

Coversheet: A New Institutional Framework for the Reserve Bank

Advising agencies	The Treasury
Decision sought	Key policy decisions on a new institutional framework for the Reserve Bank
Proposing Ministers	Hon Grant Robertson, Minister of Finance

Summary: Problem and Proposed Approach

Problem Definition	What problem or opportunity does this proposal seek to address? Why is Government intervention required?
	<p>Elements of the current institutional arrangements for the Reserve Bank of New Zealand (the Reserve Bank) do not align with modern best practice in terms of governance arrangements, accountability, and clarity of objectives. Additionally, institutional arrangements relating to financial policy do not provide the right balance between the Reserve Bank’s operational independence and accountability to elected decision makers.</p> <p>Government intervention is required to address these problems because they stem from existing settings in the Reserve Bank of New Zealand Act 1989 (the Act).</p>

Proposed Approach	How will Government intervention work to bring about the desired change? How is this the best option?
	<p>The proposal is to update existing arrangements rather than to create new impositions or entities. This update will be put in place by creating new standalone legislation constituting the Reserve Bank, aligned with modern legislative practice (the Institutional Act). These reforms should improve the overall effectiveness of the Reserve Bank in carrying out its functions, with long-term economic and financial stability benefits for New Zealand.</p> <p>The Treasury makes the following recommendations in relation to key elements of the legislation:</p> <ul style="list-style-type: none"> • the Reserve Bank should retain responsibility for prudential regulation • the Reserve Bank should have a governance and decision-making board • the Reserve Bank’s institutional framework should be similar to that of an Independent Crown Entity, with different arrangements for the appointment of the Governor, provision for a Financial Policy Remit, and continuation of the Monetary Policy Committee; • the Reserve Bank’s financial policy objective should be to protect and promote the stability of New Zealand’s financial system, and • the Reserve Bank’s expenditure should be subject to a funding agreement with the Minister of Finance, with provision for introducing a levy and fees for regulatory functions and specified services. <p>A new prudential regulatory regime for deposit takers will be established under a separate, subsequent piece of legislation.</p>

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

While the changes proposed aim to strengthen the Reserve Bank’s institutional framework (rather than directly changing regulatory requirements), we expect that there will be benefits to the financial sector and the public due to improvements in the Reserve Bank’s effectiveness in carrying out its functions. In particular, improving the clarity of the Reserve Bank’s objectives, and governance and accountability arrangements should contribute to the promotion of financial stability. Even if the contribution of the proposals considered in this RIA to financial stability is small, this needs to be considered against the significant cost of financial crises. Indeed, studies show financial crises can permanently lower economic output by between 20 and 160 percent of GDP.¹

Where do the costs fall?

To the extent that the proposed changes to the Reserve Bank’s governance, objectives and accountability arrangements increase its operating costs, future dividends to the Crown may be reduced. The proposed levying power for the Reserve Bank’s prudential functions, if implemented, would shift costs from taxpayers (through dividend increases) to regulated entities. The costs directly associated with changes to the Reserve Bank’s institutional arrangements have not generally been quantified as they are not expected to be significant and are generally not a determining factor in assessing appropriate institutional arrangements for the Reserve Bank. It should also be noted that costs associated with changes to the prudential regulation of deposit takers will be considered separately.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?

The Act, and the overall system that the Reserve Bank operates in, are complex, and the proposed changes are part of a large-scale package of related reforms. The proposals involve significant changes to the Reserve Bank’s overall institutional framework. There are risks associated with striking an appropriate balance between the Reserve Bank’s operational independence, and oversight by, and accountability to, elected decision makers. These risks are mitigated through two rounds of public consultation, reliance on domestic and international best practice, and by explicitly considering these factors when evaluating policy options. Furthermore, given the significant level of change and some novel features of the model, the new board is likely to require some time to trial alternative operating approaches before optimal working arrangements are settled on.

The timeframe for these reform is tight. The Government intends to introduce a bill progressing the institutional reforms by mid-2020. These time pressures, as well as the extensive interactions with other reforms, mean there is a greater risk of errors and unintended consequences. These risks are being mitigated by close interagency cooperation, including with the Reserve Bank and with the Parliamentary Counsel Office.

Identify any significant incompatibility with the Government’s ‘Expectations for the

¹ <https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Policy-development/Banks/Review-capital-adequacy-framework-for-registered-banks/Capital-Review-An-outline-of-the-analysis-supporting-the-risk-appetite-framework.pdf?revision=058df82e-5fc8-4e4c-9431-5f2dff5aa4a&la=en>

design of regulatory systems’.

No significant incompatibilities with the Government’s ‘Expectations for the design of regulatory systems’ have been identified.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
<p>Overall, there is good, but not conclusive, evidence for the proposed reforms. The analysis is based on organisational theory and the incentives created by different appointment, reporting and accountability provisions. Proposed reform is also informed by our practical experience of Crown entities and other regulators internationally. We have drawn heavily on reviews of good regulatory and governance practice, such as:</p> <ul style="list-style-type: none"> • the International Monetary Fund’s 2017 Financial Sector Assessment Programme (FSAP) of New Zealand; • the Productivity Commission’s 2014 <i>Regulatory Institutions and Practices</i> inquiry • the State Service Commission Crown entities guidance; • reports into general governance good practice, such as the Financial Markets Authority’s Corporate Governance Handbook; • the Government Expectations for Good Regulatory Practice; • the Legislation Design and Advisory Committee’s Legislation Guidelines • input from relevant specialists at the Reserve Bank, Treasury, State Services Commission and other agencies; • a review of international institutional arrangements for central banks and prudential regulators; • engagement meetings and workshops with domestic and international stakeholders and relevant experts; and • formal feedback from submitters through two rounds of public consultation. <p>While there is not a prescriptive set of arrangements that will be suitable for every entity, there are established principles and examples of good practice.</p> <p>The proposals have been informed by advice and input from an Independent Expert Advisory Panel.</p>

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
A Quality Assurance Panel with representatives from the Ministry of Business, Innovation & Employment and the Treasury has reviewed the ‘A New Institutional Framework for the Reserve Bank’ Regulatory Impact Assessment (RIA) produced by the Treasury and dated November 2019.
Quality Assurance Assessment:
The Panel considers that the RIA meets the Quality Assurance criteria.
Reviewer Comments and Recommendations:
The RIA is generally clear and concise. The analysis has been well-consulted, and the trade-offs between, and rationales for, options are complete and convincing within the confidence limits of some of the evidence. The level of uncertainty in some evidence means that the monitoring and review arrangements signalled in the RIA will be important for ensuring that the Government’s objectives are achieved.

Impact Statement: A New Institutional Framework for the Reserve Bank

Section 1: General information

Purpose

This analysis and advice has been produced to inform key policy decisions to be taken by Cabinet on the future institutional arrangements for the Reserve Bank.

The Treasury is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment (RIA), except where explicitly mentioned. The Treasury’s analysis is based on Phase 2 of the Review of the Reserve Bank Act (the Review), which is being jointly led by the Treasury and the Reserve Bank. An Independent Expert Advisory Panel has been established to inform and test the Review’s recommendations.

Where the Reserve Bank or the Independent Expert Advisory Panel do not concur with the analysis, as presented in this RIA, this has been noted.

Key Limitations or Constraints on Analysis

Scoping of the problem

- While Phase 2 of the Review has considered the institutional arrangements of the Reserve Bank on a first principles basis, it is limited to considering options in line with its [terms of reference](#). This constraint primarily relates to the extent to which the Reserve Bank's regulatory functions are reviewed and places few constraints in relation to the proposed Institutional Act.
- Phase 2 of the review is not revisiting [decisions made as part of Phase 1](#) relating to monetary policy, except where consequential changes are required.
- The problem considered in this RIA has been broken down into five discrete issues, each with its own options analysis, to allow for the broad range of different issues and options to be worked through in a logical manner. The analysis of some issues necessarily assumes that a particular approach has been taken to earlier, more fundamental issues.
 - E.g. the analysis of Issue 2, which examines the Reserve Bank's governance and decision-making structures, assumes that the Reserve Bank will retain institutional responsibility for prudential regulation (the preferred response to Issue 1).

Evidence of the problem

- Evidence of the problem in relation to the Reserve Bank's institutional arrangements inherently relies on subjective assessments of the impact of the current settings on its decision-making and performance over time.
- We engaged extensively with stakeholders at the start of the review process to understand better the nature of any concerns they had about the Reserve Bank Act. This informed the scope of our terms of reference.
- We have sought to strengthen this evidence by drawing on analysis of best practice, domestically and internationally, and its appropriate fit for the Reserve Bank.
- Multiple rounds of public consultation and a large number of stakeholder workshops, as well as input from an Independent Expert Advisory Panel, have helped to test our understanding of the problem, providing a broad range of perspectives on these issues.

Range of options considered

- Potential responses to topics have been grouped together into packages of potential changes in order to allow for coherent and efficient analysis of policy options. While a wide range of variations on these packages could be considered, the proposed packages are the most internally consistent responses to the issues considered.
- While we have considered non-regulatory options where relevant (e.g. operational improvements), generally regulatory solutions are necessary because the problems this review is endeavouring to solve stem from the Reserve Bank's existing institutional settings in the Act.
- The range of options has also been constrained in light of the established need for central banks and prudential regulators to retain a significant degree of independence from Ministers, particularly in relation to monetary policy and the operations of regulatory functions.

Criteria used to assess options

- While there is no prescriptive set of arrangements that will be suitable for every

entity, there are established principles and examples of good practice.

- We have assessed options based on a multi-criteria analysis framework, with criteria determined for each issue examined. We have generally not sought to establish formal weightings for these criteria, with the preferred option reflecting a judgement about which option is likely to achieve best an appropriate balance of the selected criteria. Where criteria have been given a higher weighting, (in relation to *Issue 4*) this has been noted.

Assumptions and quality of data underpinning impact analysis

- We have generally not sought to quantify costs and benefits due to the difficulty of doing so in relation to changes to governance and other institutional arrangements. Assessments reflect a judgement about the relative impact of options against the established criteria.
- Much of the analysis outlined in this RIA was formally consulted on in two rounds, providing an opportunity for stakeholders to challenge our assumptions and analysis.

Consultation and testing

- All significant issues and proposals considered in this RIA have been publicly consulted on and discussed directly with interested stakeholders.

Responsible Manager (signature and date):

Tamiko Bayliss
Director
Reserve Bank Act Review – Phase 2

Section 2: Overall context

2.1 What is the context within which action is proposed?

The Reserve Bank of New Zealand (Te Pūtea Matua) is New Zealand’s central bank and prudential regulator. It formulates and implements monetary policy, registers and licenses entities to promote a sound and efficient financial system, and has the sole right to issue currency in New Zealand. It is now 30 years since the Reserve Bank Act has been substantively reviewed. Phase 1 of the current review addressed aspects of monetary policy, resulting in amendments to the Reserve Bank Act in 2018. Phase 2 is addressing further aspects of governance and financial policy.

The Reserve Bank was first established in 1934 as New Zealand’s central bank, centralising the issuing of bank notes (which had previously been issued by individual trading banks). While the Reserve Bank was initially partially privately owned, it was nationalised shortly after its establishment. The responsibilities of the Reserve Bank have varied over time, with significant reforms in the 1980s giving it operational independence from Ministers and establishing the Policy Targets Agreement model for monetary policy. These reforms established the basis for the Reserve Bank’s role in the prudential regulation of banks, but its approach was comparatively minimalist compared to international practice today, with significant reliance on self-discipline and market discipline.

In the time since the Act was passed, there have been many changes to the economy and the financial sector globally. Financial institutions have grown in size relative to the global economy and in the range of financial services that they offer. As a result, the global financial system is larger and more interconnected than in 1989.

The regulation of financial markets has come under extensive scrutiny following the global financial crisis (GFC). The GFC highlighted vulnerabilities in New Zealand’s financial system and regulatory settings. In particular, it highlighted risks associated with banks’ dependence on short-term wholesale funding, which was unavailable for a period at the height of the crisis. Financial regulation has responded to these changes on an international scale. The pace of change has increased over the last ten years as most advanced countries undertook significant reforms. At the same time, international standards have been developed that increase the attention given to consistency and comparability across jurisdictions. The Reserve Bank has responded to these changing global expectations by also increasing the intensity of its regulatory framework.

The failure of a large number of non-bank deposit takers in the 2000s also highlighted shortcomings in the disclosure regime and in their oversight by trustees. Standards for insurers have similarly been increased.

Extensive changes were subsequently made to financial sector regulation in New Zealand, in particular through:

- making the Reserve Bank the prudential regulator of non-bank deposit takers through amendments to the Reserve Bank Act, and then through the Non-Bank Deposit Takers Act 2013 (NBDT Act)
- making the Reserve Bank the prudential regulator and supervisor of insurers under the Insurance (Prudential Supervision) Act 2010 (IPS Act)

- the establishment of the Financial Markets Authority (FMA), to replace the Securities Commission
- reform of conduct and disclosure requirements through the Financial Markets Conduct Act (FMC Act) and associated legislation, and
- changes to Conditions of Registration for banks, such as changes to liquidity, funding and capital requirements, and the introduction of macro-prudential tools.

The counterfactual assumes no changes to the institutional arrangements of the Reserve Bank beyond those implemented through Phase 1 of the Review.

2.2 What regulatory system, or systems, are already in place?

The Reserve Bank Act 1989 (the Act) establishes the Reserve Bank as a body corporate responsible for:

- Monetary policy: The maintenance of price stability and support of maximum sustainable employment through the setting of the Official Cash Rate (OCR), which is reviewed around seven times a year.
- Issuing currency: The Reserve Bank is the only organisation authorised to issue currency for New Zealand. Banks buy currency in wholesale amounts from the Reserve Bank at face value and return it to the Reserve Bank for replacement.
- Financial markets operations: The Reserve Bank holds and manages foreign exchange reserves. The Bank also operates in New Zealand’s domestic markets to implement its monetary policy objective and provide liquidity to the banking system.
- Payments and settlements: The Reserve Bank oversees and operates New Zealand’s wholesale payment and settlement systems – the Exchange Settlement Account System (ESAS) and the NZClear system, which financial institutions use to complete transactions with each other.
- Registration and prudential regulation of banks: In order to help maintain a sound and efficient financial system, the Reserve Bank registers and monitors banks and requires them to meet criteria, such as relating to capital adequacy, liquidity and risk management. This includes macro-prudential requirements, such as lending standards, which aim to manage systemic risks.

More generally, the Reserve Bank is responsible for the prudential “peak” in New Zealand’s “twin peaks” financial markets regulatory system (as discussed in section 3.1.1). FMA is responsible for financial markets conduct issues (other than in relation to consumer credit, which is regulated by the Commerce Commission). Financial markets regulators and policy agencies coordinate through the Council of Financial Regulators (CoFR), which is a non-statutory body.

The role of the Reserve Bank expanded over the late 2000s to include oversight of insurers and non-bank deposit takers. The scope, focus, and intensity of regulation and supervision have also evolved over the last 30 years, enabled by the flexibility provided by the current

statutory framework. Change to the statutory framework has occurred through a series of separate, targeted amendments rather than through a comprehensive review.

Reserve Bank Act Review – Phase 1

In November 2017, the Government announced it would undertake a Review of the Act to modernise the monetary and financial stability policy framework and the Reserve Bank's governance and accountability settings. The Review has been split into two phases, with Phase 1 focusing on high-priority improvements to the monetary policy framework. Phase 1 was completed in 2018 and resulted in:

- amendments to monetary policy objectives – targeting maximum sustainable employment alongside price stability as a monetary policy objective, and
- the establishment of a Monetary Policy Committee (MPC) to make decisions on monetary policy.

Reserve Bank Act Review – Phase 2

Phase 2 of the Review is a wide-ranging review of the financial policy provisions of the Act (including the legislative basis for prudential regulation, supervision, and crisis management) as well as the broader governance arrangements for the Reserve Bank. Work on Phase 2 is being led by a joint Review team of Reserve Bank and Treasury staff.

The International Monetary Fund's (IMF) Financial Sector Assessment Programme (FSAP) for New Zealand in 2017 provided a starting point for aspects of the Review. The IMF highlighted that a significant amount of progress had been made since the last FSAP in 2004. Notwithstanding this, the IMF recommended an increase in the Reserve Bank's resources for supervision and regulation, steps to strengthen cooperation with Australian authorities, and clarifications of responsibilities to reinforce the role and autonomy of the Reserve Bank as prudential regulator and supervisor.

An initial scoping exercise at the start of the review process helped the joint Review to understand the nature of some of the problems industry saw with current arrangements. This exercise, which informed the terms of reference for Phase 2 of the Review, highlighted the need for a comprehensive review of the Act, with feedback focussing on decision-making and governance arrangements, prudential regulation and supervision, and resolutions and crisis management.

The Review has subsequently involved two rounds of public consultation as well as targeted meetings and workshops with key stakeholders. The consultation papers and accompanying background material can be found [here](#). This consultation has covered the key policy issues relating to the governance of the Reserve Bank and the prudential framework for banks and other deposit takers. The Review received submissions from a range of stakeholders as part of this process, including individuals, regulated entities, industry or advocacy bodies, and consultancy and law firms.

Amendments to the Reserve Bank's legislative framework are now being progressed in two parts:

- An “**Institutional Act**”, which will establish the Reserve Bank's governance, decision-making and accountability arrangements, as well as its central bank functions. The

key policy decisions being sought as part of this new Act are the subject of this Regulatory Impact Assessment.

- A “**Deposit Takers Act**”, which will establish a single prudential regulatory regime for deposit takers, consolidating and reforming the regulation of banks and non-bank deposit takers. The Deposit Takers Act will progress after the Institutional Act, with final policy decisions expected to be sought in mid-2020.

2.3 Are there any constraints on the scope for decision-making?

The following matters are outside of the scope of the Phase 2’s [terms of reference](#):

- Fundamental change to the New Zealand-Australian home-host relationship², whereby the Australian Prudential Regulation Authority (APRA) becomes the sole regulator and supervisor of Australian-owned banks operating in New Zealand.
- The IPS Act 2010, the NBDT Act 2013, and the proposed Financial Markets Infrastructures Bill, except where consequential changes are necessary or could encourage alignment.
- Covered bonds or netting, except to the extent that any issues requiring change are identified during the review process (for example, if work on crisis management or depositor protection created the need to also look at how encumbrance limits are set).³
- Clearing, payment, and settlement systems, and the regulation of Financial Market Infrastructures.
- AML/CFT functions – statutory review of operation of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 will commence following referral by the Minister of Justice no later than 1 July 2021 (AML/CFT Act s. 156A). New Zealand’s AML/CFT regime is scheduled to be assessed for compliance by the Financial Action Task Force in 2020.
- Other financial system functions within the Reserve Bank such as market operations, other than those that are relevant to the areas for Phase 2.

The terms of reference also provided guidance on the desired outcomes for the review, noting in particular that the operational independence of the Reserve Bank remains paramount and will be protected.

In addition, matters that were considered as part of Phase 1 of the review, such as the objectives of monetary policy and the monetary policy decision-making process, are not being revisited as part of Phase 2, except where consequential changes are necessary.

While a number of the matters considered as part of this RIA were subject to in-principle decisions by the Government in June 2019, this does not impose a constraint on the analysis or the options considered. In-principle decisions were taken in order to facilitate further

² Australian-owned banks are regulated by both their “home” regulator on a consolidated basis (the Australian Prudential Regulation Authority) and their “host” regulator in relation to their New Zealand operations (the Reserve Bank).

³ Covered bonds have a security over a bank’s assets and rank ahead of unsecured depositors in a resolution. Encumbrance limits set the maximum proportion of a bank’s assets can be used as collateral, such for a covered bond. Netting entails offsetting the value of multiple positions or payments due to be exchanged between parties, such as in relation to derivative contracts. These provisions of the Act were recently enacted.

consultation on the design of core elements of the regime. We have noted where in-principle decisions have been made.

The discussion in Section 3 identifies where any particular options have not been considered as part of the analysis of different options relating to specific issues, and the rationale for their exclusion.

2.4 Other changes being progressed

In addition to the substantive issues that are considered in this RIA, the Institutional Act will also deal with a range of less significant changes to the Reserve Bank Act. These changes are either consequential to other changes, involve modernising or formalising the current approach, or are minor and technical or deal with redundancies. A number of these issues have been discussed at a high level in the consultation documents and will have no or low levels of regulatory impact, or be of public or stakeholder interest more broadly. The following proposed changes fall into this category:

Modernising foreign exchange management provisions

It is proposed that the power of the Governor to close the foreign exchange market and the power of the Minister (under the authority of an Order in Council) to direct foreign exchange dealing to be at a fixed rate be removed. These powers could not be used to achieve the desired outcome in modern financial markets. The Minister will continue to have the power to direct the Bank to deal with foreign exchange within guidelines in order to influence the exchange rate.

Strengthening Reserve Bank coordination with other agencies

The Cabinet paper seeks agreement to update and formalise the Reserve Bank's coordination functions, including, clarifying that the Reserve Bank should have a function to cooperate with relevant New Zealand and overseas agencies. The paper also proposes establishing the Council of Financial Regulator's mandate in legislation.

These changes are not expected to impose direct material costs on the Reserve Bank or other parties and are expected to have benefits associated with facilitating closer coordination in financial sector regulation.

Modernising the overall legislative framework

A large number of the decisions discussed in the Cabinet Paper relate to the detail of how the Reserve Bank's institutional arrangements should be translated into a modern legislative framework. While, some of these changes are discussed as part of *Issue 3: Accountability and Independence*, others are minor matters that are consequential to the adoption of the broad model assessed in this RIA.

We also note that a related project on the future of cash, being led by the Reserve Bank, is being progressed separately from the Review. To the extent that this project results in any legislative changes, these will be considered by Cabinet separately and will be subject to a subsequent RIA if necessary.

Section 3: Problem definition, objectives and options analysis

This section considers the following key policy issues for the Institutional Act in turn:

- Issue 1: Institutional responsibility for prudential regulation
- Issue 2: Governance and decision-making
- Issue 3: Accountability and independence
- Issue 4: Financial policy objectives
- Issue 5: Funding

These issues have been considered separately because different decision-making criteria are relevant and because the response to each issue has consequential impacts on the context for, and response to, subsequent issues.

Issue 1: Institutional responsibility for prudential regulation

3.1.1 What is the policy problem or opportunity?

Under New Zealand’s current institutional arrangements for financial sector regulation, the Reserve Bank is responsible for prudential regulation and supervision, and the Financial Markets Authority (FMA) is the agency responsible for implementing financial market conduct regulation. The Commerce Commission also regulates the conduct of consumer credit providers.

The demarcation of financial market conduct and prudential responsibilities into separate agencies represents a ‘twin peaks’ set of institutional arrangements and is found in around 10 percent of jurisdictions internationally (according to a comparative 2018 study by the Bank for International Settlements). This model has increased in popularity since the GFC, with the change in institutional arrangements in the UK being a notable example.

The central bank assumes responsibility for the ‘prudential peak’ in around half of all jurisdictions with a twin peaks framework – in the other half the prudential peak is housed in a separate agency outside the central bank.

Under New Zealand’s current institutional arrangements, the Reserve Bank is responsible for prudential regulation and supervision in order to promote and maintain a sound and efficient financial system, and the Financial Markets Authority (FMA) is the conduct authority with an objective to promote and facilitate the development of fair, efficient, and transparent financial markets.

During the scoping of this Review, some stakeholders raised concerns about the Reserve Bank continuing to be responsible for prudential regulation and supervision. Potential risks that were highlighted included:

- Management attention being stretched across a wide number of functions, and the potential for resources to be prioritised to one function over the other.
- Blurring of monetary policy and financial stability objectives.
- Trade-offs between inflation and financial system outcomes being managed in

suboptimal ways.

- Reputational risks to monetary policy from the failure of a supervised entity.
- Inappropriate use of the Lender of Last Resort (LoLR) function to delay bank resolution.
- Differences in the level of independence expected for monetary and prudential functions.

In light of these concerns, a number of stakeholders advocated some form of institutional ‘separation’ of current prudential responsibilities from the Reserve Bank.

Stakeholders did not generally identify specific issues or risks that may have crystallised due to the structure of financial markets regulation in New Zealand. Instead, they largely pointed to theoretical risks associated with the current model. Some stakeholders associated the breadth of the Reserve Bank’s responsibilities with its historically light-touch approach to prudential regulation, arguing that the breadth of the Reserve Bank’s functions had resulted in a lack of focus, resource, capability and capacity. It is, however, difficult to determine the extent to which these issues are the result of institutional responsibilities or the Reserve Bank’s philosophical approach to regulation, which has relied more on self-discipline and market-discipline than international approaches to prudential regulation.

It is not possible to quantify the likelihood of these risks eventuating or the potential harm that they might cause. To the extent that these structural issues have an influence on New Zealand’s long-term financial stability, the impact could be significant, given the very high costs associated with a financial crisis (estimated to result in lowering output by between 20 and 160 percent of GDP⁴).

3.1.2 What options are available to address the problem?

In the first consultation document, the Review team identified and consulted on three institutional design options for prudential regulation:

- **Enhanced status quo** – this option would take the current twin peaks model as a given, with the Reserve Bank retaining its prudential responsibilities, but could include a number of changes to arrangements within the Reserve Bank that would potentially address some of the concerns of stakeholders who had advocated separation. Changes could include: developing clearer objectives for the Reserve Bank; changing governance and accountability arrangements; and increasing resourcing to enable a greater focus on the Reserve Bank’s financial system responsibilities. Many of the changes that are contemplated at a broad level as part of the ‘enhanced status quo’ option are the subject of issues 2, 3, 4 and 5 of this RIA.
- **New Zealand Prudential Regulation Authority (NZPRA)** – this option would loosely resemble the twin peaks arrangements in Australia, with the Reserve Bank’s prudential role transferred to a separate agency. The Reserve Bank would retain responsibility for monetary policy and lender of last resort (LoLR). As noted above, this variant of the twin peaks model is found in around 5 percent of jurisdictions

⁴ <https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Policy-development/Banks/Review-capital-adequacy-framework-for-registered-banks/Capital-Review-An-outline-of-the-analysis-supporting-the-risk-appetite-framework.pdf?revision=058df82e-5fc8-4e4c-9431-5f2dff5aa4a&la=en>

worldwide.

- **New Zealand Financial Services Authority (NZFSA)** – this separate agency would assume responsibility for the Reserve Bank’s prudential role and the FMA’s financial market conduct mandate. This is similar to arrangements in the UK before the GFC, and arrangements currently in place in all Nordic countries. The Reserve Bank would retain responsibility for monetary policy and LoLR. Internationally, this model is found in around 18 percent of jurisdictions.

3.1.3 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The Review team consulted on four general evaluative criteria as part of the first consultation process, which stakeholders generally agreed were appropriate:

- **Focus** – the emphasis given to an agency’s mandate(s). This is linked to the number and clarity of objectives and the degree of management and decision maker attention paid to each.
- **Synergies** – the nature of the interactions between an agency’s mandates. This has both policy and operational dimensions: policy outcomes improve through sharing data and analytical perspectives, and staff capabilities are enhanced through the cross-fertilisation of skillsets and greater career opportunities.
- **Conflicts of interest** – the nature of any trade-offs across an agency’s mandates and how they are managed.
- **Costs** – the regulatory costs for the system as a whole, including the transition costs associated with changes to the baseline (set-up costs, impact on productivity etc.).

There are trade-offs between achieving these criteria – in particular, synergies and costs generally need to be traded-off against focus and the management of conflicts of interest.

3.1.4 What other options have been ruled out of scope, or not considered, and why?

A ‘sectoral’ approach to financial sector regulation has not been considered in detail. This approach would involve establishing specialist agencies for each financial sector (e.g. banking, insurance, securities firms), combining both a prudential and a financial market conduct mandate. A sectoral approach is the predominant model internationally (at around 50 percent of jurisdictions, concentrated in Latin America, Asia and Africa), although this model has lost popularity since the GFC. In most countries adopting a sectoral approach, the central bank is the specialist regulator and supervisor of the banking system (with advanced economy examples including Hong Kong SAR, Israel and Spain), rather than a separate agency.

While this approach was outlined in the first consultation document, it was not proposed or subsequently assessed as an option for New Zealand. That is because it would require very significant changes to New Zealand’s overall model of financial markets regulation, introduce significant institutional complexity and is not considered a viable option for New Zealand’s small financial markets. Only one submitter advocated for a sectoral-based approach in New Zealand (in relation to the insurance sector).

Another option not considered was a version of an ‘integrated’ model for financial sector regulation in which the central bank is responsible for prudential and conduct regulation for all sectors. Over 10 percent of jurisdictions surveyed operate this model. Central bank

examples of the integrated model include arrangements in the Czech Republic, Ireland and Singapore.

This central bank institutional arrangement was not considered in the options analysis of the first consultation since it involves *adding* additional functions and responsibilities to the Reserve Bank (i.e. the current conduct functions of the FMA), rather than any separation, and therefore would not address the key concerns raised during the scoping of Phase 2.

3.1.5 What do stakeholders think?

The majority of submitters on the first consultation document thought that any challenges with the Reserve Bank retaining responsibility for the prudential function were outweighed by the significant costs of creating a new prudential authority. Stakeholders also highlighted benefits from the current model in terms of better coordination across functions (such as those between monetary policy and macro-prudential policy, and that between the prudential function and LoLR in times of financial crisis) and the exploitation of underlying synergies.

Almost all submitters in favour of the enhanced status quo recognised that improvements to the current prudential framework are necessary. Several submitters were explicit that their support for the enhanced status quo option was contingent on the efficacy of a broader range of changes coming out of the Review, and that if these did not proceed, or were not successful, they would re-evaluate the merits of separating out the prudential function.

A small number of submitters supported a shift to the NZPRA model. These stakeholders argued that the NZPRA model would give greater focus to prudential regulation of both deposit takers and the insurance sector, with less management and decision maker distraction, and conflicts of interest given a narrower mandate. They argued that there is little or no synergy between the Reserve Bank's prudential mandate and its other functions, and that the current co-location with monetary policy significantly complicates the construction of optimal governance arrangements for the Reserve Bank.

No stakeholders supported the NZFSA model, with some arguing that it would compromise the financial market conduct functions of the FMA, which do not require fundamental redesign.

3.1.6 Impact Analysis

	No action	Enhanced Status Quo	NZPRA	NZFSA
Focus	0	<p style="text-align: center;">+</p> <ul style="list-style-type: none"> Potential to clarify focus by re-specifying high-level objectives (discussed in Issue 4 below) or adding new lower-tier objectives. Any additional financial sector objectives might require a potential refocus of the regulatory and supervisory approach. Increased funding and governance changes (e.g. the new governance board discussed in Issue 2 below) could increase focus on financial system responsibilities. But there is still a risk of management distraction, given the broad range of responsibilities. 	<p style="text-align: center;">++</p> <ul style="list-style-type: none"> Narrower set of responsibilities for both the Reserve Bank and the NZPRA by design, less potential for 'management distraction' at both agencies. Potential to develop distinct organisational culture. Opportunities for appointment of senior management with industry experience and/or greater familiarity with prudential issues. NZPRA will still need to decide which sectors to focus on within its remit. Mandates are potentially clearer (unless NZPRA and the Reserve Bank are both given financial stability objectives, creating some confusion for stakeholders). Not clear where macro-prudential policy or oversight of the payments system would sit in this model. 	<p style="text-align: center;">--</p> <ul style="list-style-type: none"> Narrower focus for the Reserve Bank, broad focus for NZFSA. Potential for management distraction within NZFSA across its prudential and conduct mandates. Less scope for regulatory underlap in prudential and conduct functions. Depending on specification, mandate could blur prudential and conduct functions. Not clear where macro-prudential policy or oversight of the payments system would sit in this model.
Synergies	0	<p style="text-align: center;">+</p> <ul style="list-style-type: none"> Pre-existing synergies across three policy domains (micro/macro-prudential and monetary policy) preserved. Reserve Bank still gets to internalise outcomes across three policy domains. Additional funding and some internal organisational changes could help to further exploit potential benefits from co-locating these functions. 	<p style="text-align: center;">--</p> <ul style="list-style-type: none"> Retain synergies associated with cross-sectoral approach to prudential regulation, and those between policy and supervision/enforcement. But lose synergies between prudential, and monetary policy and systemic oversight roles. Reduced staff development opportunities for staff in NZPRA and the Reserve Bank. However, opportunities for greater focus for NZPRA on recruiting staff with deep knowledge of relevant sectors and/or regulatory issues. 	<p style="text-align: center;">+</p> <ul style="list-style-type: none"> Retain synergies associated with cross-sectoral approach to prudential regulation, and those between policy and supervision/enforcement. Exploit any complementarities between prudential and conduct roles. Lose synergies with monetary policy, systemic oversight role of Reserve Bank. Reduced development opportunities for Reserve Bank staff, but enhanced for NZFSA staff.
Conflicts of interest	0	<p style="text-align: center;">+</p> <ul style="list-style-type: none"> Separation of monetary and financial policy decisions should mitigate any conflicts. 	<p style="text-align: center;">++</p> <ul style="list-style-type: none"> Internal Reserve Bank conflicts reduced by design. Policy trade-off management will require establishment of external coordination mechanisms with the Reserve Bank, FMA and Treasury. 	<p style="text-align: center;">-</p> <ul style="list-style-type: none"> Internal Reserve Bank conflicts reduced by design. Potentially new conflicts created between prudential and conduct (e.g. looking after consumers versus the soundness of the financial institution, and confidentiality vs transparency). Need for external coordination with Reserve Bank and Treasury.
Costs	0	<p style="text-align: center;">-</p> <ul style="list-style-type: none"> Could increase from increased resourcing of prudential function, servicing the new governance Board, or more intensive approach to supervision. 	<p style="text-align: center;">--</p> <ul style="list-style-type: none"> Loss of economies of scale and transition costs from setting up the new agency. Question of whether New Zealand can sustain three agencies (NZPRA, FMA and Reserve Bank) in terms of overall regulatory costs (and capabilities). Some cost increases could come from generally better resourcing of prudential function that comes with greater focus, relative to the baseline. Funding model would need to be considered (e.g. industry levies). 	<p style="text-align: center;">-</p> <ul style="list-style-type: none"> Steady-state costs for regulatory system are not clear. Transition costs high – this option would be disruptive to both Reserve Bank and FMA. The new authority would need to be established quickly to avoid this disruption and to ensure that the Reserve Bank and the FMA are not undermined while carrying out their existing functions. Funding model would need to be considered (e.g. industry levies).
Overall assessment	0	++	+	--

Key:

- ++ much better than doing nothing/the status quo
- + better than doing nothing/the status quo
- 0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- much worse than doing nothing/the status quo

3.1.7 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

The Treasury prefers *Option 1: Enhanced Status Quo*. This reflects a judgement that any benefits from the creation of a separate prudential regulator in terms of focus and reducing conflicts of interest would be more than outweighed by the loss of synergies between prudential and central bank functions and by the additional cost and disruption of creating and shifting these functions to a new institution. This approach was supported by the vast majority of stakeholders.

Retaining the prudential functions within the Reserve Bank would preserve the strong complementarity between a prudential mandate (which includes crisis management) and the Reserve Bank's central bank functions. Co-locating these functions enables synergies to be exploited, and the benefits would be particularly evident in times of financial stress. In addition, since the GFC a number of other jurisdictions have moved closer to New Zealand's model (of combining prudential and central bank functions) rather than away from it.

The enhanced status quo would also keep transition costs to a minimum (since a new agency would not be required) and would not duplicate business functions (such as human resources, IT, and data/information management services).

The changes to governance, objectives, and resourcing that are being considered elsewhere in the Review should effectively address many of the issues that were identified with this model, particularly providing adequate focus and resourcing for the Bank's prudential functions.

The Reserve Bank and the Independent Expert Advisory Panel support this recommendation.

We note that Cabinet has made an in-principle decision for the Reserve Bank to retain responsibility for prudential regulation.

3.1.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	Comment: <i>nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks</i>	Impact <i>\$m present value, for monetised impacts; high, medium or low for non-monetised impacts</i>	Evidence certainty (High, medium or low)
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Additional costs of proposed approach, compared to taking no action

Regulated parties			
Regulators	Few additional costs directly associated with the preferred option, although the analysis is premised on the Reserve Bank allocating more resources to its regulatory functions.	Low	Medium ⁵
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Medium

Expected benefits of proposed approach, compared to taking no action

Regulated parties	Broad benefits associated with improved accountability and transparency.	Medium	Low
Regulators	Clarified focus on high-level objectives.		
Wider government			
Other parties			
Total Monetised Benefit			
Non-monetised benefits		Medium	Low

⁵ We have defined evidence certainty ratings as follows – High: strong theoretical and quantitative evidence; Medium: clear theoretical evidence, including on general scale of cost/benefit; Low: some theoretical evidence, limited clarity on scale of impacts.

3.1.9 What other impacts is this approach likely to have?

No other impacts have been identified.

3.1.10 Is the preferred option compatible with the Government’s ‘Expectations for the design of regulatory systems’?

The preferred option is compatible with the Government’s ‘Expectations for the design of regulatory systems’, in that it is seeking to achieve the objectives in the lowest cost way, is well-aligned with existing requirements, and has scope to evolve over time.

Issue 2: Governance and decision-making

3.2.1 What is the policy problem or opportunity?

The Reserve Bank’s current governance arrangements are anomalous in comparison with both common international practice and other independent regulators in New Zealand. Its governance arrangements were set in the Reserve Bank Act in 1989. Their design largely reflected the Reserve Bank’s then primary function of monetary policy, alongside a relatively narrow prudential role focused on registered banks. The features considered paramount at the time were clear independence from government and a focus on the Governor’s individual accountability via a single decision maker model.

Since 1989 the Reserve Bank’s role in the financial system has expanded substantially, and the financial system itself has evolved. Phase 1 of this Review introduced the first major legislative changes to the Reserve Bank’s governance structure in almost three decades, establishing a Monetary Policy Committee (MPC) with responsibility for formulating monetary policy decisions and changing the way that the Reserve Bank’s monetary policy targets are set.

The Reserve Bank’s single decision maker governance model is unusual, particularly given its broad range of economically significant functions. While the creation of an MPC has provided group decision-making in regards to the formulation of monetary policy, responsibility for all other functions and for the governance of the Reserve Bank itself still rests solely with the Governor. The Reserve Bank Board does not have a decision-making or governance function; instead it is responsible for monitoring and reporting on the Reserve Bank’s performance. The Governor in effect assumes the role of both the ‘board’ and the ‘chief executive’.

The New Zealand Productivity Commission’s [Inquiry into Regulatory Institutions and Practices](#) highlighted the risk associated with single decision makers in a regulatory context making decisions without adequately considering a sufficiently broad range of perspectives and arguments. It is also difficult for a single decision maker to have a sufficient breadth of knowledge and skills to effectively engage in the broad range of different issues across the Reserve Bank’s broad functions. A single decision maker model may also make the Reserve Bank more prone to changes in approach and focus over time. There is therefore an increased risk associated with the single decision maker model, with this risk having become more pronounced as the Bank has taken on a broader range of functions.

3.2.2 What options are available to address the problem?

The following options have been identified and were consulted on as part of the first round of consultation.

1: Board governance and decision-making

This option would involve shifting from a single decision maker model for governance and financial policy matters, to a collective, board-based model. The board would be responsible and accountable for the Reserve Bank’s governance and for all of its functions – other than those given to the MPC for monetary policy. This would include responsibility for financial

policy matters, meaning that the board would have significant policy-making responsibilities in relation to prudential standards, as well as responsibility for the supervision and enforcement of regulated entities. The board would therefore need to have a broad range of skills and expertise in order to both provide strong organisational leadership and to undertake effectively its financial policy functions.

The New Zealand Productivity Commission (2014) concluded that multi-member decision-making bodies have the potential to produce better-quality decisions, as long as the members in themselves are of high quality. This is because individuals have different perspectives through which they interpret information and options – this allows group decision makers to base their decisions on a larger set of concerns, information, and judgements than are available to an individual.

The board would be fully non-executive. A number of studies have noted the accountability benefits of creating a clear divide between governance and management responsibilities, which is a feature of non-executive board models.⁶

2: Governance board and a Financial Policy Committee

This option would include the changes in option 1, but would transfer decision-making responsibility for financial policy matters (i.e. prudential and macro-prudential policy) to a legislatively established Financial Policy Committee (FPC). The board would have responsibility for the overall governance of the Reserve Bank and for all other matters not specifically conferred on the FPC and MPC. The make-up of the FPC would be similar to the current MPC model for monetary policy, with the Governor and other key executives as members, alongside independent external members with expertise in prudential policy matters.

3.2.3 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

Several features of effective governance were identified as criteria for assessing governance-related options in the first consultation document:

- **Balanced composition**, ensuring a breadth of expertise, experience, and perspective at the governing body level
- **Efficient decision-making** that balances timeliness with quality to enable the organisation to discharge its responsibilities and to meet its objectives
- **Simplicity** in legal and operational structure, to avoid unnecessary costs and keep processes manageable and flexible
- **Consistency in behaviour**, facilitating coherent decision-making over time that is not dependent on the views of any one individual and is well understood by stakeholders
- **Strategic leadership** by the governing body, ensuring that the organisation's strategy and direction are clear with a sufficient focus on all governance responsibilities
- **Accountability and transparency** in the performance of the organisation's functions and the achievement of its objectives, sufficient for effective monitoring by a monitoring authority so that the organisation can be held to account for its performance.

⁶ For example: Australian Government (2015) [Fit for the Future: A capability review of the Australian Securities and Investments Commission](#)

These criteria were identified based on governance literature published by: the Committee on the Financial Aspects of Corporate Governance; the International Monetary Fund; the FMA; the Organisation for Economic Cooperation and Development; the Office of the Auditor-General; and the Institute of Directors in New Zealand, among others. Submitters on the first consultation document were broadly supportive of these criteria.

3.2.4 What other options have been ruled out of scope, or not considered, and why?

Options that were not considered include:

- Changing the role of the MPC: the establishment of the MPC was a focus of Phase 1 of the Review and its role is out of the scope of Phase 2 (other than consequential changes).
- Establishing a fully-executive commission-type model: we have not considered this option in detail as it would require very significant structural changes to the Reserve Bank and its functions. This model is not commonly used internationally for either central banks or for prudential regulators.

3.2.5 What do stakeholders think?

While most submitters supported the establishment of a governance board, there was a difference of view on what its responsibilities should be. The majority of submitters were in favour of the board governance and decision-making model. These submissions tended to focus on the board as a conventional group decision-making structure with robust internal accountability. Some submissions noted the flexibility inherent in a board model including the use of delegations and internal committees. While most submissions favouring a board model did not argue against the FPC model, those that did tended to focus on the increased complexity, novelty and inflexibility associated with the FPC model. Those submitters favouring the FPC model tended to note the complexity associated with financial policy, suggesting that decisions on financial policy would benefit from focused expertise.

3.2.6 Impact analysis

The identified options have been separately assessed against the criteria, in comparison to the status quo.

Key:	
++	much better than doing nothing/the status quo
+	better than doing nothing/the status quo
0	about the same as doing nothing/the status quo
-	worse than doing nothing/the status quo
--	much worse than doing nothing/the status quo

	Status Quo	1: Board governance and decision-making	2: Governance board with Financial Policy Committee
Balanced composition	0	<p style="text-align: center;">+</p> <p>Pros – ideally boards have a diversity of expertise, experience, and perspective in decision-making. A well-represented board with a robust decision-making process can provide a good balance of judgement, particularly if it includes external members.</p> <p>Cons – there is a potential for ‘groupthink’ (a tendency for individuals to prefer uniformity rather than challenge the group) and hence a bias towards favouring the status quo. This is a particular risk with homogenous groups that emphasise consensus-based decision-making. Ensuring the board has the breadth of expertise required to undertake both its governance and financial policy roles may be challenging.</p>	<p style="text-align: center;">++</p> <p>Further to the pros and cons of Option 1, a statutory committee can provide a greater level of diversity and expertise than the status quo but also allow for more specialised and focused expertise than a full board, and can hence enhance the quality of an organisation’s decision-making. This option also allows for the board to specialise and focus on governance issues.</p>
Efficient decision-making	0	<p style="text-align: center;">-</p> <p>Boards take time to convene, ensure members have sufficient information, deliberate, and reach a consensus or vote. Boards with external members may also have more conflicts of interest to manage. The Reserve Bank’s board would need to be relatively large due to the scope of its responsibilities. A board may also be less well placed to respond where decisions are required in haste.</p>	<p style="text-align: center;">--</p> <p>In addition to the efficiency costs associated with the shift to a board, the introduction of a Financial Policy Committee can make an organisation less efficient at making decisions due to the coordination, information, resourcing, and administration requirements, including between the board and the Committee.</p>
Simplicity	0	<p style="text-align: center;">-</p> <p>Boards add operational costs and coordination requirements to the decision-making process, increasing complexity. The organisation may find it difficult to recruit enough external members with appropriate expertise who do not have conflicts of interest.</p>	<p style="text-align: center;">--</p> <p>A statutory committee introduces a further layer of operational costs and coordination requirements to the decision-making process. A statutory committee is inherently less flexible with its mandate prescribed in legislation. Consideration would also need to be given to the interaction between any statutory committees and cross-agency regulatory coordination and cooperation mechanisms such as Council of Financial Regulators.</p>
Consistency in behaviour	0	<p style="text-align: center;">+</p> <p>A board can provide more ‘corporate memory’ over time and does not depend on the views of any one individual. Consistency can be enhanced through the use of staggered board appointments, which can minimise disruptions to the board’s composition.</p>	<p style="text-align: center;">+</p> <p>A committee can provide more ‘corporate memory’ over time on policy areas within its mandate. Internal committees can also provide greater consistency, although a statutory committee is considered more enduring as its mandate, composition, and powers are provided for in legislation.</p>
Strategic leadership	0	<p style="text-align: center;">+</p> <p>Boards are less reliant on the leadership skills of one individual. They also can create a clear divide between governance and management responsibilities, which can help to ensure that enough attention is paid to the organisations’ strategic direction and priorities.</p>	<p style="text-align: center;">++</p> <p>A committee focussed on financial policy could ease the decision-making burden on the board, enabling them to give more attention to their other responsibilities and allow the right expertise to be brought to bear.</p>
Accountability and transparency	0	<p style="text-align: center;">+</p> <p>Pros: internal accountability can be enhanced in a board model through the separation of governance and management functions, particularly if the board is non-executive. Separation allows the governing body to exercise more objective judgement when assessing the performance of management. Because the governing body remains accountable for the actions of management, it has strong incentives to ensure the discharge of management functions is being conducted appropriately.</p> <p>Cons: weaker external accountability due to the board being collectively accountable to the Minister for performance. It can be challenging to monitor the performance of individuals acting within a group.</p>	<p style="text-align: center;">0</p> <p>In addition to the pros and cons of a board model, a further committee with statutory responsibilities introduces additional complexity to the governance arrangements. As with a board model, individual accountability for performance is reduced with a group and it can be challenging to monitor the performance of individuals acting within a group. A further statutory committee may blur responsibilities by splitting them across decision makers thereby reducing accountability.</p>
Overall assessment	0	<p style="text-align: center;">++</p> <p>We consider that the benefits of a multi-member decision-making model significantly outweigh the costs and risks.</p>	<p style="text-align: center;">+</p> <p>On balance, the Treasury does not consider that an FPC would add sufficient benefits in terms of focus and expertise (beyond those provided by a board model) to justify the additional complexity and reduced accountability.</p>

3.2.7 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

The Treasury prefers *Option 1: Board governance and decision-making*. We consider that the benefits of a multi-member decision-making model, in terms of providing a breadth of perspectives and expertise and reducing the reliance on a single individual for the effective leadership of the organisation, outweigh the costs associated with reduced efficiency, additional complexity and the potential for weaker external accountability.

On balance, the Treasury does not consider that the benefits of establishing a specialist legislated FPC with responsibility for financial policy matters outweigh the costs and risks. While we acknowledge that an FPC could provide benefits of improved focus and expertise in relation to financial policy decision-making, we do not consider that these benefits would be sufficient to justify the additional complexity and potential for reduced efficiency and accountability (when compared to a board only model). Compared to an MPC, an FPC would have a broader range of functions and would create more complexity in terms of responsibilities vis a vis the board. Under the board model the board will be able to establish committees, which could include a committee that specialises in financial policy matters.

The Reserve Bank supports the recommendations to establish a board with decision-making and delegation powers and not to establish an FPC.

The Independent Expert Advisory Panel support the establishment of a board, but members' views differed on the establishment of an FPC, with a majority favouring the board controlling prudential policy (to avoid diluting its role and introducing additional complexity) and a minority supporting an FPC (to increase the prominence and focus of prudential policy decisions).

We note that Cabinet has made an in-principle decision to shift to a board-based decision-making model and not to establish an FPC.

3.2.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	Comment: <i>nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks</i>	Impact <i>\$m present value, for monetised impacts; high, medium or low for non-monetised impacts</i>	Evidence certainty (High, medium or low)
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Additional costs of proposed approach, compared to taking no action

Regulated parties			
Regulators	Incremental additional costs associated with remunerating and supporting a governance board (as opposed to only a monitoring board).	Low. The current monitoring board's remuneration is approx. \$220k pa, whereas, for comparison, FMA's governance board is approx. \$500k pa.	Medium.
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Medium

Expected benefits of proposed approach, compared to taking no action

Regulated parties	Benefits associated with improved governance and decision-making.	Medium	Low
Regulators	Benefits associated with improved governance and decision-making.	Medium	Low
Wider government			
Other parties			
Total Monetised Benefit			
Non-monetised benefits		High	Low

3.2.9 What other impacts is this approach likely to have?

The decision to establish a board may reduce the perceived legitimacy of Reserve Bank decision-making in the transition period (particularly once the legislation is enacted but the board has yet to come into effect). The board may have different views on existing policy setting, which may result in changes to policy settings, with potential change impacts on industry. These costs and risks will need to be assessed and managed by the Reserve Bank during this process. The board is a significant change to the current institutional structure, the new board is likely to take some time to settle on optimal operating arrangements.

3.2.10 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

The proposed approach is compatible with the Government's 'Expectations for the design of regulatory systems', which highlights the importance of providing for predictable and consistent outcomes for regulated parties and of alignment with related regulatory systems.

Issue 3: Accountability and independence

3.3.1 What is the policy problem or opportunity?

In addition to the question of the Reserve Bank’s high-level organisational structure and governance responsibilities, the Review has considered a range of secondary issues relating to the Reserve Bank’s governance arrangements, with a particular focus on maintaining operational independence, ensuring effective accountability and protecting the public legitimacy of the organisation. The IMF’s New Zealand FSAP in 2017 highlighted the importance of maintaining an accountability framework that does not jeopardize the integrity and independence of the Reserve Bank’s regulatory decision-making.

These following issues are not necessarily problems, rather they are secondary policy questions that needing to be resolved in designing an overall accountability and independence framework to support the shift in Reserve Bank governance examined in *Issue 2*.

Alignment with other public sector entities

In New Zealand, entities that operate with a degree of independence from the government are typically established as ‘Crown entities’ under the Crown Entities Act 2004. The Reserve Bank was established before the Crown Entities Act was introduced. Its single decision maker model, combined with unique board-monitoring arrangements, has historically been seen as inconsistent with governance arrangements in the Crown entities framework. It has its own category in the state sector.

Cabinet has made an in-principle decision to introduce a governance board (as examined in *Issue 2*) which is also a feature of Crown entities. Two of the options assessed in this RIA consider the benefit in further harmonising the Reserve Bank’s governance and accountability arrangements with the framework for other Crown entities. In particular, independent Crown entity (ICE) status provides the governance and accountability framework for other independent regulators such as the FMA and the Commerce Commission.

Board appointment and removals

The process for the appointment and removal of members of the Reserve Bank board will play a key role in ensuring that the Bank has an appropriate level of independence and that the board has the right mix of skills and experience, while still providing an important lever by which the Minister can hold board members accountable for their performance.

While there are standard appointment models for different categories of Crown entities, these provide the Minister with a significant amount of control and discretion in regards to the appointment process, which may not be appropriate, given the need for a strong skills-based board and robust operational independence on the part of the Reserve Bank.

Monitoring

Current monitoring arrangements will need to change to align with the shift to a governance board. Monitoring plays an important part in ensuring that regulatory agencies are effective,

efficient, and accountable. Monitoring also provides assurance to Ministers that regimes are working as intended.

At present, the Reserve Bank board is the Minister's monitoring agent for the Reserve Bank. Each year it must deliver to the Minister a report setting out its assessment of the matters for which it is tasked. The current board lacks legislated funding or independent secretariat resources with which to conduct its monitoring function. As a monitoring agent, the board is therefore dependent on the Reserve Bank for information and resourcing, raising questions about whether it is adequately positioned to perform its public monitoring role with sufficient independence.

Transparency

Transparency helps to ensure the democratic legitimacy of a regulator's activities and encourages good governance. Accountability documents, alongside statutory publications such as Monetary Policy Statements and Financial Stability Reports, provide a degree of transparency over the Reserve Bank's activities and priorities. In practice, the Reserve Bank consults publicly and publishes more widely about banking supervision policy and other regulations than legislation requires.

Greater statutory accountability and transparency could formalise many of the Reserve Bank's existing practices, ensuring that such practices are undertaken as a matter of course rather than at the Reserve Bank's discretion. Additional requirements could also increase public engagement, support regulatory robustness and legitimacy, and further encourage an open culture within the Reserve Bank.

Independent oversight

The Reserve Bank does not have the normal level of oversight by key offices of Parliament. The Reserve Bank is excluded from the Auditor-General's scope to initiate, without a ministerial request, a performance audit of the extent to which a public entity is carrying out its activities effectively and efficiently. No other public entity is excluded from the Auditor-General's scope in this regard.

Similarly, the Reserve Bank is not subject to the provisions of the Ombudsmen Act 1975, meaning that the Office of the Ombudsman is not able to investigate administrative decisions of the Reserve Bank that affect people in their personal capacity. Other independent regulators, such as the Commerce Commission and Financial Markets Authority are subject to the Ombudsmen Act, and the Australian Commonwealth Ombudsman is able to investigate complaints about both the Reserve Bank of Australia and the Australian Prudential Regulation Authority.

3.3.2 What options are available to address the problem?

Option 1: Enhanced status quo

Option 1 would involve making a range of enhancements to the Reserve Bank's independence, accountability and transparency, that have been identified and tested through stakeholder engagement and consultation. Key changes would include:

- assigning responsibility for monitoring the Reserve Bank to the Treasury, reflecting

the shift from a monitoring board to a governance board and aligning with normal Crown entity practice

- aligning with the Crown entities' reporting framework through the use of statements of performance expectations, alignment of statements of intent provisions and a greater specification of requirements for annual performance reporting
- formalising and expanding requirements on the Reserve Bank to publish information on its prudential and supervision approach
- enabling the Auditor-General to undertake performance audits of the Reserve Bank and including the Reserve Bank within the jurisdiction of the Office of the Ombudsman.

Option 2: An independent Crown entity (ICE) with an independent nominating committee

This option would involve making the changes outlined in *Option 1: Enhanced status quo*, as well as categorising the Reserve Bank as an ICE. Categorising the Reserve Bank as an ICE would provide for:

- the basis for its legal status as a body corporate
- limits on the validity of its actions in line with its empowering legislation and functions (e.g. establishing that it can only act for the purpose of performing its functions)
- the role of the board, the responsible Minister and the monitor
- remuneration of board members being set by the Remuneration Authority
- ministerial direction powers to support a whole of government approach in relation to particular matters (for example, in relation to procurement by requiring ICEs to apply the Government Rules of Sourcing)
- the Minister to be able to exert indirect influence over the Bank through the statement of intent and statement of performance expectations
- alignment of the annual reporting requirements with the Crown entities framework, and
- appointment of the Governor by the board

Under this option, we would propose to depart from the usual process for ministerial appointment of board members, by establishing an independent nominating committee. The Committee would nominate candidates for the Board (based on agreed appointment criteria) to the Minister, who would make appointments (via a recommendation to the Governor-General) after consulting other political parties. The committee members would be appointed by the Minister on the basis of their skills and experience in identifying potential board members.

This model is similar to that used by the Guardians of the New Zealand Superannuation Fund. This model could mitigate against undue political influence, and provide strong political legitimacy to appointments through the cross-party consultation process. Most importantly, it would provide a credible and enduring appointment process targeted at the specific skills and experience required by the board. The use of a nominating committee reflects the very significant governance and financial policy responsibilities of the board under the model outlined in *Issue 2* and the critical importance of the board having the right skills and experience to undertake this role. It also helps to protect the independence of the Reserve Bank by guarding against purely political board appointments.

A number of further variations from the ICE model would be necessary to provide for the role of the MPC in relation to monetary policy and to accommodate the Reserve Bank's commercial functions, which are a core part of its role as a central bank.

Option 3: Modified ICE model

This option would adopt the approach outlined in *Option 2*, but with two further changes from the ICE model to provide a more appropriate balance of independence and accountability. The State Services Commission has advised that it would not be appropriate to formally classify the Reserve Bank as a Crown entity under this model (primarily due to the proposed appointment process for the Governor, which differs significantly from normal chief executive appointments), but that the other elements of the governance arrangements could be closely modelled off (and potentially refer directly to) the ICE provisions in the Crown Entities Act.

Ministerial appointment of the Governor

Under this option, the current ministerial appointment process would remain for appointment of the Governor. A ministerial appointment recognises the significant public role of the Governor and the Governor's significant statutory role as an *ex officio* member and chair of the MPC. MPC members are all appointed to the MPC by the Minister. Statutory decision makers in New Zealand are typically, but not exclusively, appointed by Ministers.⁷ Internationally, governors of central banks are generally appointed or approved for appointment by the Government.

Appointment of the Governor would be on the recommendation of the board. This would give the board the responsibility for selecting the candidate, effectively creating a "double veto". The board would continue to have a duty to advise the Minister if the Governor is not performing.

Financial Policy Remit

Under this option the Minister of Finance would be required to issue a Financial Policy Remit that provides matters the Reserve Bank should have regard to when pursuing the financial stability objective. This would be issued at least five yearly. Unlike a standard Letter of Expectations, the Financial Policy Remit would have legislative backing and would be directly linked to the financial stability objective.

The Remit provides a mechanism for the Government to communicate its expectations in relation to the significant policy decisions that have been delegated to the Reserve Bank, particularly in relation to prudential standard setting. This delegation is significantly broader than is typically provided to independent regulators and it is reasonable to expect some level of democratic input into these significant policy decisions. While primary legislation establishes objectives to be achieved using these powers, these objectives are broad and subject to interpretation.

Matters that may be addressed in the Remit could include:

⁷ Exceptions include the Director of Maritime Safety, who has a number of statutory powers and is appointed by the board of Maritime NZ.

- expectations as to risk tolerance, for example, the Remit could provide an expectation that the prudential framework is broadly aligned with international standards
- expectations as to addressing long-term risks, for example, the Remit could provide that the Reserve Bank should consider how climate change risks impact on the financial sector and how to inform the public of those risks
- information in relation to emerging risks to the financial sector that may be relevant to the Reserve Bank's financial stability monitoring.

The Remit would not be able to require the performance or non-performance of a particular act in respect of a person. This would ensure that the Remit does not impinge on the Reserve Bank's operational independence, particularly in regards to supervisory and enforcement activities.

The Remit would replace the Minister's current power to direct the Reserve Bank to have regard to Government policy, which has never been used. It would also apply instead of the provisions in the Crown Entities Act that allow the Minister to direct an entity in regards to matters included in its Statement of Intent or Statement of Performance Expectations.

3.3.3 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The Treasury has adopted the following criteria:

Operational independence

- The operational independence of the Reserve Bank is a critical feature of its role in the system, as highlighted in standard macroeconomic theory and the Basel Core Principles for Effective Banking Supervision. The Reserve Bank needs to be able to maintain a strong level of independence in regards to setting monetary and financial policy and in its operational activities.

Accountability

- It is critical that the governance arrangements for the Reserve Bank provide strong accountability mechanisms. The Reserve Bank's functions are critical to the functioning of the financial system and the economy more broadly, and it needs to be accountable to elected representatives for these functions (while maintaining its operational independence).

Legitimacy

- As an independent regulator and policy maker, it is important that the Reserve Bank is able to maintain the legitimacy of its critical economic role with the general public and stakeholders. Options that strengthen the alignment of the Reserve Bank's approach with the priorities of democratically-elected officials can strengthen legitimacy, by helping to address the 'principal-agent problem' where the Reserve Bank (the 'agent') may not always act consistently with the interests of Parliament as

a proxy for society (the 'principal'). Transparency in decision-making is also an important element of this, alongside strong decision-making capability and appropriate levels of oversight.

Complexity and cost

- The complexity and cost of governance arrangements is an important assessment consideration. Additional complexity in governance arrangements can reduce their effectiveness, for example by promoting a focus on complex administrative requirements over substantive matters. Arrangements that add cost will result in reduced returns to the Crown and/or additional costs on the sector (see *Issue 5* for discussion of funding arrangements).

There can be trade-offs between a number of these criteria. In particular, it is important to strike an appropriate balance between operational independence and accountability. Measures designed to promote accountability and public legitimacy can add to the cost and complexity of the overall governance arrangements.

3.3.4 What other options have been ruled out of scope, or not considered, and why?

The Treasury's analysis of options for strengthening the Reserve Bank's independence, accountability and transparency arrangements are based on the premise that the Reserve Bank will have a governance board, in line with the Government's in-principle decision on this matter (see *Issue 2*). Different arrangements may be more appropriate for an entity with different governance arrangements.

We have not considered other Crown entity options, such as a departmental agency, Crown agent or autonomous Crown entity (ACE) in detail, on the basis that other entity types would not provide an appropriate level of independence for the Reserve Bank. To the extent that the ACE model could be modified to be suitable, this option would not look substantively different to the ICE model, and would not as effectively signal the independent status of the Reserve Bank.

3.3.5 What do stakeholders think?

Submitters on both rounds of consultation in general agreed with our assessment of the problems associated with the current model. A number of submitters on the first round of consultation argued that the Reserve Bank's exclusion from performance audits by the Office of the Auditor-General should be removed, and that existing transparency and accountability requirements should be formalised. These proposals have been built into each of the options.

In general, submissions on the second round of consultation supported:

- alignment with the Crown entity framework
- the use of an independent nominations committee for the board
- a fully or majority non-executive board
- Treasury taking on the role of monitoring the Reserve Bank, and
- the board having a significant role in the appointment of the Governor, if not a determining role.

3.3.6 Impact analysis

	No action	1: Enhanced status quo	2: ICE with nominating committee	3: Modified ICE model
Independence	0	0 No change	++ Formally classifying the Reserve Bank as an ICE would further strengthen expectations of operational independence, although influence through the SOI process may reduce independence in some areas. The use of an independent nominating committee would promote skills based board appointments.	+ Compared to Option 2, would provide increased Ministerial influence, however this would be appropriately focussed on providing guidance in relation to the significant financial stability policy functions that have been delegated to the Reserve Bank.
Accountability	0	+ Alignment of reporting and monitoring arrangements with the Crown entities framework would strengthen accountability.	+ Similar to Option 1	+ Similar to Option 1, plus the Remit would improve accountability by providing a regular mechanism for dialogue on the Government's expectations in relation to financial stability. There is a risk that ministerial appointment of the Governor could undermine board accountability.
Legitimacy	0	+ Formalising and expanding transparency requirements, along with Auditor General and Ombudsman oversight, would improve public legitimacy.	0 Removing ministerial appointment of the Governor would reduce the legitimacy associated with this economically critical position (given the Governor's statutory role as chair of MPC). The nomination process would support legitimacy by ensuring appropriately skilled board members.	++ Similar to Option 1, plus the Remit would improve transparency about how the Government communicates its expectations, and provide the Reserve Bank with a greater democratic mandate for its financial stability functions. Retains legitimacy of ministerial appointment of the Governor.
Complexity and cost	0	- Some additional costs for the Reserve Bank in strengthening its reporting and transparency arrangements.	0 Classifying the Reserve Bank as a Crown entity would reduce complexity and facilitate ongoing consistency with the broader public sector. Some additional costs associated with the nominating committee process.	- Some additional costs (compared to Option 2) associated with the Remit process and some complexity associated with not formally categorising the Reserve Bank as a Crown entity. Additional governance and accountability complexity associated with the board not directly appointing the Governor.
Overall assessment	0	+ While the changes outlined in this option would improve the Reserve Bank's overall accountability arrangements, they would not address concerns about alignment with the broader public sector.	+ Adopting an ICE model would reduce costs and complexity, but would not provide the level of accountability and legitimacy for the Reserve Bank's critical monetary policy and financial stability functions that is provided by Option 3.	++ On balance, modifications to the ICE framework would provide a more appropriate balance of independence and accountability, while strengthening the perceived legitimacy of the Reserve Bank.

Key:

- ++ much better than doing nothing/the status quo
- + better than doing nothing/the status quo
- 0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- much worse than doing nothing/the status quo

3.3.7 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

The Treasury considers that *Option 3: Modified ICE model* would provide the best balance of accountability, legitimacy and independence while not being overly complex. This option incorporates a range of changes to the status quo, which would protect the Reserve Bank's operational independence while providing enhanced accountability and legitimacy. This option would provide greater alignment with the Crown entities framework, although the Reserve Bank would not be designated as an ICE.

The Treasury considers that the modifications to the ICE framework that are included in *Option 3* would provide a more appropriate balance of independence and accountability. Ministerial appointment of the Governor recognises the significant public and statutory role that the Governor plays as chair of the MPC. On balance, we consider that the need to maintain strong legitimacy for this role outweighs the complexity and potential blurring of accountabilities associated with the Minister appointing the Governor. While the board would not have final decision-making rights over Governor appointments, any appointment would need to be on the recommendation of the board, meaning that any Governor would have been selected and nominated by the board. The board would also have extensive scope to deal with underperformance by a Governor, including removing delegations and recommending to the Minister that the Governor be removed.

The Treasury considers that the Remit provides an appropriate mechanism for the Minister to influence the Reserve Bank's financial stability functions, as this influence will be limited to commenting on the Reserve Bank's financial stability objective, such as by outlining the government's expectations in relation to risk tolerance and long-term risks. This provides an appropriate level of democratic influence over the very significant policy-making functions that Parliament has delegated to the Reserve Bank in relation to financial stability. The Crown Entities Act envisages that ICE's might be subject to ministerial directions to have regard to government policy. For example, the government issues Government policy statements to the Commerce Commission, setting out matters which it must give regard. The Remit is preferred by Treasury as it is limited to matters relating to the financial stability objective, thereby protecting the Reserve Bank's operational independence.

The nominations committee (also included in *Option 2*) ensures that board members will be selected on a merits basis and is supported by both entities.

The Reserve Bank does not agree with the analysis presented here and prefers *Option 2*. The Reserve Bank's view is that the Board should appoint the Governor, on the basis that ministerial appointment will result in a unique set of institutional and governance arrangements that risk undermining the board, the role of which is central to the reforms.

The Reserve Bank considers that the scope and nature of the Remit is untested and ambiguous, and that the current provision for the Minister to direct the Bank to have regard to Government policy, combined with the letter of expectations and regular engagement between Minister and Governor would be preferable. The Reserve Bank is concerned that the Remit may impact on its operational independence (in respect to financial policy decisions), create uncertainty, introduce scope for unwarranted lobbying and create a risk of unintended consequences. The Reserve Bank also argues that the Remit would be

unique in the New Zealand context.

The Treasury does not share the Reserve Bank's concerns and considers that the Remit provides a mechanism for ministerial influence at the appropriate level, while protecting operational independence. It is similar to ministerial powers in relation to other regulators in New Zealand and other prudential regulators internationally.

The Independent Expert Advisory Panel supports moving the Reserve Bank's governance closer to the ICE model, but has mixed views on the appropriate process for the appointment of the Governor, with some members supporting the Minister appointing on the recommendation of the board, and others recommending that the board should retain sole responsibility for appointing and removing the Governor. On balance, the Panel is supportive of the Remit.

Option 3 is recommended in the Cabinet paper.

3.3.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	Comment: <i>nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks</i>	Impact <i>\$m present value, for monetised impacts; high, medium or low for non-monetised impacts</i>	Evidence certainty (High, medium or low)
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Additional costs of proposed approach, compared to taking no action

Regulated parties			
Regulators	Additional costs associated with strengthened reporting and transparency requirements.	Low	Medium
Wider government	Costs to Treasury associated with its monitoring role.	Low	Medium
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Medium

Expected benefits of proposed approach, compared to taking no action

Regulated parties	Reductions in compliance costs from a more transparent regulatory framework, providing participants with a clearer sense of the Reserve Bank's approach and focus in relation to regulatory issues.	Low	Low
Regulators	Benefits from having a clearer and	Medium	Medium

	more standard governance and accountability framework. In particular, a robust appointment process for the board will support strong governance.		
Wider government	Benefits from avoiding the costs and complexity associated with having a unique governance framework for the Reserve Bank.	Low	Medium
Other parties	Benefits associated with improved public confidence in the Reserve Bank, through stronger transparency and accountability requirements and by maintaining the legitimacy of the Governor role.	Low	Low
Total Monetised Benefit			
Non-monetised benefits		Medium	Medium

3.3.9 What other impacts is this approach likely to have?

No other impacts have been identified.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

The proposed approach is compatible with the Government's 'Expectations for the design of regulatory systems', which highlights the importance of providing for predictable and consistent outcomes for regulated parties and of alignment with related regulatory systems.

Issue 4: Financial policy objectives

3.4.1 What is the policy problem or opportunity?

Context

Clear objectives are the bedrock of an independent regulator’s role: they define the regulator’s purpose for its staff, allowing them to prioritise and establish boundaries for their work; and they provide the means for the public to hold the regulator to account.

Phase 1 of the Review established a new purpose statement for the Reserve Bank Act, setting out the reason for creating the Act and for giving the Reserve Bank its monetary and financial policy objectives:

The purpose of this Act is to promote the prosperity and wellbeing of New Zealanders and contribute to a sustainable and productive economy.

This new purpose statement is intended to clarify that the Reserve Bank’s monetary and financial policy objectives are not ends in themselves, but a means to support wider prosperity. It is intentionally broad and therefore insufficient on its own to provide clarity on the Reserve Bank’s role in policymaking – for that, additional objectives are required.

Phase 1 also amended the Reserve Bank’s primary monetary policy objective, to “achieve and maintain stability in the general level of prices over the medium term, and support maximum sustainable employment”. This objective has not been reconsidered in the Phase 2 review.

Financial Policy Objective

The Reserve Bank’s financial regulatory powers are applied for the purpose (among other things) of:

*promoting the maintenance of a sound and efficient financial system.*⁸

As part of the scoping of Phase 2 of the review, stakeholders raised a number of questions and potential issues with the Reserve Bank’s financial policy objective above:

- **Relevance: is the Reserve Bank’s existing financial policy objective still appropriate?** – the Reserve Bank’s existing objective is almost 30 years old, and the nature and tools of financial regulatory policy have evolved significantly since 1989. Are ‘soundness’ and ‘efficiency’ still the right overarching terms to use?
- **Coverage: should the Reserve Bank be given additional financial policy objectives?** – there may be gaps in New Zealand’s financial regulatory architecture, related to the intensity with which consumer protection and competition objectives are pursued. Should the Reserve Bank contribute to plugging such gaps? Should it be given other, new objectives?
- **Weighting: how much weight should be put on the different elements of its objective?** – the different elements of the Reserve Bank’s current financial policy objective can conflict with one another. Should an explicit hierarchy be prescribed in legislation, or should weightings be determined by another mechanism? If so, by whom?
- **Specificity: should the Reserve Bank’s objectives be specified in more detail?** – the Reserve Bank’s existing objectives are abstract concepts that are subject to interpretation. What mechanisms can be used to clarify and further specify them? Or is

⁸ This is limited to the insurance sector under the IPS Act

the current flexibility helpful?

These concerns point to an overarching problem – that the current specification of the Reserve Bank’s financial policy objective has not provided the Reserve Bank or stakeholders with an ideal level of clarity. In particular, there are different perspectives on how efficiency should be taken into account in pursuing the soundness objective. A clear and appropriately specified financial policy objective that applies across all relevant functions, and provides clarity as to what concept of efficiency is to be taken into account, is particularly critical for the Reserve Bank, given the broad scope of powers that have been delegated to the Reserve Bank.

Without a sufficiently clear objective, there is a risk that the Reserve Bank’s approach in this area is too dependent on the perspectives of particular decision makers and could be prone to drift over time.

While it is not possible to quantify the impact of any issues associated with a lack of clarity around the Reserve Bank’s financial policy objective, this objective is critical in guiding its prudential policy and regulatory decisions, and certain central banking functions, and has substantial implications for the broader economy. While the Reserve Bank’s financial policy decisions focus on safeguarding the financial system, they also affect the everyday lives of New Zealanders in a multitude of ways – from influencing the cost of borrowing and the returns to saving, to affecting the availability of credit for households to buy homes and businesses to invest. Taking the costs of its actions into account is critical to ensure the Reserve Bank’s actions have a net benefit.

3.4.2 What options are available to address the problem?

The below options for financial policy objectives for the Reserve Bank have been considered as part of the Review process. These options are not necessarily mutually exclusive, and could be supplemented by other tools for influencing decision-making, such as the Remit (outlined in *Issue 3*) and by establishing decision-making principles to which the Reserve Bank must have regard.

1. Protecting and promoting the stability of New Zealand’s financial system

Financial stability is a common objective for prudential regulators and central banks. It can be interpreted as subtly different from the Reserve Bank’s current financial soundness objective. ‘Soundness’ is often interpreted as promoting the resilience of a country’s financial system to shocks (see, for example, the IMF’s Financial Soundness Indicators), whereas financial stability can be interpreted slightly more broadly as empowering the central bank to mitigate risks to the financial system and hence minimising the incidence of costly financial booms and busts.

According to these definitions, a ‘financial stability’ objective could give the Reserve Bank a slightly broader mandate to use macro-prudential tools to mitigate financial stability risks, in addition to promoting resilience, and would be consistent with the way the Reserve Bank interprets the soundness part of its objective already (it has published a Financial Stability Report since 2004). Both financial stability and soundness objectives primarily focus on the whole financial system, rather than on individual financial institutions. This option would therefore clarify the soundness part of the Reserve Bank’s current financial policy objective. Financial stability is also more appropriate for functions such as lender of last resort that seek to stabilise the financial system, so better captures the range of the Reserve Bank’s

functions.

Protecting and promoting financial stability also requires consideration of longer-term systemic risks such as climate change. As is noted in the [background paper](#) produced by the Review team, the Reserve Bank will need to have a forward-looking and flexible approach to climate change that ensures financial firms are managing their climate-related risks now in a way that keeps them resilient to climate risks into the future.

It would however be important to ensure that the Reserve Bank does not pursue financial stability at all costs. This option on its own would need to be supplemented by other elements, such as decision-making principles, that provide more guidance on the extent to which this objective should be pursued.

We note that the Government made an in-principle decision to adopt a financial stability objective in June 2019.

2. Promoting the safety and soundness of registered and licensed entities

Submitters have suggested that the Act needs to include a primary objective in relation to promoting the safety and soundness of smaller, non-systemic entities, to reflect the fact that much of the Reserve Bank's prudential regulation is directed at individual institutions that may not pose risks to the financial system themselves (e.g. for NBDTs and insurers). Other prudential regulators have this objective: the Prudential Regulation Authority in the UK, for example, has a primary objective to "promote the safety and soundness of PRA-authorised persons".

This objective would seek to ensure that the regulation of these entities receives an appropriate amount of focus and resourcing, and acknowledges the substantial impact that a failure of a smaller entity can have on depositors and on particular places or sectors. Limiting the provision to 'promote', in addition to decision-making principles, avoids the implication that the Bank should run a zero failure regime.

3. Promoting the efficiency of the financial system

The option would mirror the efficiency part of the Reserve Bank's current financial policy objective. Although the Reserve Bank's powers have been directed at promoting a sound and efficient financial system since 1989, the word efficient is open to interpretation. In principle the term can be interpreted very broadly to cover:

- regulatory efficiency – minimising the regulatory burden on firms
- competitive efficiency – improving competition in the financial sector
- dynamic efficiency – encouraging new investment and financial innovation that raise the productive potential of the economy, and
- allocative efficiency – ensuring that financial resources are allocated to their most productive uses to maximise long-term economic growth.

A broad interpretation, encompassing all these terms, would give the Reserve Bank licence to operate in many areas (similar to other central banks that have secondary objectives to promote economic growth). In practice, the Reserve Bank has tended to interpret its efficiency objective more narrowly. It has focused on minimising excessive compliance costs

(regulatory efficiency) and taken a targeted approach to promoting dynamic efficiency (e.g. seeking to not stymie the development of new business models) and allocative efficiency (e.g. by reducing the build-up of debt in the household sector).

4. Maintaining competition in the financial system

Relatively few prudential regulators have explicit mandates to facilitate effective competition. For those that do (e.g. the UK's Prudential Regulation Authority), they are typically interpreted as requiring the regulators to use existing tools to reduce businesses' barriers to market entry, for example, by lowering initial capital requirements for new firms. A competition objective would have clear overlaps with the any efficiency objective.

5. Protecting consumers

Consumer protection is a broad term that could encompass a wide range of policy areas. Such an objective is likely to be most relevant in relation to protecting against the failure of regulated firms and, in the case of a failure, seeking to minimise the impact on depositors. Most prudential regulators under the twin peaks model do not tend to have broad consumer protection objectives due to the risk of creating overlaps and confusion on responsibilities vis-à-vis the market conduct regulator.

6. Maintaining public confidence in the financial system

Public confidence was a Reserve Bank high-level objective before 1989. In the Reserve Bank Amendment Act 1986 it was tasked with "maintaining public confidence in the operation and stability of the financial system". This objective was replaced with the current objective which was considered to more accurately reflect the scope of the Reserve Bank's actual role. It is currently an objective in the IPS and NBDT Acts. Most other central banks, and some regulators, have implicit public confidence objectives and some have them in their legislation. For example, APRA is tasked with "enhancing public confidence in Australia's financial institutions", while the Bank of England must "protect and enhance public confidence in the financial system's stability when considering how to resolve a failing bank". A broad interpretation of a public confidence objective would:

- give the Reserve Bank responsibility for ensuring confidence in the financial system as a whole. This is in keeping with the original wording in the 1986 Act, and would encourage it to take a stewardship role for the whole system, coordinate with other regulators (e.g. the FMA) and take account of public confidence in resolution (for example using lender of last resort in the case of bank runs)
- overlap with the Reserve Bank's other functions, such as maintaining public trust in banknotes
- potentially require the Bank to promote public understanding of the financial system (improving financial literacy) or ensure that the public always has access to critical financial services.

3.4.3 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The following criteria have been used for assessing the appropriateness of different objectives, based on the analysis in the two rounds of consultation documents and feedback from public submissions. Given the need to provide clarity around the use of the broad powers provided to the Reserve Bank, both 'clarity' and 'functional alignment' have been given higher weightings than the other criterion.

Clarity

An effective objective should be clear to the regulator and help to provide clarity and focus to its overall role in the system. Objectives should also not result in overlapping or unclear responsibilities in the regulatory system.

Functional alignment

Objectives should align with the functions that we expect a regulator to perform, reinforcing expectations of what we expect the regulator to achieve when carrying out those functions. Objectives that do not align with a regulator's functions can distract the regulator from its core role and create a risk of mission creep.

Breadth of considerations

Appropriately broadly framed objectives can help to ensure that a regulator does not take a blinkered approach to its functions, pursuing a particular objective without taking due consideration of other factors or public policy objectives. Other legislative requirements, such as decision-making principles, can also be used to broaden the range of matters that are taken into account in pursuit of an objective.

3.4.4 What other options have been ruled out of scope, or not considered, and why?

The options have been selected based on a review of international practice and submissions on two rounds of public consultation. There are a range of relatively minor variations on these options that could also be considered, but which we do not think would have a substantive impact on the analysis.

For the purposes of this analysis we have not separately examined every potential combination of objectives and have instead analysed each individual objective on its own merits before considering the combined effect of the preferred objectives.

3.4.5 What do stakeholders think?

Submissions on the first consultation paper expressed almost unanimous support among stakeholders for retaining a soundness or stability objective as a high-level financial policy objective of the Reserve Bank. Many stakeholders linked this objective to the core purpose of prudential regulation, which they defined as strengthening the risk management and governance practices of financial firms so as to reduce the risk of costly financial failure. Submitters' views were divided on whether soundness or stability is the preferable term, but around two-thirds of responders favoured a switch to 'stability'.

A number of submissions on Consultation Paper 1 recognised that the scope of the Reserve Bank's existing efficiency objective was unclear and needed clarifying. However, there was a range of views as to which aspects of efficiency should be included in the objective's definition, with some supporting the status quo, some supporting a shift to a focus on competition, and others considering that efficiency is too broad a mandate and should instead be a decision-making principle.

Submissions on the second consultation paper were mixed in their response to the Government's in-principle decision to adopt a financial stability objective. While about half of submitters reiterated their support for a financial stability objective, a significant minority expressed their concern over efficiency not being included as a primary consideration for the Reserve Bank. These stakeholders preferred that efficiency be retained either as a primary objective, or as a secondary objective or consideration. Reasons for retaining efficiency as a consideration by the Reserve Bank are that efficiency acts as a natural constraint in the pursuit of financial stability, leading to net benefit decision-making by the Reserve Bank; and, that efficiency is a core part of financial stability. These submissions particularly noted that efficiency as an additional objective will ensure that regulatory burdens are minimised and justified.

Consultation Paper 2 also asked submitters how climate change risks should be included in the scheme to ensure it received sufficient consideration. The majority of submitters who commented on this matter did not consider that climate change should be included as a legislative objective. However, many submitters noted climate change will have implications for financial stability and therefore is an important consideration for the Reserve Bank.

3.4.6 Impact analysis

	Financial system stability	Soundness of entities	Efficiency	Competition	Protecting consumers	Public confidence
Role clarity	+	+	-	0	--	-
	Consistent with the objective of prudential regulation internationally. The change to “stability” from “soundness” would clarify that the Reserve Bank should seek to mitigate risks to the financial system as well as ensuring the ongoing soundness of the system as a whole. We note that the appropriate level of financial stability to be pursued still requires judgement.	Clarifies that the Reserve Bank should seek to ensure the soundness of individual entities. This is a common objective for prudential regulators internationally.	A broad efficiency objective has a number of different elements, with potential confusion as to the types of efficiency which the Bank should be seeking to promote.	Clarifies that maintaining competition should be a focus, but could create overlaps with Commerce Commission.	The breadth of this objective creates potential for confusion about the extent of the Reserve Bank’s role, and how this compares to the FMA.	Public confidence is a necessary component for financial system stability but in itself is a very broad concept and could create overlaps with the FMA.
Functional alignment	+	+	-	-	-	-
	Aligns closely with the Reserve Bank’s prudential functions.	Aligns closely with the Reserve Bank’s prudential functions, including in relation to non-systemic entities.	The regulatory systems that the Reserve Bank is responsible for do not seek to promote efficiency first and foremost, rather efficiency is a constraint on the exercise of powers.	The regulatory systems that the Reserve Bank is responsible for do not seek to promote competition first and foremost, and tend to restrict market entry to participants meeting registration conditions.	While the Reserve Bank can help to protect consumers against the risk of the failure of a regulated institution, it is not responsible for broader conduct matters that are core to consumer protection.	The Reserve Bank’s ability to promote confidence is largely by strengthening the regulation of entities and by managing entity failures.
Breadth of considerations	-	+	+	+	+	0
	Does not specify the limits to which financial system stability is desirable.	Ensures the Reserve Bank does not focus solely on systemic risks.	Encourages the Reserve Bank to take costs and broader efficiency issues into account in decision-making.	Encourages the Reserve Bank to take competition impacts into account in decision-making.	Would encourage the Reserve Bank to focus on consumer outcomes.	May encourage the Reserve Bank to take a broader range of matters into account in resolving entity failures.
Overall assessment	++	+	-	0	-	-
	This is an appropriate and internationally consistent primary objective for a prudential regulator. Risks of a focus on ‘stability at all costs’ can be addressed through appropriate decision-making principles.	This objective would appropriately reflect the role that the Reserve Bank has been given in relation to less systemically important entities. However, it may be more appropriate to address this in the relevant sector Acts rather than the Institutional Act which also covers central bank functions (to which this is not applicable).	While an efficiency objective would protect against a blinkered view, it has proved difficult to interpret and does not align closely with the Reserve Bank’s function. It is better considered as a constraint on the Reserve Bank’s exercise of its powers and therefore included as a decision-making principle.	While a competition objective would protect against a blinkered view, it does not align closely with the Reserve Bank’s functions. It may be more appropriate as a decision-making principle.	A consumer protection objective is likely to create confusion about the boundary between the role of the Reserve Bank and the FMA. The Reserve Bank’s functions do not align well with a broad consumer protection mandate as it is too broad.	A public confidence objective would need to be bounded by an overall financial stability objective to avoid creating confusion about the boundary between the role of the Reserve Bank and the FMA.

Key:

- ++ much better than doing nothing/the status quo
- + better than doing nothing/the status quo
- 0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- much worse than doing nothing/the status quo

3.4.7 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

Based on the assessment above the Treasury considers that the following main financial policy objective for the Institutional Act best meets the criteria:

Protecting and promoting the stability of New Zealand's financial system

'Financial stability' relates directly to the purpose of prudential regulation and supervision, which is to ensure that financial firms conduct their business in a careful and judicious ('prudent') way. It provides a clear objective that aligns with the Reserve Bank's role and can be counterbalanced by lower-tier decision-making principles. It is also an objective of many of the Reserve Bank's central banking functions, such as lender of last resort and management of foreign reserves. It can therefore be considered relevant across all the Reserve Bank's functions

This objective would sit alongside the Reserve Bank's monetary policy objectives, with the overall purpose of the Act being to promote the prosperity and wellbeing of New Zealanders and contributing to a sustainable and productive economy. This means the objective is to be pursued in a manner that promotes overall wellbeing.

The Reserve Bank's other legislation (such as the IPS Act) would then set out purpose statements that specify the application of this objective in regards to the particular sector. In particular, it is important that the relevant sector Acts ensure that the Reserve Bank is focussed on both the stability of the overall financial system as well as the soundness of individual institutions. This is particularly important in relation to smaller regulated entities, which may not present a systemic financial stability risk, but which the Reserve Bank is responsible for prudentially regulating in order to avoid the significant impacts of a failure on particular places, sectors and on individual depositors. The purpose statements of the sector acts will be considered when these Acts are reviewed.

A number of stakeholders have expressed concern about the prospect of removing the efficiency component of the objective, while others have advocated for an explicit competition objective. In our view, competition and efficiency should not be the Reserve Bank's core mandate – rather they are important considerations that should shape how it seeks to achieve its main objectives. Concerns about whether the Reserve Bank adequately takes efficiency and competition into account would be more appropriately addressed through decision-making principles. We see the core concept of efficiency to include a principle that regulation needs to generate net benefits.

We propose to supplement the preferred objectives with the following decision-making principles, based on those currently in place in sector legislation, such as the IPS Act. These principles would ensure that a range of broader issues and countervailing considerations are taken into account in the Reserve Bank's decision-making:

1. the desirability of minimising unnecessary costs from regulatory actions, taking into account the value of outcomes to be delivered
2. the desirability of taking a proportionate approach to regulation and supervision, and ensuring consistency of treatment of similar institutions

3. the desirability that sectors regulated by the Bank are competitive, taking into account the size of the market
4. the desirability of taking into account long-term risks to financial stability
5. the value of transparency and public understanding of the Reserve Bank's objectives and how the Bank's functions are exercised, and
6. practice by relevant international counterparts carrying out similar functions, as well as guidance and standards from international bodies.

The Reserve Bank and the Independent Expert Advisory Panel support the proposed approach.

3.4.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	Comment: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	Impact \$m present value, for monetised impacts; high, medium or low for non-monetised impacts	Evidence certainty (High, medium or low)
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Additional costs of proposed approach, compared to taking no action

Regulated parties	Potential that a clearer focus on financial stability could create a more intensive approach to prudential regulation, with flow on costs to the sector.	Medium	Low
Regulators	Potential that a clearer focus on financial stability could require increases to the resourcing of prudential functions. Some implementation costs associated with updating documentation and explaining the new approach.	Low	Low
Wider government			
Other parties			
Total Monetised Cost			
Non-monetised costs		Low	Low

Expected benefits of proposed approach, compared to taking no action

Regulated parties	Clear objectives improve certainty for regulated entities.	Medium	Low
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Regulators	Clear objectives allow for more effective prioritisation and establish boundaries.	Medium	Low
Wider government	Improved role clarity vis a vis other regulators	Low	Low
Other parties	A clearer focus on financial stability should, over the long term, reduce the risk of spill-over effects that could threaten the real economy. Clear objectives also better enable the public to hold regulators to account.	Medium	Medium
Total Monetised Benefit			
Non-monetised benefits		Medium	Low

3.4.9 What other impacts is this approach likely to have?

No other impacts have been identified.

3.4.10 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

The proposed approach is compatible with the Government's 'Expectations for the design of regulatory systems', which highlights the importance of a regulatory system having clear objectives.

Issue 5: Funding

3.5.1 What is the policy problem or opportunity?

The Reserve Bank’s funding has a direct bearing on its ability to achieve its statutory objectives. While the Institutional Act will not determine the level of funding provided to the Reserve Bank, it will establish the funding model. A well-designed funding model maintains operational independence with accountability checks that ensure that the public is getting good value for money.

The Reserve Bank earns money from its activities, including its monopoly power to create physical cash, and uses a portion of this revenue to cover its expenditure, with the balance (less retained earnings) being returned to the Crown as a dividend. The total amount that the Reserve Bank can spend on its operating expenses each year is currently set out in a five-year agreement between the Minister of Finance and the Reserve Bank Governor. The Reserve Bank has discretion to allocate and use the funding it has agreed with the Minister. The funding agreement requires ratification by a Parliamentary resolution.

The agreement model aims to achieve a balance between budgetary independence and value for money based on the incentives of the two parties, but it has been criticised for lacking flexibility, transparency and accountability. Some stakeholders consider it has delivered insufficient funding for the Reserve Bank to achieve its statutory objectives.

Key concerns raised about the current funding model include:

The process has proved inflexible, leading to resourcing not keeping up with needs

From a practical perspective, given the dynamic nature of the financial services industry, it is challenging to forecast new strategic priorities five years in advance. Furthermore, since the GFC there has been a significant increase in expectations as to the intensity of the Bank’s prudential functions. The Reserve Bank, the Treasury, stakeholders and the IMF all view the Reserve Bank’s prudential functions as under-resourced relative to current expectations as to the intensity of these functions.

The legislation allows for flexibility, as the funding agreement can be amended at any time, upon agreement between the Minister and the Bank, however amendments between the five years have been rare in practice. While in part this comes down to practice, the requirement for the funding agreement, and any amendment, to be ratified by Parliament reduces this flexibility and may contribute to a reluctance to make amendments.

Scope of agreement

The current agreement covers ‘operational expenditure’ as reported in the Statement of Financial Performance, but the Reserve Bank and Minister may agree to exclude certain items of expenditure. Capital expenditure is incorporated through depreciation but is not part of the agreement. In theory, the Reserve Bank could therefore make significant capital expenditure decisions without ministerial approval, which would have an impact on future depreciation levels (and therefore operating expenditure). In practice this has not been a problem, as the Reserve Bank has consulted with the Minister on significant capital

expenditure.

The funding process lacks transparency

The current agreement model lacks sufficient detail for stakeholders on how funding levels have been determined and how funds will be spent on providing each of the Reserve Bank's functions.

The funding source is simple, but may not align with where benefits fall

The costs of funding the Reserve Bank's regulatory regime do not fall on those who most benefit from the regime, namely, the financial sector itself and its customers. Instead, the costs of funding the Reserve Bank's regulatory functions fall largely on taxpayers (through lower dividends from the Reserve Bank). Internationally, when compared with central banks, prudential authorities are more commonly funded – at least in part – by industry levies. As there are both private benefits and broad public benefits from prudential regulation, there is a case for a mixture of funding through levies and tax-payer funds.

3.5.2 What options are available to address the problem?

The following four options have been assessed, the first three of which are mutually exclusive, while the fourth could work in combination with any of the other options:

Option 1: Amended agreement model

This model would adopt the current five year agreement model with the following key features:

- All expenditure would prima facie be subject to a funding agreement between the Reserve Bank and the Minister.
- The Reserve Bank and the Minister could agree to exclude particular expenditure from the funding agreement (i.e. exempt some functions or operations from a funding constraint).
- The Reserve Bank would be required to produce a five-year budget that informs the funding agreement, providing detail on the expected level of service for each of the Reserve Bank's key functions and outputs.
- The funding agreement would continue to be able to be amended or renegotiated at any time.
- The funding agreement and supporting budget would be required to be tabled in Parliament rather than ratified by Parliament.
- The proposed and final versions of documents would be published.

Option 2: Budgetary independence

This option would provide for significant budgetary independence across all of the Reserve Bank's functions.

- The Reserve Bank would prepare an annual budget (with three-year rolling forecasts) based on the board-approved strategy and proposals by the Governor and bank management. Final spending decisions would be the responsibility of the board;
- The Minister would be consulted on the budget (and the Reserve Bank would be required to publicly respond to their feedback), in addition to being consulted on the SOI and Statement of Performance Expectations (SPE).
- As under *Option 1*, the Minister would make the final determination of the amount of

the annual dividend.

- The Reserve Bank, with ministerial input, would agree the reportable classes of outputs for the purposes of the annual SPE.
- Other transparency requirements would be the same as under *Option 1*.

Option 3: Appropriations model

This option would require Reserve Bank funding to be determined and approved through the budget process and then provided to the Bank through annual appropriations.

- Similar to other budget-funded entities, if the Reserve Bank required additional funding, it would make a budget bid, seeking and justifying a funding increase, which would be assessed and weighed against other budget priorities.
- Baseline funding would not typically need to be reassessed through the budget process.
- Final funding levels would be determined by Cabinet through the budget process.
- The Reserve Bank's spending would be subject to the normal oversight and accountability mechanism, including select committee estimates hearings.
- Under this model all of the Reserve Bank's revenue would be returned to the Crown.

Option 4: Levy and fee making powers (not mutually exclusive with options 1-3)

This option would provide for a levy-making power, allowing for some or all of the Reserve Bank's regulatory functions to be funded through a levy on regulated entities, such as banks, other deposit takers and insurers. A levy would be set through regulation on the advice of the Minister, following consultation with the Reserve Bank. The Act would prescribe certain procedural requirements for setting the levy. This would ensure that the financial sector, which benefits from a stable and sound financial system, bears at least part of the cost of the regulatory system. The proportion of costs that should be recovered through a levy and how these costs should be distributed amongst the financial sector would require further analysis and consultation.

This option would also provide for a fee-making power, allowing for fees to be prescribed for specific services provided by the Reserve Bank. For example, this would enable fees to be set via regulations for the Reserve Bank's licensing and exemption making functions. These fees would be set at a cost-recovery level in accordance with the *Guidelines for Setting Charges in the Public Sector*. This power would replace current fee setting powers in the Act.

3.5.3 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The following criteria are used to assess the options:

Democratic oversight

Any revenue that the Reserve Bank does not spend is returned to the Crown as a dividend, meaning that Bank funding is essentially competing against other alternative spending priorities. Funding options that allow the Minister some degree of control over Reserve Bank spending allow for the Minister to weigh up these priorities, and can restrain spending while providing assurance that funds are being utilised in an appropriate and efficient way.

Accountability

The funding model should promote both accountability for the delivery of the Reserve Bank's objectives and functions, as well as ex-post accountability for the efficient expenditure of

funds.

Operational independence

Any funding model should not undermine the operational independence of the Reserve Bank by inappropriately constraining its ability to undertake its core roles. Ideally a funding model should also provide the Reserve Bank with sufficient certainty around future funding levels to allow it to invest in longer-term initiatives.

Complexity

A funding model should be as straightforward and understandable as possible and should avoid unnecessary administrative costs. It should also be flexible enough to accommodate changing risks to financial stability over time that may require a reassessment of the Reserve Bank's resourcing.

3.5.4 What other options have been ruled out of scope, or not considered, and why?

A range of variations on the models assessed could also be considered, such as different variations on the funding processes or different durations for funding agreements. We selected the variations on the different approaches that were most likely to meet the assessment criteria.

3.5.5 What do stakeholders think?

Most of the relevant submitters agreed with the issues outlined above. Some submitters noted that the potential issues with the funding agreement relate to the *use* of the model rather than the *design*. A small number of submitters endorsed a particular funding model, with four submitters supporting an "agreement" model and two submitters supporting a budgetary independence model. There was also general support for more accountability and transparency on the Reserve Bank's spending and funding.

The majority of submissions noted that the Reserve Bank is under-resourced, or should be provided with more resources, with a particular focus on the prudential function. There was strong support for levies or fees provided there is associated industry consultation and adherence to public-sector guidance and practice when setting such charges and on the basis this would result in a higher level of service. However, a number of submitters noted the increasing costs of regulation for the financial sector in particular due to a number of new regulatory initiatives being instigated at present. Additional costs may affect the viability of some firms or be passed onto customers.

3.5.6 Impact analysis

	No action	Option 1: Amended agreement model	Option 2: Budgetary independence	Option 3: Appropriations model	Option 4: Levy and fee making powers
Democratic oversight	0	+	--	++	+
		An agreement model maintains a strong, ex-ante democratic check on spending intentions.	The Reserve Bank Board would have discretion to spend without a formal ex-ante democratic check.	Provides the strongest democratic check on spending, including Cabinet and Parliamentary approval.	A levy would be set and approved by Ministers via regulations.
Accountability	0	+	+	-	+
		Balances accountability for adequate funding between the Bank and the Minister. Requirements for approval and transparency requirements strengthens ex-post accountability.	Supports Board accountability by giving them budget independence and by strengthening transparency requirements. Retains a degree of ex-post accountability through performance monitoring and Board accountability to the Minister.	Shifts responsibility for adequate funding to the Minister/Treasury, although the Bank retains accountability for the efficient use of its resources.	Improves accountability for spending on functions for which a levy or fees are used to cost recover.
Operational independence	0	+	++	-	+
		An agreement model which provides funding certainty for an extended period supports budgetary independence.	Provides for the greatest degree of budgetary independence.	Potential to compromise operational independence as funding needs would compete directly with wider government.	Cost recovery from industry improves independence from Ministers (as the funding cannot be redirected to other areas).
Complexity	0	+	+	-	-
		Amendments create no more complexity than current arrangements, but will be more flexible, due to the removal of the Parliamentary ratification requirement.	The simplest model available as all decision rights, apart from dividend, rest with the Board.	Annual budget process involves significant process requirements, although baseline funding would not typically be reassessed and this is consistent with the state sector generally.	Process for setting and recovering levies and fees adds complexity.
Overall assessment	0	++	+	-	+
		An amended agreement model would be better than the status quo, improving both accountability and operational independence.	The significant increase in budgetary independence and improvements in board accountability is offset by a lack of democratic control over expenditure.	Strengthens democratic control but operational independence could be compromised and the process is more complex.	Accountability improves as spending needs to be justified. Improved operational independence. Process requirements increase complexity.

Key:

- ++ much better than doing nothing/the status quo
- + better than doing nothing/the status quo
- 0 about the same as doing nothing/the status quo
- worse than doing nothing/the status quo
- much worse than doing nothing/the status quo

3.5.7 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

The Treasury considers that *Option 1: Amended agreement model* would best address the issues identified in relation to the Reserve Bank’s funding. The Treasury considers that this model provides sufficient flexibility and that this would be enhanced by the removal of the requirement to obtain Parliamentary ratification. Improvements in the funding agreement process and increased transparency requirements will improve accountability and help protect operational independence. On balance, stakeholders were supportive of an agreement model.

The Treasury notes that while *Option 2* would provide significant operational independence, it would remove an ex-ante democratic check on the Bank’s spending intentions, and does not provide Ministers with the opportunity to weigh the use of funds by the Reserve Bank against other possible uses. This would be unusual for a public sector entity in New Zealand. While *Option 3* aligns with normal practice in the state sector, including for other independent Crown entities, it does not provide an optimal level of operational independence for a central bank and prudential regulator. The Treasury therefore prefers *Option 1* over *Options 2 and 3*.

In addition, the Treasury recommends that the Institutional Act provide for levy and fee making powers (*Option 4*), which would be set through regulations. The levy and fee making powers would further future-proof the Act, provide an independent funding source, and allow the costs of some functions to fall on those who benefit from them. Stakeholders were strongly supportive of levy and fee making powers, subject to the calibration involving consultation with industry and the public sector guidance for setting charges and fees is followed.

The Reserve Bank prefers *Option 2: Budgetary independence*. Internationally, such a model is common for central banks, but less so for prudential regulators. The Reserve Bank considers that *Option 2* would provide significant operational independence, providing the Reserve Bank with adequate resources to meet evolving systemic and stability issues, while reinforcing the board model, as the board would be responsible for setting the budget necessary to achieve objectives and deliver outcomes. *Option 2* would also have the relative advantage of simplicity compared to the other Options.

The Independent Expert Advisory Panel support a funding framework that enables the Reserve Bank to be strategic and responsive to future conditions. In this context, the Panel have mixed views on the optimal funding model. Some Panel members noted an agreement model provides democratic oversight of spending and is flexible enough to enable appropriate budgetary independence across different functions (supporting the Treasury’s recommendation). Other Panel members noted that a funding agreement would constrain the board and believe full budgetary independence is more appropriate (supporting the Reserve Bank’s recommendation).

3.5.8 Summary table of costs and benefits of the preferred approach

Affected parties (identify)	Comment: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg	Impact \$m present value, for monetised	Evidence certainty (High,
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	<i>compliance rates), risks</i>	<i>impacts; high, medium or low for non-monetised impacts</i>	<i>medium or low)</i>
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Additional costs of proposed approach, compared to taking no action			
Regulated parties	Regulated parties would pay any fees and levies set under the proposed fee and levy making powers.	Medium – noting that the appropriate level of any fee or levy has not been determined. In 2017/18 the Reserve Bank spent \$24 million on its financial stability-related responsibilities. Increased resourcing is likely to be required to enable a shift to a more intensive supervision regime.	Low
Regulators			
Wider government			
Other parties	Regulated entities may pass on some of the additional costs from levies or fees.	Low - noting that the appropriate level of any fee or levy has not been determined and the ability and desire from entities to pass on costs is uncertain.	Low
Total Monetised Cost			
Non-monetised costs		Medium	Low

Expected benefits of proposed approach, compared to taking no action			
Regulated parties	Regulated parties have generally supported changes to funding arrangements that would support strengthened supervisory and enforcement capability.	Low	Low
Regulators	Proposed funding model would be more flexible and better enable	Medium	Low

	cost recovery for fee-funded functions.		
Wider government	Improved oversight of Reserve Bank expenditure through Treasury monitoring. Any future levy funding of regulatory funding would increase Reserve Bank dividend to the Crown.	Medium	Low
Other parties	Improved transparency on Reserve Bank expenditure.	Low	Low
Total Monetised Benefit			
Non-monetised benefits		Medium	Low

3.5.9 What other impacts is this approach likely to have?

No other impacts have been identified.

3.5.10 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

The proposed approach is compatible with the Government's 'Expectations for the design of regulatory systems', which emphasises the importance of regulatory regimes having scope to evolve in response to changing circumstances.

Section 4: Conclusions

4.1 Will the package of preferred options, across the various issues examined, meet the overall objectives and deliver the highest net benefits?

The Treasury’s preferred package of options for responding to the issues considered in this RIA are as outlined below. As noted, these proposals are inherently interlinked, with later proposals aiming to build on the strengths of earlier proposals, while mitigating any risks or weaknesses. In particular, many of the design elements in *Issues 3, 4 and 5* aim to support operationally independent board decision-making over a wide range of central bank and financial policy matters, while maintaining public legitimacy and sufficient democratic oversight.

On net, we consider that the package of changes will significantly strengthen the Reserve Bank’s decision-making and governance framework, while maintaining an appropriate balance between clear operational independence and accountability to Ministers and the public more broadly. While the changes would be significant in terms of the way that the Reserve Bank operates, they should not in of themselves impose any significant costs on the financial sectors or the public.

Issue 1: Institutional responsibility for prudential regulation

The Treasury prefers *Option 1: Enhanced Status Quo*. This reflects a judgement that any benefits from the creation of a separate prudential regulator in terms of focus and reducing conflicts of interest would be more than outweighed by the loss of synergies between prudential and central bank functions and by the additional cost and disruption of creating and shifting these functions to a new institution. This approach was supported by the vast majority of stakeholders.

Issue 1: Summary impact assessment of preferred option	
	Enhanced Status Quo
Focus	+
Synergies	+
Conflicts of interest	+
Costs	-
Overall assessment	++

This is consistent with Cabinet’s in-principle decision and is reflected in the Cabinet paper.

Issue 2: Governance and decision-making

The Treasury recommends the establishment of a governance and decision-making board. We consider that the benefits of a multi-member decision-making model, in terms of providing a breadth of perspectives and expertise and reducing the reliance on a single individual for the effective leadership of the organisation, outweigh the costs associated with reduced efficiency, additional complexity and the potential for weaker external accountability. On balance, the Treasury does not consider that the benefits of establishing a specialist FPC with responsibility for financial policy matters outweigh the costs and risks.

We note that Cabinet has made an in-principle decision to shift to a board-based decision-

making model, but not to establish an FPC. This is reflected in the Cabinet paper.

Issue 2: Summary impact assessment of preferred options	
	Governance board
Balanced composition	+
Efficient decision-making	-
Simplicity	-
Consistency in behaviour	+
Strategic leadership	+
Accountability and transparency	+
Overall assessment	++

Issue 3: Accountability and independence

The Treasury considers that *Option 3: Modified ICE model* would best address the identified issues with the Reserve Bank’s accountability and independence framework. This option incorporates a range of changes to the status quo, which would preserve the Reserve Bank’s operational independence, while enhancing accountability and legitimacy. In particular, the Treasury considers that the Remit provides an appropriate channel for ministerial influence on the significant financial stability policy matters delegated to the Reserve Bank. This model would be implemented through alignment with the Crown entities framework, rather than by designating the Bank as an ICE.

The Reserve Bank prefers *Option 2: ICE*.

Option 3 is reflected in the Cabinet paper.

Issue 3: Summary impact assessment of preferred option	
	3: Modified ICE model
Independence	+
Accountability	++
Legitimacy	++
Cost and complexity	-
Overall assessment	++

Issue 4: Financial policy objectives

Based on the assessment above the Treasury considers that the objective of “Protecting and promoting the stability of New Zealand’s financial system” best meets the criteria for inclusion in the Institutional Act. ‘Financial stability’ relates directly to the purpose of prudential regulation and supervision, which is to ensure that financial firms conduct their business in a careful and judicious (‘prudent’) way. It provides a clear objective that aligns with the Reserve Bank’s role and can be counterbalanced by lower-tier decision-making principles.

The sector Acts would then set out additional purpose statements that specify the application

of this objective in regards to the particular sector.

This option is reflected in the Cabinet paper.

	Financial system stability
Role clarity	+
Functional alignment	+
Breadth of considerations	-
Overall assessment	+

Issue 5: Funding

The Treasury considers that *Option 1: Amended agreement model* would best address the issues identified in relation to the Reserve Bank’s funding. The Treasury considers that this model provides flexibility and protects operational independence. Improvements in the funding agreement process and increased transparency requirements will also improve accountability and help protect operational independence. We consider that it is appropriate that Ministers have some level of control over total levels of Reserve Bank spending in order to maintain democratic oversight and legitimacy.

In addition, the Treasury recommends that the Institutional Act provide for levy and fee making powers, which would be set through regulations (*Option 5*). The levy and fee making powers would further future-proof the Act, provide an independent funding source, and allow the costs of some functions to fall on those who benefit from them.

The Reserve Bank prefers the budgetary independence model with no levy making power.

Options 1 and 5 are reflected in the Cabinet paper.

	Option 1: Amended agreement model	Option 5: Levy making and fee powers
Democratic oversight	+	+
Accountability	+	+
Operational independence	+	+
Complexity	+	-
Overall assessment	++	+

Section 5: Implementation and operation

5.1 How will the new arrangements work in practice?

The changes are proposed to be given effect by a bill for introduction in mid-2020 which will create a new Institutional Act for the Reserve Bank. Subject to the Parliamentary process, we would expect the bill to be enacted some time in 2021.

This process will be led by the Treasury, and the legislation, once enacted, will be administered by the Treasury. The Treasury will also take on the role of monitoring the performance of the Reserve Bank on behalf of the Minister of Finance.

A transitional period is expected to be required to allow for the new governance arrangements to be stood up. Regulatory requirements in the current Act relating to banks and payment systems will be preserved in a separate Act until the Deposit Takers Bill and Financial Market Infrastructures Bill are enacted.

5.2 What are the implementation risks?

Risks associated with the implementation of the Institutional Act are relatively minimal, although there will be implementation pressures on both the Reserve Bank and the Treasury. In particular, the Treasury will need to expand its capacity and capability in this area in order to effectively undertake its role as monitor. These risks and resource requirements have already been highlighted to both agencies, who are planning to increase resourcing in effected areas. The extent that any changes require additional resources on the part of the Reserve Bank is being considered as part of the development of its 2020 funding agreement. In addition, undertaking development of the Institutional Act over a short timeframe means certain more minor issues may not be considered.

The new board will need to develop new operating procedures. It may take time for the board to settle on operating procedures.

The most significant risks are likely to result from the significant implementation pressures on the Reserve Bank in relation to a new prudential regime for deposit takers. Progressing the Institutional Act ahead of the Deposit Takers Act mitigates these risks by providing time for the new governance and accountability arrangements to be bedded-in before the Deposit Takers Act comes into force.

Section 6: Monitoring, evaluation and review

6.1 How will the impact of the new arrangements be monitored?

The new regime will establish the Treasury's role as monitor for the Reserve Bank and administrator of the Institutional Act. In accordance with the State Service Commission's *Operating Expectations Framework for Statutory Crown Entities*, a formal monitoring delegation will need to be put in place from the Minister of Finance, and the Treasury will need to establish robust ongoing monitoring arrangements, including establishing regular requirements for information from the Reserve Bank, and working with the Reserve Bank to identify and assess relevant performance metrics.

6.2 When and how will the new arrangements be reviewed?

As part of its role in administering the new Institutional Act and in addition to its ongoing monitoring role, the Treasury will review the institutional framework five years after it has come into force. This review will provide an opportunity to evaluate the effectiveness of the new institutional arrangements and to ensure no unexpected issues have arisen. It will also allow us to examine the interaction with the new prudential framework for deposit takers.

Potential future changes to the Crown Entities framework, which have been [signalled by the State Services Commission](#), would also provide an opportunity to assess their applicability to the Reserve Bank and to revisit the performance of new governance arrangements more generally.