Phase 2 Reserve Bank Review – Responses to Questions for Submission

INFINZ sets out our responses to your questions for submission below. A core mission of INFINZ is to promote strong and vibrant capital and financial markets, recognising the contribution they can make to our economy and wellbeing. Accordingly, we have focused in this submission on these aspects of the Phase 2 proposals.

What high-level financial policy objectives should the Reserve Bank have? (Chapter 2)?

We think it is important at this time to review the Reserve Bank's objectives. It has been 30 years since the RBNZ Act was enacted and that time has seen very significant changes in the economy, in prudential regulation and in the financial system – the next thirty years are only going to accelerate these trends.

The same period also saw a legislative move toward greater sophistication and transparency of statutory objectives (perhaps best exemplified by a comparison between the statement of objectives in the FMCA and its predecessor, the Securities Act 1978). This is significant because of the golden rule of statutory interpretation that Acts should be interpreted in accordance with their purpose, and in guiding executive actions and decisions.

It is also particularly important in the context of the RBNZ Act, in view of the significance of the Reserve Bank's role and its inter-linkages with other bodies and regulatory frameworks. In this regard, the stated objectives can also form an important part of providing links across complementary legislative regimes and a guiding force for their lead regulatory agencies – most notably in this context, between:

- the RBNZ Act/Reserve Bank and the FMCA/FMA, under the "twin peaks" model;
- the RBNZ Act/Reserve Bank and the CCCF Act/Commerce Commission in respect of the lending market (and in particular, responsible consumer lending) – a "triple peaks model"; and
- the RBNZ Act/Reserve Bank and the Commerce Act/Commerce Commission in respect of competition policy.

With these introductory comments in mind, we comment on your more specific questions below.

1. Are the Reserve Bank's existing high-level financial policy objectives still appropriate and fit for the future?

Yes, financial soundness/stability and efficiency are the cornerstones of a prudential regime, and as such they remain appropriate and fit for purpose. But, for reasons elaborated below, we consider that they should be supplemented with a number of second-level objectives.

In relation to the 'factors to consider', we have the following comments:

- **Narrowness v breadth**: The objectives should be broad enough to reflect matters that the Reserve Bank can reasonably influence or contribute to. A two-tier set of objectives will make the Reserve Bank's core accountabilities clear. This is one of the reasons that it is important for there to be a clear hierarchy (as with the FMCA). For these reasons, we also agree with points made in the Phase 2 Report under "blinkered view".
- **Minimising conflicts**: This is important, but if there are conflicts affecting the Reserve Banks activities they will arise in the real world whether they are reflected in its stated objectives or not. It is better that such conflicts are identified and addressed transparently.

- **Maximising synergies**: Like all organisations, the Reserve Bank will be more effective if it maximises synergies and engagement – with peer prudential authorities, other government agencies (such as Treasury, FMA, and the Commerce Commission), the private sector, the academic community, and international agencies. We also agree that shared objectives should contribute to coordination and results – for example, both the FMA and the Reserve Bank have clear contributions to make to a strong and vibrant capital markets, using their respective resources and strengths.

(a) Should 'soundness' remain a high-level financial policy objective of the Reserve Bank, or would a 'financial stability' objective be more appropriate?

We submit that stability/soundness should remain a key objective. On balance, we would favour moving to 'financial stability' – as the term more commonly applied globally – from 'soundness' as at present, although we regard those terms as largely synonymous.

It could be argued that there is a substantive difference, for example in relation to an increased role for prudential authorities in attempting to address macroeconomic imbalances or smooth the business cycle. That may be so, but it recognises a new reality in prudential regulation both here and overseas, e.g. through the Basel III countercyclical buffers. While it is yet to be seen whether such initiatives will be successful, there is plenty of evidence that financial crises are associated with excessive debt build-up and related imbalances. In a New Zealand context, the innovative use of macroprudential high LVR restrictions on the face of it met its objectives of reducing the proportion of such loans and of contributing to a short-run dampening of house price inflation.

(b) What role should the Reserve Bank play in promoting 'efficiency'? Should it have a narrow mandate (e.g. focused on regulatory efficiency) or a broad one (e.g. including allocative efficiency and promoting sustainable growth)?

The Reserve Bank has a key role in either promoting or diminishing efficiency whether this objective is stated or not, as its activities and the regulatory setting can affect (among other things) the cost of capital, asset prices, asset allocation decisions, the level of investment and capital accumulation, the funding balance between intermediation and capital markets channels, and the shape and diversity of the financial system. Given this, it is essential in our view that efficiency remains a first-level objective alongside soundness/stability.

We also think that efficiency should be regarded as complementary to stability, not as secondary or as a 'counterweight' to it. The impact of policies on growth and employment is an efficiency matter which needs to be considered in its own right, but also in terms of its potential secondary impacts on acknowledged financial stability vulnerabilities, such as high levels of private debt connected with long-term housing inflation (e.g, a policy adversely affecting investment and employment could also have flow-on effects, creating or exacerbating stress in the financial system). The relationship also runs the other way, as stability underpins long-term investment and therefore productivity. In the long run, we believe that stability and efficiency go hand in hand.

We also consider that the particular features of our financial system are such that efficiency remains an important first-tier objective in its own right – as noted in the IMF FSAP review, we rank highly for stability but relatively low for diversity and competition in the finance sector.

As to scope, it is difficult to see why efficiency would be interpreted to have a meaning that is narrower than its ordinarily recognised components, including dynamic and allocative efficiency. This is because it is apparent that a central bank's activities can have an impact on these and, unless there is some trumping reason (dealing with a banking crisis might be an example), it should have an objective of ensuring as far as possible that the impact is positive.

We do not think there is much merit in the potential arguments for demoting or removing efficiency (on pg 33). Optimality is a focus which may sometimes be complex, but is clear in its intent and is self-evidently appropriate as a goal. Efficiency is an economic concept which does not need, and likely would not benefit from, a statutory definition. In particular, it should not be restricted to regulatory efficiency, although that may be an appropriate objective for more narrowly focused agencies.

(c) Should 'efficiency' remain a high-level objective of the Reserve Bank, or should it be demoted to a lower tier of the legislation?

As discussed more fully under (b), it is important that efficiency remains a first-level objective of the Reserve Bank, because it is:

- important in its own right; and
- complementary to the stability/soundness objective.

2. Should the Reserve Bank be given additional high-level financial policy objectives?

No, we think the key focus should remain on stability and efficiency. But, for the reasons given below, those two core objectives should be supplemented by second-level objectives, to which the Reserve Bank should have regard when exercising relevant aspects of its mandate.

(a) How many high-level financial policy objectives should the Reserve Bank have – are the gains of having multiple objectives worth the costs of lost focus?

We don't think there is any issue with multiple objectives as such, particularly given the range of things the Reserve Bank does and the broad range of impacts its decisions and activities can have.

The FMCA provides an example. There the "*main purposes*" are relatively high level – promoting confident and informed participation in the financial markets and the development of fair, efficient, and transparent financial markets (s 3). The "*additional purposes*" are more specific components contributing to those objectives: high quality disclosure, appropriate governance, avoiding unnecessary compliance costs, and promoting innovation and flexibility (s 4).

This core is supplemented by targeted purpose provisions in other parts of the Act, relating to: disclosure documents (s 49) and principles governing regulation of financial markets (s 229) – including encouraging "a diversity of financial product markets to take account of the differing needs and objectives of issuers and investors". We think this provides a good model for enhanced objectives in the RBNZ Act both in structure and in overall regulatory ethos.

In order to control for conflicts and lack of focus, each potential objective should be assessed:

- first on its own merits in isolation; and
- second, as to whether it potentially clashes with other objectives (and whether this may be mitigated by appropriate provision).

Once a provisional list of candidate first and second-level objectives has been established, they can be assessed as to whether they are too cluttered overall. Ultimately, we think there is minimal risk that the Reserve Bank will 'lose focus' merely as a result of recognising explicitly some of the broader objectives that already underlie its prudential activities.

(b) Should 'competition' be promoted to a high-level objective of the Reserve Bank, or should it remain as a lower-tier objective?

Competition should remain as a lower-tier objective, but should not be restricted to the position of NBDTs. The IMF in its recent FSAP found that New Zealand's financial system ranks highly for stability, but relatively low for competition and diversity – suggesting there should be a renewed focus in this area. In addition, the increasing influence of Fintech and different business models has been a reality for some time. This is likely to improve efficiency and customer experience but it will require continuous adaptation both from the finance industry and from regulators.

Although much of the focus is on new technology, and the potential for it to be disruptive, there are also very significant changes happening locally and worldwide in the shape of the financial system, which will create new opportunities and challenges and will require both regulators and market participants to regularly re-assess their models and the way they do things. This includes the growth of institutional investors, private equity and even family office operations (which may have overtaken the hedge fund industry)[1], which increasingly is outstripping that of the traditional public equity and debt markets. This offers new possibilities for funding and investment, while presenting a challenge to the traditional public markets, and to regulatory models which put those markets at the centre of their focus.

(c) Should 'consumer protection' be added to the Reserve Bank's objectives?

Arguably consumer protection is already an implicit objective, as it provides the most cogent rationale for NBDT regulation and also for aspects of the emerging regulatory framework for financial markets infrastructures. A focus in this area is also evident in the recent joint Reserve Bank and FMA Conduct Review.

Consumer protection is also linked to financial literacy and, in turn, to matters underlying the Reserve Bank's regulatory approach – most notably, the market discipline pillar. If the proposal for depositor protection is adopted, this would require the Reserve Bank to increase its focus on the consumers of financial products and services offered by banks, insurers and NBDTs, and on the dividing line between depositors and other financial stakeholders such as wholesale market investors.

We therefore think that some formulation relating to consumer protection and/or financial literacy may have merit as a second-tier objective, and the focus should be on the particular contribution that can be offered by then Reserve Bank according to its mandate and strengths and potentially on managing some of the market failures that underlie prudential regulation (such as moral hazard and information asymmetries).

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[1] The Economist "Family Offices Become Financial Titans" (13 December 2018).

(d) Should 'public confidence (or trust)' be reinstated as a high-level financial policy objective of the Reserve Bank?

Public confidence is closely related to consumer protection and is subject to similar considerations as outlined in relation to the previous question.

(e) Are there any other objectives you think the Reserve Bank should be given?

We submit that consideration should be given to adding an objective relating to the interface with emerging international rules which may affect local financial institutions or their customers and coordination with offshore banking and prudential authorities and international agencies.

One of the distinguishing features of the RBNZ Act and of the Reserve Bank's role is that it is set against an interconnected global financial market and regulatory framework. To take just some examples:

- The Basel framework is designed as a set of best practice principles applying globally. This encompasses a 'home-host' model or prudential supervision, in which regulators in the home jurisdiction of a cross-border banks have a key role in regulating those banks (a factor particularly relevant in New Zealand given the ownership structure of our banking system).

- Core parts of the international financial markets are now governed by norms and rules to which our banks may in practice be subject even if they don't arise from local law, for example as subsidiaries of offshore banks or because their counterparties are bound. A prominent example of this are central clearing and similar requirements applying to OTC derivatives under the G20 Pittsburgh Accord.

- Insolvency as a general matter has global dimensions, reflected for example in the UNCITRAL principles codified in New Zealand under the Insolvency (Cross Border) Act 2006, but these are particularly significant in the resolution of financial institutions, which involves further dimensions such as depositor protection, bail-in, and the need to manage contagion risks and financial stability more generally. Increasingly since the GFC new bank resolution regimes have been implemented, such as the BRRD in the European Union and new Dodd-Frank rules in the United States, and international collateral and clearing frameworks are also increasingly significant and complex.

These factors make it impossible to bring a purely domestic perspective to prudential regulation and make it imperative to coordinate with offshore regulators and agencies, such as APRA, the BIS, FSB and IOSCO. They also require an additional lens to be brought to local rule-making and law reform.

Given the continuously evolving state of prudential practices and tools worldwide, and the interconnectedness referred to above, we also think it is important that prudential policy matters (including crisis management tools and procedures) are subject to in-depth review more frequently than the generational legislative cycle. For example, the legislation could provide for a periodic (say five-yearly) review of prudential settings by a body or panel with some degree of independence, reporting to Parliament or the responsible Minister. Similarly, there may be merit in a formal procedure for responding to reviews undertaken by international bodies, most notably the IMF's FSAP, ideally incorporating a degree of independent scrutiny and opportunity for engagement and debate.

In relation to more specific areas (along the lines of the precedents in the FMCA referred to previously), consideration could be given to focused principles or objectives in the context of, for example:

- The regulation of financial markets infrastructures, such as payment and settlement systems.

- The scope of macroprudential tools.

- Crisis management – including the application of statutory management, coordination with overseas prudential authorities and insolvency officials, and potentially the applicability of emerging international norms such as 'no creditor worse off'.

Who does the Reserve Bank regulate and how should the regulatory perimeter be set? (Chapter 3)?

The question of the regulatory perimeter is an important one, which is influenced by a number of potentially conflicting considerations.[2] It also raises difficult issues about the market failures underlying prudential regulation (in particular, the dimensions and implications of moral hazard), and how these can best be managed to achieve both stability and efficiency (including competition and diversity).

3. What are your views on the costs and benefits of moving from the current perimeter to an ADI (authorised deposit-taking institution) type of framework? Based on your views, is this an issue worth pursuing?

There are two distinct elements encompassed within this question:

1. What is the appropriate framework for entities within the regulatory perimeter (currently defined by reference to deposit-taking)? Should there continue to be separate regimes for registered banks and NBDTs, or a single regime as for ADIs?

2. Should the regulatory perimeter extend beyond retail deposit-takers, for example to encompass wholesale-funded non-bank lenders?

As to the first, in principle a unified ADI-style regime seems more rational and transparent. The challenge is in achieving an optimal mix of standardisation, tailoring and proportionality, recognising the inherent conflict between those goals. These would be amplified if the perimeter is extended to wholesale-funded non-bank lenders, because the prudential regime would also have to cater to different (non-deposit) funding models in addition to the parameters of scale and financial stability impact.

As to the second, the overall boundary for the regulatory perimeter is an important question with a lot of dimensions and impacts, and needs careful thought and debate. A challenge is that no best practice framework has yet emerged internationally as to the correct boundary for prudential regulation and the best way to monitor and regulate non-deposit taking institutions, even though other jurisdictions have a far more significant non-bank financial sector (e.g. around 40% of the financial system in Europe). The fact that New Zealand's non-bank sector is such a small component of our own financial system at least gives us breathing room to do the policy work and make decisions that will benefit our consumers, capital markets, and economy.

In undertaking that policy work, in our view there are the four important dimensions to consider, particularly in recognition of the key market failures of implicit guarantee/moral hazard and information asymmetry which underlie systemic risk:

(1) **Clarity of boundaries**, both within the regulatory perimeter (deposits vs bail-in instruments and equity) and as to its limits. In principle and in practice, and depending on decisions made on other aspects of the Phase 2 proposals, this may be best defined by reference to the scope of deposit protection.

[2] IMF "The Perimeter of Financial Regulation" (March 2009).

(2) Sound management of counterparty risk and other forms of **interconnectedness** between the regulated and unregulated sectors. This is largely an issue to be managed within the regulatory perimeter.

(3) **Entity-neutral** application of rules and tools which are not inherently connected with entity regulation (for example, macroprudential tools and FMIs).

(4) High quality and timely **data to enable effective prudential monitoring** of risk across the financial system (e.g. the FSCODA regime in Australia and the framework being proposed for FMIs in New Zealand).

An important lesson from the GFC is that, wherever the regulatory perimeter is set, it is crucial in limiting the scope for the associated issues of implicit guarantee and moral hazard that the boundary is clear and is well-understood. In the United States in particular, it is likely that many of the issues leading to taxpayer bailouts were contributed to by those lines being blurred by a very complex taxonomy of financial institutions and regulators. This was exacerbated by widespread use of OTC derivatives, resulting in a lack of transparency about the location and quantum of exposures (an issue addressed by the G20 Pittsburgh reforms).

There are a number of steps that could be taken to improve the clarity of the regulatory perimeter and financial stability, while promoting diversity of funding options for New Zealand consumers and businesses. These would include giving priority to enacting laws to give effect the OTC derivatives reforms. New Zealand could also take a lead from new rules in Australia designed to mark a clear boundary line between the regulated and deposit-insured sector and financial institutions operating outside the prudential regulation perimeter.[3]

4. Is new legislation the most appropriate way to adjust the prudential perimeter, or could a timelier mechanism be better? What accountability processes would be necessary to accompany any new mechanism?

There may be merit in creating a process for flexing the regulatory perimeter in response to emerging risks, although the size of the sector means that this issue may not be a priority, particularly in view of the challenges in creating an optimal regime in the absence of any clear international precedent. Because any designation power could have an immediate impact on confidence and investment in the non-bank sector, any such proposal should be subject to the same level of scrutiny as would a current proposal for expanding the current perimeter, including as to the dimensions outlined under Question 3. In this regard, it will be important to have key design parameters clearly identified and pre-positioned, from the perspective of providing:

- the ability to respond in a timely fashion to any crises or threats to financial stability as they emerge (particularly as they can arise quickly and be amplified at the late end of cycles); and
- transparency and regulatory certainty to the class of persons who may become regulated and to their stakeholders.

The dimensioning should be focused not only on the circumstances in which the power could be exercised, but on the particular rules and arrangements that would be applied if it is, given that – by definition – wholesale-funded non-bank lenders will be operating under a different funding model than the deposit model for which the prudential regime is ordinarily designed.

Any intervention in the form of a call-in power would be based on the Reserve Bank's analysis of emerging risks, so it is important that it is informed by high quality data. The Reserve Bank's monitoring capability could

[3] Refer Banking Exemption No. 2 of 2018 (Cth), which restricts prudentially exempted deposit-takers from use of words such as 'deposit' and from retail-facing accounts and requires them to add disclaimers and warnings.

be enhanced by reporting requirements, along the lines of those applying under the FSCODA regime in Australia and proposed to be applied in connection with financial markets infrastructures in New Zealand.

Should there be depositor protection in New Zealand? (Chapter 4 – questions 5 to 8)

Analytically, the answer to this question is generally framed as an assessment of the benefits of depositor protection (preventing damaging bank runs) compared with its costs (exacerbating moral hazard). Despite there being an enormous theoretical and empirical literature on this question, the answer to it remains hazy, as – in addition to the normal problems in identifying causation – it seems to be sensitive to endogenous factors such as the quality of institutions in the jurisdiction concerned.

From a more pragmatic perspective, there are other influencing factors in play:

- **Implicit guarantee**: According to a recent FMA survey, nearly three-quarters of respondents think there is a government guarantee of deposits.

- **International practice**: If Israel adopts its depositor protection scheme, New Zealand would be alone in the OECD in not having a scheme in place. This also would make it politically difficult to resist calls for depositor protection, in particular in circumstances of system-wide distress.

- **Market discipline**: If the focus of a Crown guarantee is on retail depositors, implementing a scheme may have limited impact on market discipline, since dispersed depositors do not have a comparative advantage in monitoring complex financial institutions.

Ultimately, depositor protection may be an instance where political reality trumps economic arguments. If that is so, it could be argued that the status quo involves the worst of both worlds, in the sense of having moral hazard arising from a widely perceived guarantee, but lacking a formal scheme which would enable effective planning or delineation in order to contain and manage risk.

In addition, a formal depositor protection scheme would provide an opportunity to establish a transparent and credible boundary to Crown support, confining the extent of any implicit guarantee and associated moral hazard. It would also recognise that wholesale investors outside the boundaries of the scheme have greater capability and incentives to monitor the credit of banks, which could improve market discipline overall.

9. Are there any alternative protection options, design principles, or complementary policies that could improve outcomes for the stakeholders identified above?

As to optimal design, New Zealand is widely acknowledged by rating agencies and multilateral bodies as have a strong institutional framework, which is an important element of any successful depositor protection scheme. A credible crisis resolution framework is another key component (we understand this will be the subject of a later consultation). In relation to other details, there is plentiful best practice guidance, including through the publications of the International Association of Deposit Insurers.[4]

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4 Including the IADI's "Core Principles for Effective Deposit Insurance Systems" (June 2009 and November 2014) and "Enhanced Guidance for Effective Deposit Insurance Systems: Mitigating Moral Hazard" (May 2013).

Should prudential regulation and supervision be separated from the Reserve Bank? (Chapter 5 – questions 10 and 11)

There are conflicts and complementarities in monetary and prudential policy, which are well-known and addressed in a substantial literature, including contributions from the Reserve Bank. As with objectives which share these features, they need to be acknowledged and managed to achieve the best outcomes. It is difficult to see that separating the management of these issues would improve the situation, and it would carry the risk of creating agency and coordination costs. As a result, we support the 'enhanced status quo' option and have no further comments on Questions 10 to 15.