Submission

By

THE NEW ZEALAND INITIATIVE

to the Finance and Expenditure Committee's

Inquiry on

Banking Competition

25 September 2024

Prepared by:
Dr Eric Crampton, Chief Economist,
Roger Partridge, Chair and Senior Fellow,
and Dr Bryce Wilkinson, Senior Fellow
The New Zealand Initiative
PO Box 10147
Wellington 6143
bryce.wilkinson@nzinitiative.org.nz

1 INTRODUCTION AND SUMMARY

1.1 This submission in response to the Finance and Expenditure Committee (FEC) Inquiry into Banking Competition (the Inquiry)[1] is made by The New Zealand Initiative (the Initiative), a think tank supported primarily by major New Zealand businesses. In combination, our members employ more than 150,000 people.

1.2 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.

1.3 The Initiative's members span the breadth of the New Zealand economy, including banks and companies that use banking services. However, the views expressed in this submission are the views of the author, not those of our members.

1.4 In summary, we submit:

(a) If margins in banking are considered high, or if service to particular sectors is considered poor, and those concerns are motivating this Inquiry, the first question Parliament should ask is why a competitor has not entered or expanded its share of the relevant part of the market. If incumbent banks provide poor service to one sector and providing better services to that sector would be profitable, why has a challenger not done so and taken that part of the market? If profitability is high overall, why has a new entrant not challenged for those profits? If excess profits truly exist, or profitable opportunities for providing better services to particular sectors exist, competitors will seek to take those profits away from incumbents, because those competitors also like profits. If they have not, have regulatory or legislative barriers prevented that entry? Why would profit-seeking overseas banks not enter if profitability is as high as the government seems to believe?

(b) 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 last government dropped efficiency from the over-riding objective statement for banking regulation. That change reduces community well-being to a subsidiary consideration. The over-riding pursuit of financial stability encourages inefficient "gold-plating" financial stability regulation. This raises the cost and reduces the availability of bank credit for borrowers. It invites disintermediation. One option for restoring the primacy of net 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".

(c) An independent review of the RBNZ's prudential regulatory settings, including the December 2019 decision to increase bank capital requirements, is necessary. This review should evaluate whether the benefits of current settings from greater financial system resilience outweigh the potential costs to market competition and economic efficiency.

(d) The Minister of Finance should exercise her Financial Policy Remit (FPR) powers to direct the RBNZ to implement the results of the independent review proposed above. This would provide a mechanism for addressing any harmful effects of the RBNZ's capital decision on lending rates and the economy.

(e) To enhance the governance of prudential regulatory strategy and performance, either:

[1] https://www.parliament.nz/en/pb/sc/make-a-submission/document/54SCFIN_SCF_FC430602-F4C3-4B04-957D-08DCB036CF74/inquiry-into-banking-competition

- the RBNZ's board should be strengthened by appointing board members with prudential regulatory expertise, or
- the RBNZ's prudential regulatory functions should be shifted to a new prudential regulatory agency as in Australia, or
- as a half-way house, the RBNZ should have a new Financial Policy Committee to govern the RBNZ's financial stability function (mirroring the Monetary Policy Committee).

Each option would ensure that prudential regulatory strategies and performance are evaluated by a body with an expert understanding of its potential benefits and costs.

(f) Separating the executive RBNZ 'Governor' role from board membership would improve governance and oversight of prudential regulatory decisions. This separation is consistent with good governance practice, and is the approach taken with the RBNZ's peer regulator, the Financial Markets Authority (**FMA**), with the FMA's CEO not being a member of the FMA board. The separation would enhance the RBNZ's board's ability to independently assess and challenge the RBNZ's regulatory strategy and performance.

(g) Previous studies, including the Productivity Commission's 2014 report and our own surveys in 2017 and 2021, have consistently shown that external monitoring of regulatory agencies like the RBNZ is inadequate. Only 15.4% of respondents in our most recent survey agreed that the RBNZ was readily held to account. The newly established Ministry of Regulation should conduct periodic reviews of the RBNZ's regulatory strategies and performance, with a focus on how prudential regulation affects banking competition and efficiency.

2 *GENERAL OBSERVATIONS RELEVANT TO THE STATE OF COMPETITION IN THE BANKING SECTOR*

2.1 Competition is best understood as a process rather than an outcome. The extent of competition is not best measured by industry concentration or the number of current players, but rather by whether firms face substantial undue barriers to entering the market or expanding within the market.

2.2 To take a simple example, a market with six large firms in which new entrants are forbidden can be less competitive than a market with four larger firms, but where each one knows that entry by any of several far-larger international potential competitors is possible. If entry is forbidden, existing banks might not compete that strongly with each other for market share. If entry is easy, each incumbent must compete against potential international entrants.

2.3 The Reserve Bank has suggested that a 'Financial Stability Frontier'[2] may exist such that more competition is not necessarily desirable. If prudential regulation is very tight and consequently sets very high barriers to entry, the smaller number of incumbent firms could be highly profitable and resilient against financial instability. If prudential regulation is very light and the sector is more competitive, it may be less resilient against economic shocks. The Reserve Bank has provided little reason to believe that it can assess where the New Zealand banking system is in that kind of analysis. We may well be far from the efficiency frontier, with improvements in resilience and competitiveness possible. But the potential for tradeoffs is real.

2.4 Similarly, bank profitability is neither good nor bad in itself. A profitable banking sector is less likely to suffer from banking failures. Incumbent banks are motivated by profits, but so are existing smaller competitors - as well as potential competitors that have not entered

[2] https://www.rbnz.govt.nz/hub/publications/speech/2024/resilience-as-a-pathway-to-prosperity

the market. High incumbent profits in one sector, or in the market overall, if real and durable rather than ephemeral, should spur competitive entry. Canadian, American, and British banks have not been criticised for being averse to chasing down profitable opportunities.

2.5 Three potential explanations seem plausible if banks here are viewed as highly profitable, but large foreign banks have not sought to take those profits from incumbent banks.

2.6 It could be that bank profitability is overestimated, and potential competitors with expertise in banking understand that better than banking regulators or legislators.

2.7 It could be that, even in the absence of substantial regulatory barriers to entry, the up-front cost of establishing a presence in the market and winning customers from existing banks is too high relative to the potential returns. That could be the case if, for example, new banks could not offer substantially superior services to existing incumbents because those incumbents had kept up with service levels abroad.

2.8 Or, it could be the case that incumbent banks are highly profitable and that service to parts of the market or the market overall has been harmed by a substantial lack of competition because large regulatory barriers deter new banks from entering the market to provide better services.

2.9 Adjudicating between those potential explanations would be difficult. However, we note that the shift from in-person banking to online and mobile services vastly reduces real entry costs. A century ago, establishing a bank meant buying a lot of expensive properties and building ornate bank branches: the quality of the bank was partially demonstrated by the weightiness of its real presence. Those real entry costs are gone.

2.10 The only remaining potential barriers to entry are:

(a) Consumer inertia, which is a fancy way of saying that the new entrant's offerings are not worth the depositor's time, which also means that the new entrant's offerings do not offer that substantial an advantage over incumbents' offerings; and

(b) Regulation.

2.11 Regulatory barriers to entry do not have to mean discriminatory processes that explicitly favour incumbents. Simply having very high overall regulatory costs, including the cost of keeping up with numerous inquiries into banking and constantly changing regulatory edicts around capitalisation requirements, risk weights, consumer lending rules, and disclosing and stress-testing portfolio exposure to various types of risks as and when they become politically salient, can suffice. Large established banks have difficulty with these requirements. New competitors would need to reach a relatively large size relatively quickly to find them bearable. A high regulatory burden can sharply restrict competition without having the intention of restricting competition.

2.12 The Commerce Commission's Report on Competition in the Personal Banking Sector (Report) is more enthusiastic than we might be about new entry.[3] The Commission suggests, for example, capitalising Kiwibank to act as a 'maverick disruptor'. It would be excellent if Kiwibank attracted more competitive capital because investors thought it had a product that could attract a lot of business and provide a good return. However, subsidising Kiwibank to provide disruption, rather than expecting it to be able to provide a return on investment, views competition the wrong way around.

[3] Commerce Commission Final Report into Competitition in the Personal Banking Services, (Commerce Commission: Wellington, 20 August 2024).

2.13 Subsidising competitors that otherwise are not viable might help if you think of competition as just counting the number of large banks, but it does not help competition as a market process where the efficient number of competitors is part of what needs to be discovered, and changes through time.

2.14 Instead, easing undue regulatory barriers to entry makes competitive entry more viable for a given level of consumer inertia. It also induces incumbents to compete harder to avoid losing market share to innovative entrants.

2.15 The Commerce Commission's report, in Chapter 7, points to a host of regulatory factors affecting competition. The Committee would do well to consider those issues, while exercising caution about recommendations to subsidise particular competitors. Governments should enable competition by avoiding getting in the way of potential competitors, rather than by subsidising them.

3 'EFFICIENCY' REQUIREMENT SHOULD BE REINSTATED IN RBNZ'S STATUTORY FINANCIAL STABILITY OBJECTIVE

3.1 Until the provisions were repealed in the last Parliament in 2021, the RBNZ's financial stability objective required it to consider the 'efficiency' of its prudential regulatory settings. The requirement was set out in former section 1A(b) of the Reserve Bank of New Zealand Act 1989 (the 1989 Act). Section 1A(b) specified that the RBNZ's high-level financial policy objective was to "Promote the maintenance of a sound *and efficient* financial system" (italics added).

3.2 During the former Labour government's review of the 1989 Act, The New Zealand Initiative repeatedly submitted that the efficiency requirement should be retained.[4] The reason for our submission is that the purpose of all regulation, including financial stability (or 'prudential') 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. Dropping efficiency from the overriding objective statement for prudential regulation would reduce community well-being to a subsidiary consideration.

3.3 Unfortunately, our submissions were not successful. When Parliament passed the Reserve Bank of New Zealand Act 2021 (the 2021 Act), section 9 of the Act provided that the Reserve Bank's "Financial Stability Objective" is one of "protecting and promoting the stability of New Zealand's financial system."

3.4 This was a mistake. It is not a well-being objective; it does not address the need to balance benefits and costs. It elevates the stability of New Zealand's financial system to an end in itself. Yet New Zealanders only want or need financial stability *to the extent it makes them better off.* An over-riding efficiency requirement is needed to ensure this.

3.5 Without such a requirement, the 2021 Act encourages the Reserve Bank into "gold-plating" financial stability regulations, leading, in turn, to unnecessary cost for the banking system and higher costs of banking services for consumers.

3.6 **Recommendation (1): Parliament should amend section 9 of the 2021 Act to reinstate efficiency as an overriding objective of financial stability regulation. One simple way**

[4] See Roger Partridge and Bryce Wilkinson, "Second submission to the Independent Expert Advisory Panel on Phase 2 of the Reserve Bank of New Zealand Act Review" (The New Zealand Initiative: Wellington, 16 August 2019) and Roger Partridge and Bryce Wilkinson, "Third Submission to Treasury and the Reserve Bank of New Zealand on The third consultation round of Phase 2 of the Reserve Bank Act Review" (The New Zealand Initiative, Wellington: 22 October 2020).

of achieving this 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".

4 QUESTIONS REMAIN CONCERNING RBNZ'S FINANCIAL STABILITY (OR 'PRUDENTIAL REGULATORY') SETTINGS

Competition and Prudential Regulatory Settings

4.1 The Commerce Commission's August 2024 report on its market study into personal banking services provides significant insights into how prudential regulatory settings affect competition in the banking sector. The report highlights that "The overall regulatory burden on providers of personal banking services is high" and that this burden "shapes the competitive environment, and it has been a common theme that the extent of regulation is the primary constraint on growing competition."[5]

4.2 The Commission identifies several areas where regulatory settings may be impacting competition. These include the proposed Deposit Compensation Scheme (DCS) levy and policies governing access to the Exchange Settlement Account System (ESAS).[6]

4.3 The Commission also notes that "Regulatory requirements impose substantial fixed costs on market participation, and this is limiting the ability of the smaller banks, NBDTs and fintechs to compete as they do not have the scale of business of the major banks and Kiwibank."[7]

4.4 These findings suggest that various prudential regulatory settings, while aimed at ensuring financial stability, may have the unintended consequence of raising barriers to entry and expansion for smaller providers, thereby limiting competition in the sector.

4.5 The Commission emphasises the need for balance, stating that "An appropriate balance should be struck between financial stability and competition."[8] It further recommends that "the Reserve Bank needs to broaden its competition assessments and place greater focus on reducing barriers to the entry or expansion of smaller providers."[9]

Efficiency and the RBNZ's bank capital requirements

4.6 The RBNZ embarked on its review of bank capital adequacy in 2017. This culminated in the RBNZ's decision in December 2019 to nearly double the levels of capital required to be held by New Zealand's big four trading banks.[10] The total capital requirement for the largest and most systemically important banks was required to increase from a minimum of 10.5% to 18% of risk-weighted assets (RWAs). For smaller banks, the requirement was set at 16%.

4.7 The new capital regime was scheduled to take effect from 1 July 2020, with banks given up to seven years to fully comply with the new requirements (though the implementation timeline was paused for a period during the COVID-19 pandemic).

---

5 Commerce Commission "Personal banking services Final competition report" (20 August 2024),180.

6 Ibid.

7 Ibid.

8 Ibid.

9 Ibid.

10 Reserve Bank of New Zealand, "Capital Review Decision," December 2019, available online at: https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/consultations/banks/review-capital-adequacy-framework-for-registered-banks/decisions/capital-review-decisions.pdf

4.8 The RBNZ's stated aim in deciding to increase bank capital was to make the banking system safer for New Zealanders. Specifically, the RBNZ aimed to reduce the risk of bank failure "so small that the chances of a large bank in New Zealand failing should be no more than once every 200 years."[11]

4.9 The RBNZ's capital requirements are much more stringent than international norms and higher than comparable rates set by the Australian Prudential Regulatory Authority (**APRA**). Indeed, in 2021, S&P Global was reported as describing these requirements as "some of the toughest bank capital standards worldwide". S&P predicted that: [12]

> "[m]eeting the high requirements [would] likely force New Zealand banks to cut riskier exposure, such as loans to smaller businesses, and require billions of dollars in extra funding".

4.10 What is more, as the RBNZ acknowledged during the consultation process and in its final decision, the increase in bank capital would not come without cost and, specifically, would lead to:[13]

"an increase in the interest rates that banks charge their customers."

4.11 The reason why the RBNZ's decision to increase bank capital leads to increased interest rates for customers is straightforward. If banks in New Zealand are required to hold relatively more capital to support their lending activities than elsewhere in the world, they will need to increase net interest margins to fund their increased capital cost. Higher interest-rate margins to fund higher bank capital requirements mean higher interest rates for borrowers, lower interest rates for depositors, or both. To the extent that the higher capital is overseas owned that transfer reduces national income directly.

4.12 The RBNZ's April 2019 "Capital Review Paper" estimated that for every 1% rise in bank Tier 1 capital, lending rates would increase by 8.1 points.[14] With the proposal involving a near doubling of banks' Tier 1 capital, these estimates suggested expected increases in lending rates of 20 to 40 basis points.

4.13 When lending margins increase, it is not just bank customers who suffer. So, too, does the economy as interest-sensitive spending falls. The RBNZ acknowledged GDP might fall by as much as 0.32 per cent a year.[15] Other commentators put the annual negative effects on GDP as high as 1 per cent.[16]

---

11 Reserve Bank of New Zealand, "Go-to-Guide," December 2019, available online at https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/consultations/banks/review-capital-adequacy-framework-for-registered-banks/decisions/capital-review-guide.pdf

12 Ranina Sanglap and Zia Khan "World's toughest capital requirements in New Zealand may squeeze credit" S&P Global online, 8 August 2021.

13 Reserve Bank of New Zealand, "Capital Review Decision," December 2019, op. cit. 2.

14 Reserve Bank of New Zealand, "Capital Review Background Paper: An outline of the analysis supporting the risk appetite framework," April 2019, available online at https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/consultations/banks/review-capital-adequacy-framework-for-registered-banks/capital-review-an-outline-of-the-analysis-supporting-the-risk-appetite-framework.pdf

15 Ibid. 36.

16 See, for example, Jenny Ruth, UBS doubles down on impact of RBNZ bank capital requirements," Scoop Business, 27 February 2019.

4.14 While no one would want an unstable financial system, the Reserve Bank's proposals to double banks' capital were met with a barrage of criticism.[17] Much of this, including from The New Zealand Initiative, focused on the absence of a rigorous cost-benefit analysis by the RBNZ ahead of its decision to advance the proposal.[18]

4.15 Other critics pointed out that New Zealand's banks had been subject to regular stress testing and had always come through with flying colours. They also pointed to the lack of evidence to support the RBNZ's desire to reduce the risk of bank failure to a one-in-200-year event.

4.16 The criticisms raised a crucial issue. How much prudential regulation is too much? The RBNZ's approach was born of a single-minded focus on financial stability. However, financial stability is not an end in itself. The purpose of banking regulation – indeed, of all regulation – should be to make the community better off than it otherwise would be.

4.17 Despite these concerns, in its December 2019 decision, the RBNZ concluded that the benefits of increased resilience in the financial system would exceed the costs associated with higher capital requirements. These conclusions were supported by an internally-commissioned peer review process – though this process was not without its critics.

4.18 The RBNZ duly implemented its decision, giving the banks seven years to reach the new capital levels. This process is underway – though it was paused during the COVID-19 pandemic. (It is noteworthy that a decision to increase bank capital to reduce the risk of bank failure to a one-in-200-year event was sacrificed in the interests of freeing up bank lending during one of the biggest economic shocks of the last century).

4.19 Our own conclusion on the RBNZ's cost-benefit analysis is that it does not make a sufficiently robust case for the scale of the change proposed by the RBNZ. Specifically:

- The counterfactual appears to assume that the failure of one major bank represents a systemic failure of the entire banking system. We did not find an adequate explanation of why parent shareholder's strength, statutory management powers and 'hair-cut' arrangements would be ineffectual.
- The parameter values used in the modelling are essentially 'heroic' estimates taken from overseas empirical work based on other countries whose institutional differences structurally, and institutionally might be very different
- There needed to be more explicit consideration of what countries like Canada and Australia deem to be prudent regulation. These two countries, like New Zealand, have nothing like the bank failure record of the US.
- The analysis should also have explained why other options were not identified and evaluated. Why was only one alternative to the status quo assessed?

4.20 Having regard to the following factors, we consider it would be appropriate for the RBNZ's 2019 bank capital decision to be independently reassessed:

---

17 Particularly noteworthy is the critical submission in 2019 by former RBNZ risk assessment expert Ian Harrison, Tailrisk Economics, The 30-billion-dollar whim: A review of the Reserve Bank consultation paper: "How much capital is enough".

18 Roger Partridge, "Submission to the Reserve Bank of New Zealand on The Review of the Capital Adequacy Framework for Locally Incorporated Banks: How Much Capital is Enough," (The New Zealand Initiative: Wellington, 16 May 2019).

- the RBNZ's capital decision having been made nearly five years ago, meaning subsequent information about the effects on bank lending rates and the availability of credit can now be evaluated;
- the reservations we have expressed above about the RBNZ cost-benefit assessment; and
- no other central banks – including APRA – having followed the RBNZ's lead.

4.21 **Recommendation (2): The FEC should recommend to the Minister of Finance that an independent review be undertaken of the RBNZ's prudential regulatory settings and, in particular, of the December 2019 decision to increase bank capital requirements.**

5 ROLE OF MINISTER OF FINANCE IN FINANCIAL STABILITY SETTINGS

5.1 The extent of the RBNZ's operational independence in relation to monetary policy is widely understood. The Monetary Policy Remit (MPR) process, which replaced the former Policy Targets Agreement, provides a framework for setting monetary policy objectives while maintaining the RBNZ's operational independence.

5.2 Under this process, the Minister of Finance issues a remit to the Monetary Policy Committee (MPC) that specifies the operational objectives for monetary policy, including the inflation target range. The MPC then has full operational independence to set monetary policy to achieve these objectives.

5.3 The RBNZ is less operationally independent in relation to financial stability policy (i.e. prudential regulation). And rightly so. Unlike the RBNZ's monetary policy role, financial stability regulation, like the power to tax, warrants a high degree of political oversight. This is not just because a banking crisis could require costly government intervention. More fundamentally, it would be unusual for the Parliament to delegate regulation-making powers without oversight when those powers can significantly impact GDP. The far-reaching social and economic consequences of prudential decisions demand democratic accountability.

5.4 The Financial Policy Remit (FPR) process under section 49 of the 2012 Act allows for this political oversight of the RBNZ's financial stability and prudential regulation functions. Under the FPR, the Minister of Finance can specify matters for the RBNZ Board to "have regard to" when setting financial stability policies, including prudential requirements like capital ratios.[19]

5.5 The contents of the FPR may include matters that the Minister of Finance considers desirable for the RBNZ Board to have regard to in pursuing financial stability objectives, furthering prudential legislation purposes, and performing prudential regulation and supervision functions.[20] It can cover government policy objectives for the financial system, risks or challenges deemed relevant by the Minister, and guidance on how the RBNZ should consider and explain its consideration of specified matters. This structure allows the Minister to provide input on financial stability policy, including aspects like capital ratios, while preserving the RBNZ's operational independence in implementing specific prudential standards and regulations.

---

19 See section 49, 2021 Act. Section 49 replaced section 68B of the 1989 Act, which provided that "The Minister may direct the [RBNZ] to have regard to a government policy that relates to the [RBNZ's prudential regulatory functions.]

20 See section 204, 2021 Act.

5.6 This means the Minister could, in theory, indicate a preference for a certain level of risk tolerance in capital requirements that the RBNZ board "must have regard to" when setting prudential regulatory requirements. For example, this could specify that the Minister considers it desirable for the Reserve Bank Board to have regard to international norms for bank capital adequacy when setting prudential capital requirements. Alternatively, the minister could specify that it was desirable for the banking system to aim for a level of resilience consistent with withstanding a one-in-100-year stress event rather than a one-in-200-year event.

5.7 Consequently, FPR could provide a mechanism for undoing the harmful effects of the RBNZ's December 2019 capital decision on lending rates and the economy.

5.8 **Recommendation (3): Subject to the outcome of the independent review proposed in section 4 above, the Minister of Finance should exercise her FPR powers to direct the RBNZ to implement the results of the independent review.**

6 RESERVE BANK'S GOVERNANCE SHOULD BE STRENGTHENED

6.1 The Initiative's recommendations for strengthening the governance of the RBNZ were partially implemented by the Labour-led government when it enacted the 2021 Act.

6.2 However, serious shortcomings in the RBNZ's governance remain. These include the RBNZ board's lack of prudential regulatory expertise, the Governor's membership of the RBNZ board, and lack of effective external monitoring of the RBNZ's performance as prudential regulator.

6.3 If these shortcomings were addressed, we could expect substantial improvements in the RBNZ's performance of its financial stability objectives, leading to better outcomes for consumers and the economy.

6.4 In our 2018 report, *Who Guards the Guards? Regulatory Governance in New Zealand*, we recommended: [21]

(a) legislative reforms that make the RBNZ Governor accountable to the RBNZ board for the exercise of prudential regulatory policymaking and decision-making power;

(b) broadening the skill set of the RBNZ board to include more banking and insurance expertise;

(c) tasking an agency with appropriate expertise to undertake periodic (we suggested three-yearly) reviews on the regulatory strategies and performance of the RBNZ, along with the two other all-of-economy economic regulators, the Commerce Commission and the Financial Markets Authority; and

(d) an independent agency should be created to ensure all appointments to regulatory agency boards, including the RBNZ board, are subject to independent scrutiny and standardised processes.

6.5 Our recommendations were built on the research of the New Zealand Productivity Commission in its 2014 report, Regulatory Institutions and Practices, a review of the academic literature relating to the governance and performance of regulatory agencies and quantitative research on the performance of New Zealand's major regulators.

[21] Roger Partridge and Amy Thomasson, ''Who Guards the Guards? Regulatory governance in New Zealand,' (The New Zealand Initiative: Wellington, 2018), 75-79.

Shortcomings in RBNZ board governance

6.6 The first recommendation was implemented by the reforms introduced by the 2021 Act. The RBNZ's prudential regulatory powers to achieve its financial stability objective are now conferred by the 2021 Act on the RBNZ board. Under the 1989 Act, the powers were conferred directly on the Governor. Accordingly, the board now has overall responsibility for prudential regulatory strategy and is tasked with holding the Governor to account for its implementation.

6.7 However, we consider there continue to be shortcomings in the RBNZ's governance arrangements.

6.8 First, the RBNZ board does not have members with recognised prudential regulatory expertise. This is a serious omission. Prudential regulation is a complex, specialised field. It is unlikely that the board will be able to effectively perform its governance role of overseeing the development of the RBNZ's prudential regulatory strategy or its implementation without this expertise.

6.9 There are three options available to address the RBNZ's lack of prudential regulatory governance expertise.

6.10 First, the RBNZ's board could be strengthened by appointing board members with the relevant expertise.

6.11 Second, the government could follow the Australian model, and remove responsibility for prudential regulation from the RBNZ and place it in new APRA-like prudential regulatory agency. This was the recommendation we made in our 2023 Briefing to the Incoming Government, *"Prescription for Prosperity."*[22]

6.12 Third, the Government could consider appointing a 'Financial Stability Committee' to exercise control over financial stability policy in the same way as the 'Monetary Policy Committee' has responsibility for the RBNZ's monetary policy objectives. This would provide an opportunity to add to the RBNZ's governance arrangements experts with acknowledged expertise in prudential regulation.[23]

6.13 Such an arrangement would provide a pragmatic halfway house to Australia's approach of placing financial stability/prudential regulatory functions into a standalone, separately governed entity, APRA. The UK's Prudential Regulation Committee of the Bank of England is a good example of this halfway house approach.

6.14 This half-way house option was discussed by Treasury in its 19 July Reserve Bank Act Review Phase 2 Second Consultation Information Release.[24] In its discussion, Treasury noted as "potential way forward", not forming a Financial Stability Committee" (described at the time by Treasury as a "Financial Policy Committee" or "FPC") *at that stage* and instead leave it as a future option should the board not deliver on expectations. In Treasury's prophetic words:[25]

---

22 Prescription for Prosperity: Briefing to the Incoming Government (The New Zealand Initiative: Wellington, August 2023) 21: https://www.nzinitiative.org.nz/reports-and-media/reports/prescription-for-prosperity-2023-briefing-to-the-incoming-government.

23 For a discussion of this latter proposal, see Andrew Body and Simon Jensen, "Banking Report: Time for the Reserve Bank to Look in the Mirror," BusinessDesk, 4 April 2024.

24 Reserve Bank Act Review Phase 2 Second Consultation Information Release" (The Treasury: Wellington, July 2019): https://www.treasury.govt.nz/sites/default/files/2019-07/rbnz-p2-4092708.pdf.

25 Ibid. 3.

- *One way forward is to take an in-principle decision not to establish an FPC at this time and to communicate this decision in the June consultation (with the consultation focusing on the consequential elements of Board design). An FPC could be established in future should the Board not deliver on expectations.*

- *In the absence of an FPC, it would be important to ensure that the new Board is equipped and incentivised to take significant financial policy decisions and provide rigorous oversight of financial policy framework and the exercise of delegated powers. An effective board model will be dependent upon apolitical and highly competent appointees.*

6.15 **Recommendation (4): The FEC should recommend to the Minister of Finance that either:**

- **the RBNZ's board should be strengthened with the appointment of board members with acknowledged prudential regulatory expertise; or**

- **the RBNZ's prudential regulatory functions should be transferred to a new, prudential regulatory agency modelled on APRA in Australia; or**

- **the RBNZ's prudential regulatory powers should be conferred on a new Financial Policy Committee, mirroring the RBNZ's Monetary Policy Committee.**

6.16 To improve governance of the RBNZ, the Governor should not be a member of the RBNZ board. Removing the Governor from the board aligns with the separation of executive and non-executive roles.[26] This separation is consistent with good governance practice. It is the approach taken with the RBNZ's peer regulator, the FMA, with the FMA's CEO not being a member of the FMA board

6.17 This structure would:

- Enhance the board's capacity to objectively scrutinise the RBNZ's performance.

- Create a clearer distinction between the board's governance role and the Governor's executive function.

- Reduce potential conflicts of interest, as the board is responsible for holding the Governor accountable for implementing the bank's policies and strategies. The current structure, with the Governor as a board member, compromises the board's ability to provide independent oversight and challenge management decisions effectively.

- Improve risk management.

6.18 By implementing this change, the RBNZ would strengthen its governance framework, potentially leading to more robust decision-making processes and improved accountability.

6.19 **Recommendation (5): Under reformed RBNZ's governance arrangements, the Governor should cease to be a member of the RBNZ board. This is desirable to separate governance from executive functions within the RBNZ.**

Strengthening external governance of RBNZ

6.20 In the corporate world, shareholders and analysts play an important role in externally monitoring company performance. For regulatory agencies, this role is undertaken by a mix

26 See for example, Council on Foundations, "CEOs On Boards," available online at https://cof.org/sites/default/files/documents/files/CEOs%20On%20Boards.pdf

of government departments, ministers and Parliament.[27] The public sector has its own extensive accountability mechanisms.

6.21 Yet in its 2014 report, Regulatory Institutions and Practices, the Productivity Commission found that external monitoring of regulatory agencies has serious shortcomings.[28] In particular, the Productivity Commission found monitoring was too focused on procedural compliance, with too little focus on strategic performance.[29]

6.22 In *Who Guards the Guards,* we reported on the results of a survey of New Zealand's major companies conducted in 2017, asking them about the performance of regulatory agencies, including the RBNZ. We repeated that survey in 2021 and reported on it in our 2022 report, *Reassessing the Regulators: The Good, the Bad and the Commerce Commission*.[30] Our surveys asked respondents to evaluate regulators against 23 key performance indicators (KPIs). The KPIs ranged from consistency of decision-making to commercial expertise and from clarity of objectives to learning from mistakes.

6.23 Both surveys confirmed the Productivity Commission's findings that external monitoring and accountability of the major commercial regulators, including the RBNZ, was comparatively poor. In our 2021 survey, only 21.8% of respondents agreed or strongly agreed that regulators are readily held to account for the quality of their work by responsible government departments, Ministers or some other effective external accountability mechanism. This was the lowest rating across the 23 KPIs.

6.24 In the RBNZ's case, only 15.4% of respondents agreed that the RBNZ was readily held to account. This compared, for example, to 73.3% of respondents agreeing that the RBNZ communicates clearly.

6.25 As we observed in *Who Guards the Guards*, it should not be surprising that external monitoring and accountability of regulators like the RBNZ is considered to be poor. Regulatory regimes like the RBNZ's prudential regulatory functions, are complex. Specialist expertise is needed to evaluate them. Government departments cannot expect to replicate the expertise of a specialist regulatory agency like the RBNZ. This means government departments have only limited means to monitor the effectiveness of the RBNZ's strategic approach to regulation.

6.26 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. The government did not accept this recommendation. In *Who Guards the Guards*, we doubted its effectiveness in any event.[31] 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.

6.27 Because of the difficulties of justifying a new specialist agency to monitor a single regulator's performance – even one as important as the Commerce Commission – in *Who Guards the Guards* we suggested that the Productivity Commission itself could be tasked

---

27 Productivity Commission, "Regulatory Institutions and Practices", (Wellington: Productivity Commission, 2014) 17.

28 Ibid. 353.

29 Ibid.

30 Roger Partridge, "Reassessing the Regulators: The Good, the Bad and the Commerce Commission," (The New Zealand Initiative: Wellington 2022).

31 Ibid. 77.

with undertaking, say, three-yearly reviews of the strategies and substantive performance of the RBNZ, 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.

6.28 Parliament has taken no steps to advance this recommendation. However, recently the Australian Federal Parliament has taken steps to strengthen the external monitoring of that country's equivalent of the FMA and RBNZ (as prudential regulator). The Financial Regulator Assessment Authority Act 2021 creates and tasks the Financial Regulator Assessment Authority with biannual assessments of the effectiveness and capability of the Australian Securities and Investments Commission (ASIC) and APRA. The Authority is also required to undertake ad hoc assessments on any matter relating to APRA's, or ASIC's, effectiveness and capability when requested by the Minister.

6.29 The recent establishment of the Ministry of Regulation presents an opportunity to address the longstanding need for effective external monitoring of regulatory agencies like the RBNZ.

6.30 Given its mandate to improve the quality of regulation and regulatory systems across government, the Ministry of Regulation could be well-suited to undertake the periodic reviews we have recommended. Its whole-of-government perspective and focus on best regulatory practices position it to provide the kind of strategic performance assessment that has been lacking.

6.31 By tasking the Ministry of Regulation with conducting regular (e.g., triennial) reviews of the RBNZ's regulatory strategies and performance, we could create a robust external accountability mechanism without the need to establish a new specialist agency. This approach would leverage existing expertise and resources while ensuring that the RBNZ's prudential regulatory functions are subject to rigorous, external scrutiny.

6.32 **Recommendation (6): The government should task the Ministry of Regulation with conducting periodic (e.g., triennial) reviews of the RBNZ's regulatory strategies and performance in its prudential regulatory functions. These reviews should assess the effectiveness, efficiency, and strategic direction of the RBNZ's approach to financial stability regulation, with findings reported to Parliament to ensure transparency and accountability.**

25 September 2024

The New Zealand Initiative