

21 May 2014

Steven Bailey
Inquiry Director
Inquiry into Regulatory Institutions and Practices
New Zealand Productivity Commission
PO Box 8036
The Terrace
Wellington 6143

Dear Steven

RE: Draft report on Regulatory Institutions and Practices

Thank you for the opportunity to engage with you on your draft report on the Inquiry into Regulatory Institutions and Practices.

Further to our meeting, please find attached some additional comments on the draft report and the matters you raised in the meeting.

For any questions or clarifications, please contact Cavan O'Connor-Close on 04 471 3914.

Yours sincerely



Toby Fiennes
Head of Prudential Supervision

cc Graeme Wheeler, Governor of the Reserve Bank,
Grant Spencer, Deputy-Governor, Reserve Bank,
Cavan O'Connor-Close, Adviser, Reserve Bank.

Overview

1. Thank you for giving us the opportunity to comment on the Productivity Commission's Draft Report on Regulatory Institutions and Practices ("Draft Report"). We support the Commission's analysis and we broadly welcome the report's findings and recommendations. We are confident that the Final Report will help improve the quality and design of new regulatory regimes going forward.
2. While we are supportive of the Commission's findings and recommendations, we note that they are general in nature and that the mechanisms for reflecting these best practice principles may vary across regimes. We would not support a one-size-fits-all approach to regulatory arrangements, nor do we believe it would make sense to embark on major and disruptive changes to the structure of regulation simply in order to drive greater consistency.
3. For example, the report rightly emphasises that areas that require a high degree of technical expertise may also require different arrangements in terms of regulatory autonomy, provided appropriate accountability structures are in place.
4. The Reserve Bank considers itself as operating in areas with highly technical issues, where at times it must be able to respond quickly to risks developing in the financial sector, without loss of robust process and lines of accountability.
5. Our submission comments on a number of issues discussed in the Draft Report that we consider particularly relevant to the Reserve Bank. These issues are
 - governance;
 - independence;
 - decision review;
 - the expansion of the Reserve Bank's functions; and
 - regulatory stewardship.

Governance

6. One of the Draft Report's findings is that variation in governance arrangements across regulators appears to be *ad-hoc*. While this may be true in some cases, we believe that this is not true in regard to the Reserve Bank's model (single decision maker and non-executive overseeing Board), which the Draft Report draws upon in its discussion of governance arrangements.
7. While this model is unusual, it does provide accountability and coherence in policy development while allowing the Reserve Bank to respond swiftly to risks it sees developing in the financial sector. This is extremely important for prudential regulation where regulatory uncertainty can impose significant costs.
8. As stated in our earlier submission, the Reserve Bank has functioned well under the model since the late 1980s. A key reason, in our view, is that the Reserve Bank has a very clear role in a limited number of areas that require a high degree of technical expertise. It should be noted that the performance of the Bank and the Governor is overseen by the Reserve Bank board (membership of which is approved by the Minister of Finance) and Parliament's Finance and Expenditure Select Committee.
9. For these reasons, we believe that the single decision maker / non-executive Board model remains appropriate for the Reserve Bank. Your report correctly notes that the Reserve Bank has recently introduced a Governing Committee, comprised of the four Governors, at which all major and strategic policy decisions are tabled.

Independence

10. We agree with the Commission's finding that for most regulatory regimes the arguments for providing more independent regulation will be stronger than the arguments for less independent regulation. This is especially true for regimes where policies are highly technical and are seeking to address low-probability but high-impact risks, such as the Reserve Bank's prudential regime.
11. The Draft Report considers the Reserve Bank's regulatory independence and compares it to that of the Financial Markets Authority (FMA). It points out that the FMA implements its main requirements through regulations made by the Governor-General in Council, while the Reserve Bank is able to determine requirements of a similar significance without Cabinet approval (via banks' conditions of registration). One of the recommendations that follows from this (and other discussions around independence) is that there should be a review of regulatory legislation to ensure greater consistency in allocation of legislation between primary and secondary types of legislation.
12. However, the different roles of the Reserve Bank and the FMA may justify the differences in the mechanisms for setting requirements. As articulated in the legislation, the Reserve Bank is required to have a sectoral or systemic focus, rather than the consumer protection mandate of the FMA. For this reason, the Reserve Bank needs to be responsive to risks it sees developing in the sector as a whole and vary requirements for individual institutions as necessary to mitigate these risks.
13. For example, the Reserve Bank recently implemented a restriction on high LVR residential mortgage lending to mitigate the risks associated with rapidly increasing house prices and housing-related credit growth. As the Reserve Bank was able to implement this restriction through a condition of registration (following extensive consultation with the Minister of Finance) it was able to respond to contain this risk much more quickly than alternative mechanisms would have allowed.
14. Similarly, during the Global Financial Crisis (GFC), strain in international funding markets put considerable liquidity pressure on New Zealand banks. Recognising the risks associated with New Zealand banks being reliant on a significant proportion of short-maturity funding, the Reserve Bank responded by implementing a core funding ratio requirement in April 2010. This requirement sets a minimum level of stable funding (that can be assumed to stay in place for at least one year) that banks must maintain. The Reserve Bank's mechanisms for imposing requirements allowed it to respond to this risk relatively swiftly (the Basel Committee proposed a similar requirement as part of its Basel III reforms in December 2010¹ and earlier this year consulted on the requirement with an intention to make it a minimum requirement from January 2018²) which will make our banks more robust against liquidity risk going forward.
15. The Reserve Bank's independence was subject to review relatively recently as part of the government's Review of Financial Products and Providers (RFPP) in 2006³. In

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1. Basel III: International framework for liquidity risk measurement, standards and monitoring available at <http://www.bis.org/publ/bcbs188.pdf>
 2. Basel III: The Net Stable Funding Ratio available at <http://www.bis.org/publ/bcbs271.pdf>
 3. The Cabinet paper that resulted is titled "Institutional Arrangements for Prudential Regulation" and can be found through the following link. <http://www.treasury.govt.nz/publications/informationreleases/financialsector/prudentialregulator/edcmem-13jun07.pdf>

recommending that the Reserve Bank assume additional roles in the prudential supervision of insurers and Non-Bank Deposit Takers (NBDTs), the Treasury considered a number of reasons to maintain the Bank's independence. These included:

- the risk of a perception of a government endorsement of regulation that could give rise to an implied guarantee of regulated entities;
 - the risk of poorer quality regulation if political concerns lead to inconsistency in regulatory approach over time, reduced regulatory certainty and regulation that is short-term in focus;
 - more opportunity for lobbying by industry; and
 - risks to New Zealand's international reputation, given the weight put on independence of regulation in the sector.
16. Given these considerations, the paper concluded that the government's engagement with the Reserve Bank should not extend to involvement in regulatory decisions (such as the prudential rules set through conditions of registration). The paper did not propose any changes to the Reserve Bank's governance arrangements and concluded that the Reserve Bank should maintain independence in its regulatory functions. However, it highlighted the need for legislation to be clear about the purposes for which the Reserve Bank was acting and that government should engage with the Reserve Bank to ensure that their objectives for the financial sector are aligned. We note that these governance arrangements allowed the Reserve Bank to be responsive to the pressures that came to bear on the banks during and after the GFC as discussed above.
17. We believe that the Bank's ability to implement policy via conditions of registration works well for both the Reserve Bank and regulated entities. It allows the Reserve Bank to respond swiftly to emerging risks in the financial sector and means that technical material can be dealt with effectively and efficiently.⁴ In a number of instances, this flexibility has allowed the Reserve Bank to deal with what would otherwise be technical breaches by regulated entities where the breaches were not material in substance. These examples highlight the importance of the Reserve Bank's ability to implement policy through conditions of registration. However, we do understand that the arguments for such flexibility may not be so strong for other regulators.

Decision Review

18. We agree with the Commission's findings that "merits review does not offer additional safeguards to ensure decision makers followed good processes, beyond those offered by judicial review." The report notes that the Reserve Bank Act 1989 does not allow for a review of decisions based on their merits. Similarly, the Reserve Bank's frameworks for insurers and NBDTs only provide for merits review for decisions relating to the suitability of directors, senior officers and other participants. These are cases where decisions taken by the Reserve Bank may substantially impact an individual's livelihood.
19. As noted in our first submission, we believe that judicial review provides a sufficient avenue for appeal as good decisions flow from good processes. But due to the highly technical nature of many prudential requirements and New Zealand's relatively small pool of specialists experienced in prudential regulation, conducting a merits review of

4. BS2B, part of the Banking Supervision Handbook provides examples of some of the Reserve Bank's technical requirements. BS2B can be found via the following link:
http://www.rbnz.govt.nz/regulation_and_supervision/banks/banking_supervision_handbook/

these decisions may be difficult. In addition, protracted court proceedings would have undesirable costs to efficiency and certainty for regulated entities, as observed in other areas.

Expansion of the Reserve Bank's functions

20. The Draft Report notes (in its discussion of governance arrangements) that the Reserve Bank's prudential function has expanded substantially in recent years. In addition to regulating and overseeing registered banks, the Reserve Bank is now responsible for regulating insurers and NBDTs. The Draft Report states that "since 1989, its regulatory functions have expanded substantially, but its governance arrangements have not changed."
21. While the Reserve Bank continues to operate under the single decision maker model, the legal arrangements around the Reserve Bank's regulation of insurers and NBDTs are substantially different from those that apply for banks. For insurers, the key requirements are implemented via disallowable instruments and for NBDTs the main requirements are set out in legislation or made through regulations.
22. The Reserve Bank's institutional arrangements were considered as part of the RFPP to determine how these should change given the Reserve Bank's expanded functions. The amendments proposed following this review focussed on increased accountability through the Statement of Intent (SOI), the Reserve Bank's annual report, and through the Financial Stability Report (FSR). Briefly, these changes required:
 - The SOI to include information on the specific impacts, outcomes and objectives the Reserve Bank aims to achieve and how it intends to perform its functions and conduct its operations to achieve those.
 - The annual report to include an assessment against the intentions, measures and standards set out in the SOI.
 - The FSR to contain increased reporting on the performance of the prudential regime and its implications for the financial sector, which allows an assessment to be made of the effectiveness of the Reserve Bank's use of its powers to achieve its statutory prudential purposes.
23. This paper also proposed an amendment that allows the Minister of Finance to direct the Reserve Bank to have regard to a statement of Government policy objectives relating to the Reserve Bank's financial sector functions and objectives, and to require the Reserve Bank to demonstrate in the SOI how it has done so. The Minister of Finance annually provides the Governor with a Letter of Expectations that clarifies at a high level how he expects us to take forward our regulatory agenda.
24. Therefore, the statement that the Reserve Bank's governance arrangements have not changed despite its increased regulatory role does not take adequate account of the increased requirements for accountability documents that have been implemented. There are sound reasons for the Reserve Bank to maintain its independence, and we note the existing mechanisms for overseeing the Reserve Bank have proven robust.
25. The relatively new insurance and NBDT frameworks have highlighted some of the issues around allocating material between primary and types of secondary legislation. One feature of primary legislation is that amendments need to go through essentially the same process as the original primary legislation, including many checks, and it can take a long time before an amendment becomes law. Depending on the type of material, this may be seen as an argument either for or against allocating it to primary legislation.

26. In some cases, placing requirements in primary legislation may inhibit the Reserve Bank's ability to respond swiftly to concerns raised by regulated entities. For example, a reporting requirement set out in the Insurance (Prudential Supervision) Act 2010 placed significant compliance costs on a particular class of insurers, but in many cases the reporting provided almost no value to the Reserve Bank. As the requirement was set out in primary legislation, it took 3 years before this requirement could be altered. By contrast, had the requirement been contained in a condition of registration, the Reserve Bank would have been able to amend this requirement much more quickly and cheaply.

Regulatory Stewardship

27. The report emphasises the Commission's views on the importance of regulatory stewardship. We hold similar views to the Commission, and believe that it is important that regulators manage their stock of regulations effectively so that they remain relevant and fit for purpose. This is especially true for the Reserve Bank given that the regulatory framework has undergone significant change in recent years.

28. Over 2009 to 2011 the Reserve Bank completed a major review of its disclosure requirements for registered banks, which resulted in materially reduced requirements. More recently, the Reserve Bank has decided to undertake a stocktake of its regulations for registered banks and NBDTs over the next year. The stocktake will cover all of the prudential requirements for the two sectors, and also the registration and disclosure requirements for registered banks. The stocktake will look for ways in which the existing requirements can achieve their intended effects more efficiently, can be applied more consistently, or can be made clearer.

Conclusion

29. Overall, we are very pleased with the Draft Report and the level of engagement we have had with the Commission. Despite the magnitude of the undertaking, the Draft Report provides thorough analysis across the wide range of issues covered. We look forward to reading the Final Report and we are confident that its findings and recommendations will help to improve the quality and design of regulatory regimes going forward.