not involve an element of dishonesty.

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[25] See The New Zealand Initiative, "Submission on the then proposed Commerce (Criminalisation of Cartels) Bill (Wellington: 2018).