Institute of Finance Professionals New Zealand Inc.

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Phase 2 of the Reserve Bank Act Review
The Treasury
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By Email: rbnzactreview@treasury.govt.nz

Phase 2 Reserve Bank Review – Consultation Document 3

Thank you for the opportunity to submit on the third Consultation Document under the Phase 2 Review. This is a complex and important reform, and we commend the work of the Review Group since this process commenced in 2018, in particular the quality of this and the three preceding consultation documents, and the transparent and well-considered engagement of officials.

About INFINZ

The Institute of Finance Professionals in New Zealand Inc (INFINZ) is the pre-eminent body in New Zealand for professionals who contribute to a sustainable financial eco-system. INFINZ is a voluntary organisation, with membership of approximately 1,900 individuals drawn from across the sector, including treasury professionals, investment analysts, fund managers, bankers, lawyers, academics and students.

Key themes

Since we and our members have been involved in a number of industry submissions, we will confine ourselves to brief remarks drawing on the themes of *investment, productivity and sustainability*, addressed in our previous submissions on both the Phase 2 reforms and the Capital Review.

Although the subject matter of prudential policy is highly technical, these themes come through significantly in the review. This is clearly illustrated in the new objective implemented under Phase 1 of the Review, in s 1A of the Reserve Bank of New Zealand Act 1989 (**RBNZ Act**) to "*promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy*". This is an ambitious and appropriate goal for prudential policy in New Zealand, since we are heavily reliant on the banking system to provide the capital which fuels our economy.

In this regard, we are pleased that Consultation Document 3 places a significant focus on promoting dynamism, competition, transparency, and accountability. As we address the current and upcoming challenges arising from the Covid pandemic and associated lockdowns, it will be all-

important to ensure that credit channels remain open, and to ensure that regulatory interventions display, and are designed to enhance, efficiency.

We look forward to further engagement with the Review Team as we move from consultation into the legislative phase. We are very happy to discuss with you any aspect of our submissions.

Regards

Ross Pennington,	**Louise Tong,**
Chair, Advocacy	**Chair**

Institute of Finance Professionals New Zealand Inc.

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.

2.A: Do you agree with the proposed purposes? If not, what changes would you propose to the purposes? Are there any other purposes that we should be considering?

No, we think that the subsidiary purposes suggested for the DTA are not well-crafted to promote the contribution of the banking system to investment, productivity and sustainability. In this respect, they also appear to conflict with the core productivity and wellbeing objectives in section 1A of the RBNZ Act.

As we have submitted in detail in relation to previous consultation documents, the primary issue is not with the adoption of a financial stability objective – there is nothing in such an objective that rules out a focus on efficiency; on the contrary, we think it is more accurate to say it demands it. It is telling in this regard that the IMF's work on the meaning of "financial stability" emphasises the same factors of dynamic and allocative efficiency as the Reserve Bank's own work on this subject (which factors are absent from the regulatory cost-benefit decision-making principle), and that the financial system maintains its ability to perform those key functions even when affected by external shocks or by a build-up of imbalances.[1] In this sense and others, efficiency is interlinked with safety.

If officials' concern is that the purposes act as some sort of directive mandate that efficiency would need to be achieved through particular action or even that this would need to be done at the expense of considerations of safety, we submit that any such concerns are misplaced:

- Legislative guidelines make it clear that purpose provisions do not have that intent or effect – they show the "why", not the "how". Further, under conventional administrative law principles, it is up to the decision-maker how they weigh multiple or multi-faceted objectives.

- If this were true of an efficiency objective, it would be even more so of the objectives set out in section 1A of the RBNZ Act. For example, it is clear that running an accommodative monetary policy has an effect on housing and other asset prices, and that this in turn has adverse impacts on affordability and well-being, yet no one suggests that the Reserve Bank is thereby restricted from reducing the official cash rate to low or even negative levels.

[1] Refer Garry J Schinasi "Defining Financial Stability" (IMF Working Paper WP/04/187, October 2004); Bloor and Hunt "Understanding financial system efficiency in New Zealand" (Reserve Bank of New Zealand Bulletin, Volume 74(2), June 2011).

- The goals of stability and efficiency are best regarded as complementary – particularly given the range of options available in the prudential toolkit, which will be enhanced under the current reforms.

The design of the purposes is an issue of great significance in achieving the goals of this reform, because:

- they are designed to describe what sort of financial system we want – something that is communicated in plain language in section 1A of the RBNZ Act, a formulation we strongly support; and

- it influences the approach that will be taken throughout the regime, most notably in the new procedures for formulating prudential Standards, which we discuss briefly under Question 4.A.

As a result, we submit that subsidiary purposes to the "financial stability" goal should be carefully reviewed, in their own right, and in terms of the balance they create and the way they interact with the over-arching objective in section 1A of the RBNZ Act. In this process, we think that a useful reference point is provided by the objectives for the new, Key Attribute-compliant, United Kingdom regime.[2] This formulation involves a very clear hierarchy of objectives, enabling different ones to be given prominence in particular situations. Eliminating those specific to the EU or British legislative context, they are as follows:

> (3A) Objective 1 is to ensure the continuity of banking services in the United Kingdom and of critical functions.
>
> (4) Objective 2 is to protect and enhance the stability of the financial system of the United Kingdom, including in particular by (a) preventing contagion [...], and (b) maintaining market discipline.
>
> (5) Objective 3 is to protect and enhance public confidence in the stability of the financial system of the United Kingdom.
>
> (6) Objective 4 is to protect public funds, including by minimising reliance on extraordinary public financial support. […]
>
> (10) The order in which the objectives are listed in this section is not significant; they are to be balanced as appropriate in each case.

A number of points from the above are notable:

- The first objective of ensuring continuity of critical services is consistent with the Reserve Bank's OBR and associated policies, is key to limiting and containing the real economy damage that can result from bank failure, and is buttressed by the carefully-designed special bank liquidation and administration procedures contained in the UK Banking Act.

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2 Refer section 4 of the Banking Act 2009 (UK).

- The objectives relates to the stability of the financial system, not, as proposed in the Consultation Document, to the safety *of deposit-takers* – something which may suggest a significant shift to a micro-prudential focus, potentially at the expense of increasing moral hazard or taxpayer exposure.

- A fundamentally different approach is taken to framing the **financial stability** component of the objectives, including through specific reference to market discipline and protecting public funds.

- It is clarified that the balancing of these factors is for the responsible prudential and treasury agencies to determine.

In our submission, a formulation of the DTA's secondary purposes on this basis, or which at least is framed by reference to these elements, would conform better to the Reserve Bank's regulatory ethos and to modern prudential theory. The clear intent of the proposed secondary purposes is to help bring meaning to the sole objective of financial stability. This is the right approach, but the formulation currently proposed in the Consultation Document is imbalanced toward risk-aversion and micro-prudential concerns. We submit that the UK objectives benchmark an approach which avoids those problems and is more securely grounded in resolving the market failures that are sought to be resolved by prudential regulation.

4.A: Do you agree that the proposed scope of standards is appropriate? If not, what changes would you suggest?

We agree generally with the approach suggested for the scope of prudential Standards, and strongly support the more rigorous processes proposed for promulgating them.

We have three comments:

- The quality of the policy and consultation processes, and the degree of engagement from people outside the regulated community, will be heavily influenced by the statutory purposes – which will establish not only the nature of the financial system we're intending to achieve, but also the relevant grounds for wider stakeholders' input. For example, the submissions made by INFINZ on the Capital Review were focused on the impact of those proposals on the capital markets, on productivity via the availability and cost of capital, and on allocative efficiency through potential sectorial impacts (for example SME lending). Whether those concerns were right or not, we believe they are relevant matters to be taken into account, but – since they all ultimately relate to efficiency considerations beyond the narrow regulatory cost-benefit calculus in the decision-making principles – would not be relevant factors under the statutory purposes as proposed.

- For similar reasons, it is imperative that the Regulatory Impact Analysis is prepared, at least in draft, when the Standard or other regulatory proposal is presented for consultation, and not once the decision has been made. This requirement should be legislated.

- Prudential regulation is a technical subject, consultations on which have high barriers to entry, even among specialists. Thought should be given to new approaches to getting input from non-financial businesses, customers and other stakeholders, and informing decision-making with a wider range of inputs. For example, the approach under the Culture & Conduct review of employing consumer surveys could be considered in appropriate circumstances.

5.A: Do you agree with the general categorisation of the contraventions that should give rise to criminal and civil liability in the Deposit Takers Act?

Yes. It is a high priority that the defects within the existing liability regime are acknowledged and resolved.

At the time the current legislation was enacted, prudential regulation was in its infancy – the Basel regime, for example, was only instituted the previous year, and had not yet been implemented. Since that time, and on an accelerated basis since the GFC, the scope, significance and complexity of prudential regulation has expanded dramatically, yet still rests on narrow and ill-defined legislative foundations in New Zealand. As a consequence of this, the existing civil and criminal liabilities are poorly specified and are not tailored to the degree of harm or the behavior of the regulated persons. The associated due diligence protections are similarly inadequate.

Further, the DTA regulates the banking sector of the overall financial market and as such is effectively companion legislation of the Financial Markets Conduct Act 2013 (**FMCA**). It is particularly important that the approaches within these legislative frameworks are coordinated and that the rules are fair. In this regard, the reform should aim to achieve alignment with the 'adequate procedures', due diligence and reliance defences in sections 499-503 of the FMCA. These are designed to promote and reward well-designed and proactive compliance procedures and a culture of 'willing compliance'.

We also welcome the decision to undertake a separate review of executive accountability. Whether designated as such (like the Australian BEAR regime) or arising from the combined trends of expanding duties and broadening personal accountability for them (like the liability of directors for banks' disclosures under the FMCA), these obligations have mushroomed in recent years, and more are proposed. We submit that the opportunity should be taken to undertake a full review of such provisions across the financial services regulatory spectrum, in order to ensure that the impact of these is as intended (including as to the incentives they create), is fair, and supports the objectives of those various regimes.

5.B: Do you agree with the specification of the new positive duties for directors of deposit-takers? If not, why not?

Similar considerations apply here as set out above in relation to executive accountability regimes. It is important that any such duties are recognised as a governance overlay, and not as provisions

which directly expose directors to sanctions – the latter clearly need to be defined with a specificity and precision that is at odds with the intent of positive duties of this nature.

7.F: Do you agree that deposit takers should only be subject to one statutory management and resolution regime?

Yes, the provision for statutory management (or similar resolution procedure) in the DTA should be the exclusive basis for exercising such powers for deposit-takers. It is fundamental that any such decision is grounded in financial stability considerations – not the vague public interest and other tests applying under the Corporations (Investigation and Management) Act 1989 – and that the Reserve Bank must be the sole agency empowered to trigger this intervention, particularly given the potentially dramatic effects of it not only on the relevant deposit-taker, but also on other financial institutions and on the financial system itself.