Phase 2 of the Reserve Bank Act Review – Consultation Document 2A: The role of the Reserve Bank and how it should be governed

A report prepared for the New Zealand Bankers Association

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1. Introduction

1. New Zealand Bankers Association (NZBA) commissioned this report as an input into its response to Phase 2 of the Reserve Bank Act Review Consultation Document 2A "In-principle decisions and follow up questions on: The role of the Reserve Bank and how it should be governed" (Consultation Document).

2. The opinions expressed in this report are our conclusions and may not necessarily reflect the views of either the NZBA or its member banks.

3. We examine elements of the proposals detailed in Chapters 2 and 3 of the Consultation Document:

    - Chapter 2: What financial policy objectives should the Reserve Bank have?
    - Chapter 3: How should the Reserve Bank be governed?

4. In examining these elements, we refer to the processes being followed by the Reserve Bank for determining bank capital requirements as a case study; we consider whether the proposals in the Consultation Document would have prompted the Reserve Bank to follow policy processes closer to best regulatory practice.

5. We structure the report into four sections:

    - section 2 provides background context for the analysis with a focus on the institutional arrangements for prudential management
    - section 3 considers the financial policy objectives of the Reserve Bank and the in-principle decision proposed in the Consultation Document
    - section 4 considers the governance arrangements for the Reserve Bank and the alignment of the proposals in the Consultation Document with the principles of good practice regulation
    - section 5 summarises the conclusions from the analysis in this report.

2. Existing Act drafted with a different focus

Independence to control inflation

6. Thirty years ago, the Reserve Bank Act 1989 (1989 Act) was conceived primarily to do four things:

    - To provide the Reserve Bank with the tools to bring down New Zealand's underlying rate of inflation that had persisted in the mid-teens for many years
    - To provide for independence of the Reserve Bank in operational decisions to achieve transparent inflation objectives set by the Minister of Finance
    - To establish clear accountabilities for macro-policy instruments: the Reserve Bank became accountable for monetary policy and the Treasury accountable for fiscal policy
    - To provide for the Reserve Bank to monitor financial markets with a focus on the soundness of the banking system as a whole, rather than the soundness of individual banks.

7. Prior to the enactment of the 1989 Act, the conduct of monetary policy had been subject to poorly conceived Ministerial interventions in financial markets resulting in a financial crisis and large losses passed into the public finances. The high degree of independence of the Reserve Bank under the 1989 Act was created for the conduct of monetary policy targeted at medium-term inflation rates.

Evolution of the role of the Reserve Bank

8. As we explained in our review of the Reserve Bank's proposals to raise requirements for regulatory capital (Scott, Boyle, Lubberink, & Murray, 2019), the regulatory functions of the Reserve Bank have evolved over the life of the 1989 Act to become much more extensive and detailed than what was in the minds of the designers of that Act.

9. The Reserve Bank's range of tools for supervising the banks is now much wider than other frameworks of commercial regulation and the scope of its regulatory powers is wider. To illustrate this point, the Commerce Commission is focused on ensuring that there is competition in the markets it overlooks. It can set prices where competition is not adequate and authorises Transpower's investments in the transmission system, because the costs will be levied on the industry. It can hold firms to account for misleading advertising and other elements of consumer protection. It is required to conduct these functions in the long-term interests of consumers.

10. By contrast, the Reserve Bank has the powers, including but not limited, to:

    - register and deregister banks
    - regulate their capital structures
    - influence the appointments of their boards

- insist on methods for evaluating risks within individual banks
- regulate the relationships between foreign banks and their New Zealand subsidiaries
- place requirements on them regarding their IT systems.

Further, under the mandate for macro prudential regulation, the Reserve Bank has the power to regulate commercial decisions, which in other industries, would lie clearly within the normal discretion of business entities. The loan to value ratio restrictions in recent times are an example.

11. The existing Act clearly provides a legislative basis for very extensive and deep intervention into the banking business. But these powers are being exercised under the provisions of the 1989 Act which gives great powers to the Governor because the purpose at that time was to give that person the full authority to make monetary policy judgements within the narrow bounds of the policy targets agreement with the Minister of Finance, which was focused entirely on controlling inflation. In our view, these powers are excessive for a single decision-maker when applied to such a deep and extensive range of regulatory tools as prudential regulation. We do not mean by this to imply that the authority of the Reserve Bank to regulate the industry should be diluted but, in line with the general tenor of the Consultation Document, we recommend that the regulatory functions be placed within a framework that conforms to the best practices that have evolved over many years in other areas of commercial regulation.

12. As observed by the Productivity Commission in its review into the institutions, practices and elements of how regulation is designed and implemented in New Zealand (New Zealand Productivity Commission, 2014):

> *Good design of regulatory institutions and good regulatory practice can reduce the likelihood of regulatory failure. The institutional arrangements that make up the architecture of regulatory regimes shape how regulators and those regulated behave, the quality of decision making, and ultimately the success of regulatory regimes in achieving the desired outcomes.*

13. The Productivity Commission highlighted the aspects of the regulatory architecture, institutional design and practice it considers need to be present and working well to be effective and achieve important regulatory objectives:

    - clarity of role, as clear regulatory roles and objectives are critical to regulator accountability and focus for compliance by regulated parties and the legitimacy of the regulatory regime
    - an appropriate institutional form and degree of independence to enable them to function as intended
    - good governance and decision-making arrangements, and appropriate allocation of decision rights, including where and how discretion is exercised
    - appropriate mechanisms for reviewing regulatory decisions
    - strong monitoring and oversight arrangements to ensure that regulatory agencies are effective, efficient and accountable and that regimes are working as intended.

14. These principles and practices must be melded with the requirements and reality of the banking sector. Banking regulation is distinctive from other forms of commercial regulation, largely because the regulator—the Reserve Bank—is also the banker to the banks. It provides them with ready access to funds at the Official Cash Rate. This relationship between the Reserve Bank and the banks can mean that the Reserve Bank's engagement with the banking industry is less transparent and less formal than would occur under other regulatory institutions, while its papers are less subject to conventions and requirements for formal peer review. Its decisions and methods have never been the subject of court action. By contrast, for example, the Electricity Authority develops regulatory proposals through independently chaired industry working parties whose reports are peer reviewed and it conducts formal hearings in which submissions are publicly exposed and tested. It is not unusual for its decisions and methodologies to be challenged in the courts.

15. The absence of a structured process for the Reserve Bank to develop and consult on regulatory requirements is evident in its proposals for changes to bank capital requirements. In any complex multi-faceted policy it becomes a necessity to sequence and prioritise components for attention. However, the way in which the components are defined and sequenced influences the overall outcome. In the case of its capital adequacy proposals, the sequencing of the issues had the effect of limiting the scope of the consultation to a singular proposal for a capital ratio involving only equity capital. Given this, the way the process was conducted diminished consideration of options that might offer a more balanced consideration of the regulatory instruments available to the Reserve Bank. In addition, critical details about implementation and interaction with the regulatory requirements were not given attention. For example, the potential impact on competitive neutrality between different banks will be dependent on the details of implementation of the proposals that have yet to be explained (Scott, Boyle, Lubberink, & Murray, 2019).

16. It is therefore both timely and necessary to add to the revised Reserve Bank Act provisions that authorise, govern, resource and hold to account the regulatory functions, as they have evolved. Our perspective, in providing advice in this regard, is to bring together the principles, practices and learning from New Zealand's more successful frameworks for commercial regulation in other areas with the distinctive features and practical requirements for regulating the banking industry and the wider financial sector.

3. What financial policy objectives should the Reserve Bank have?

Dangers of disorderly use of extensive mandates

17. Consideration of the governance of regulatory functions must begin with the Parliament, whose laws create and constrain those powers. Given the very extensive powers that are involved in prudential regulation there would be considerable risks from a lack of definition about the powers that are being delegated to Ministers and the Reserve Bank. Hard lessons were learned in the 1970s and into the 1980s of the risks to the economy from policies based in laws which provided no proper processes, principles, constraints or accountability on the exercise of very wide powers of intervention. To illustrate the point, the Fourth Labour Government abolished the Economic Stabilisation Act, which gave the Cabinet vast powers of intervention, subject to minimal process and accountability in a way that would be totally unacceptable today (as one example, the previous government had used those powers to impose a blanket wage and price freeze). It is well not to forget the dangers of disorderly use of such extensive mandates.

18. Accordingly, we recommend that the legislation be drafted to incorporate as clear a statement as is practically possible about the powers that are being authorised and obligations about their use. Detailed drafting goes beyond the terms of reference for this report, however.

In-principle purpose statement unclear in its intent

19. A clear and well-thought out purpose statement is central to regulatory practice. The purpose statement becomes the touchstone for regulators when developing and explaining detailed interventions and for regulated entities, and other parties, in assessing whether those interventions are appropriate given the intent of Parliament. As the Supreme Court has explained: "[a statutory body] must act within the scope of the authority conferred by Parliament and for the purposes for which those powers were conferred" (New Zealand Supreme Court, 2007, p. 50). The Supreme Court also noted that "a power granted for a particular purpose must be used for that purpose" and that even a "broadly framed discretion should always be exercised to promote the policy and objects of the Act" (New Zealand Supreme Court, 2007, p. 53).

20. It is not unusual, in other regulatory settings, for the meaning of the purpose statement to be extensively debated during consultation by the regulator with regulated entities and other interested parties, and ultimately tested by the courts. Once the meaning of the purpose is clear, then proposed detailed rules prepared by the regulator can be assessed as to whether

they would advance that statutory purpose and, where merits review is provided, whether other interventions might be materially better at achieving that purpose.[1]

21. The drafters of the Consultation Document consider that the Reserve Bank's existing objective of "promoting the maintenance of a sound and efficient financial system" is unclear. The Consultation Document proposes that the clarity of purpose would be improved if the purpose was, in-principle, to be expressed as "protect and enhance the stability of New Zealand's financial system". However, the in-principle phrasing is not as clear as the drafters seem to think and may conflict with the recently amended overarching purpose of the Reserve Bank Act to "promote the prosperity and wellbeing of New Zealanders and contribute to a sustainable and productive economy".

22. The Consultation Document observes that the Reserve Bank, as the prudential authority, can contribute to the prosperity and wellbeing of New Zealanders by minimising the likelihood and impact of financial crises. It then asserts "This is the defining feature of financial stability…" (Reserve Bank of New Zealand, The Treasury, June 2019, p. 15). There are two problems with the assumptions that underpin that assertion:

    - financial stability may have a wider definition than minimising the likelihood and impact of financial crises
    - "minimising" the likelihood and impact of a financial crises may not promote the prosperity and wellbeing of New Zealanders.

23. We comment on each of these definitional problems.

Financial stability may have a wider definition

24. The Consultation Document does not cite any academic or other precedent for its assertion that minimising the likelihood and impact of financial crises is the defining feature of financial stability. In our reading of the literature, we did not locate a single, widely accepted and used definition of financial stability. For example, an International Monetary Fund paper suggests that financial stability should be thought of in terms of the financial system's ability to (Schinasi, 2004):

    - facilitate an efficient allocation of economic resources;
    - assess, price, allocate, and manage financial risks; and
    - perform these key functions – even when affected by external shocks or by a build-up of imbalances – primarily through self-corrective mechanisms.

25. Rather than clarify the purpose of prudential regulation, the Consultation Document proposes several secondary objectives. A comparison of those secondary objectives with the definition outlined above, suggests to us that those secondary objectives are incomplete and do not properly complete a description of the purpose of prudential regulation. Importantly, they

[1] For an example of careful explanation by the High Court of the meaning of a purpose statement and whether particular rules would achieve that purpose statement and whether other rules would be materially better see *Wellington International Airport Ltd & Ors v Commerce Commission [213] NZHC 3289 [11 December 2013]*.

would not require the Reserve Bank to consider, in the round, whether a proposed intervention would promote the prosperity and wellbeing of New Zealanders, and contribute to a sustainable and productive economy.

Balancing of benefits with the costs

26. Financial stability—whether defined comparatively narrowly as in the Consultation Document or more broadly as in the IMF working paper—is not a binary outcome (where there is either financial stability or there is not). Rather, increased degrees of financial stability can be obtained at exponentially increasing cost to society as a whole; that is, at a cost to the prosperity and wellbeing of New Zealanders.

27. Good regulatory practice would require a regulator to weigh the benefits of its proposed intervention against its costs and to proceed only where the benefits clearly exceed the costs.[2] The Consultation Document recognises that the existing requirement for the Reserve Bank to promote a "sound and efficient financial system" can be interpreted as requiring this balancing (Reserve Bank of New Zealand, The Treasury, June 2019, p. 16).[3] It also recognises that this "counterweight" is "not captured by the phrase 'financial stability'. Hence, the proposed new purpose statement would remove the existing requirement for the Reserve Bank to consider the costs of its proposed interventions alongside the expected benefits. However, the drafters of the Consultation Document suggest that such a balancing requirement "is more commonly achieved through lower-tier objectives" (Reserve Bank of New Zealand, The Treasury, June 2019, p. 17).

28. This suggestion in the Consultation Document is incorrect. The requirement for a regulator to consider whether its actions will be beneficial in the round is reflected in the purpose statements of other independent regulators in New Zealand: the Commerce Commission must "promote competition … for the long-term benefit of consumers"; the Electricity Authority must promote "reliable supply [and other things] by …the electricity industry for the long-term benefit of consumers". These purpose statements reflect good regulatory practice, as they require the regulator to consider the harm its interventions might cause as well as the benefit it seeks to achieve.

29. In documents released so far, officials do not advise the Minister that the effect of his in-principle decision would be to allow the Reserve Bank to seek stability even if the means by which it chose to do so would reduce the prosperity and well-being of New Zealanders. The current consultation by the Reserve Bank on capital requirements provides a good illustration.

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[2] The Consultation Document seems to confuse a requirement to weigh costs and benefits, with an obligation to pursue conflicting objectives without explicit weights—see reference to OECD best-practice guidelines on page 17, Consultation Paper 2A.

[3] In our view, this is the correct interpretation and the view expressed elsewhere in the Consultation Paper that the term efficient might provide the Reserve Bank with a mandate to undertake interventions to directly allocate credit to particular areas of the economy is misconceived and does not reflect how that purpose statement has been interpreted by the Reserve Bank over the past 30 years.

30. The proposed purpose statement would allow the Reserve Bank to declare that capital sufficient to meet a 1 in 200-year event is necessary for financial stability—there would be no necessity for it to consider whether the additional stability benefits would exceed the additional economic costs. Our report on the capital regulation proposal emphasises this point. The Reserve Bank only considered the trade-off between increases in stability—as defined in the Consultation Document —and the costs in terms of higher interest rates and effects on GDP at the margin *beyond* the chosen stability criterion. Whether a better balance could be achieved at a lower capital ratio was thereby not considered ((Scott, Boyle, Lubberink, & Murray, 2019, p. 14):

> *The question of whether there is a further increase of the capital ratio above the 16 per cent target for stability purposes that improves both stability and efficiency is addressed in the negative. But the analysis does not illuminate whether a lower capital ratio or one with a different composition might have produced a reduction in cost with little or any loss of stability.*

31. To bring the in-principle decision into line with good regulatory practice, the word efficiency should be retained in the purpose statement, that is to: protect and enhance the stability and efficiency of New Zealand's financial system. Retaining the word efficiency in the purpose statement would recognise that protecting and enhancing the stability of the financial system is not an end in of itself but, rather, a vehicle for promoting the prosperity and wellbeing of New Zealanders. Put simply, it would require the Reserve Bank to consider whether the stability objectives could be achieved at lower cost.

32. We are puzzled by the view expressed in the Consultation Document that the term efficiency is "a poorly defined term" (Reserve Bank of New Zealand, The Treasury, June 2019, p. 16) in the context of regulatory policy. As the Court of Appeal has observed (New Zealand Court of Appeal, 2016):

> *Efficiency became an established pillar of New Zealand's competition law and policy.*

The Court of Appeal defined efficiency (citing with approval previous High Court decisions) consistent with the accepted definition in regulatory policy making:

> *We bear in mind that efficiency has three dimensions commonly referred to as allocative efficiency, production efficiency and dynamic efficiency.*

A clearer statement of purpose is required

33. We agree that there should be a more clear statement of objectives for prudential regulation. This statement should elucidate the purpose and scope of the use of the powers so that it can be practically clear when the Reserve Bank's regulations are within the scope of the statute or otherwise. In proposed in-principle purpose statement falls well short of this criteria.

34. We have serious concerns that the proposed objective would authorise the Reserve Bank to avoid real trade-offs between stability and the broad benefits of an industry that delivers

financial services efficiently. The Reserve Bank should be charged with protecting and enhancing the stability and efficiency of New Zealand's financial system.

35. We are not convinced that there is a widely accepted and used definition of financial stability. The lack of clarity as to the meaning of financial stability might be addressed by requiring the Reserve Bank to publish, and consult on, a definition of what that term means for the purposes of prudential regulation.[4]

[4] This practice, of a regulator, publishing a definition of its purpose statement for consultation has been adopted by other regulators, for example, the Electricity Authority has published and regularly refers to its view of what its statutory purpose statement means, available https://www.ea.govt.nz/about-us/strategic-planning-and-reporting/foundation-documents/ .

4. Governance accountability

Structure

36. The performance of the Reserve Bank's regulatory functions will be significantly affected by the organisational architecture within which they are conducted. The main features of this architecture will resolve questions about lines of accountability, the appointment of governors together with their rights and duties, how the functions will be resourced, the engagement with stakeholders and the provisions for performance review.

37. Decisions have already been made in-principle that the structures for the conduct of monetary policy are not to be separated from the regulatory functions into a separate organisation. So, the remaining structural question to be resolved concerns the principles and practice of governance for the regulatory functions within that context. But for the reasons stated above (Existing Act drafted with a different focus) the Reserve Bank's situation is unique amongst the regulatory bodies of the State. This uniqueness arises firstly from the proximity of the regulatory functions to the Reserve Bank's other functions in monetary policy and as lender of last resort to the banks, and secondly to the depth and breadth of the regulatory functions. Thirdly, the emergence of macro prudential policies that span monetary policy and prudential regulation, while also encroaching on the Treasury's responsibility for fiscal policy, is a substantial additional complication with respect to how the various functions are governed.

38. So, how should these features emerge in the question of the legal form of the Reserve Bank. The momentum in the Consultation Document is towards the use of a Crown Entity. We note a few points about this proposal.

39. It is worth recalling that the Reserve Bank Act in 1989 pre-dated the development of the Crown Entity framework. The Finance Minister at that time, Sir Roger Douglas, asked the Governor of the Reserve Bank and the Secretary to the Treasury to investigate whether the newly created State-Owned Enterprise framework could be adapted for use with the Reserve Bank. The central principle in his mind was that he saw the need to formalise the relationship between the Minister of Finance and the operations of the Reserve Bank through the use of a board that operated in a way that was partly analogous to a State-Owned Enterprise board. The attempt to find a performance metric that operated in a manner similar to the financial performance of State Owned Enterprises was ultimately abandoned in favour of inflation targeting. And, by holding the Governor accountable for the organisation's performance in controlling inflation, the board's role became attenuated with respect to the conventional functions of a board. It didn't really govern the core business of the organisation although it had oversight of the Governor.

40. The Consultation Document proposes that board of the Reserve Bank should take on a more conventional governance role of the activities of the bank, while quarantining its monetary policy decision-making to a statutory committee. The idea is to give the board of the Reserve Bank a conventional governance authority over everything else and, while the implications are sketchy, this seems to mean that the board of the Reserve Bank could actually take regulatory

decisions if it chose to because, unlike monetary policy, there is no statutory basis for that authority to lie with the Governor or anyone else.

41. The Consultation Document might be read to imply that the board of a Crown Entity cannot also be a statutory committee (Reserve Bank of New Zealand, The Treasury, June 2019, p. 65). In fact, there is nothing to stop this if it were seen as desirable. For example, the Productivity Commission was created by a short act of Parliament which established its existence and the appointment, powers and accountabilities of the Commissioners. In the conduct of the work that this Act requires them to undertake, they operate as a commission in accordance with their powers under the Act. However, the Act also specifies that the Productivity Commission is a Crown Entity insofar as the expectations on them for the proper administration of the organisation are concerned:

> (1)The Commission is a Crown entity for the purposes of the Crown Entities Act 2004.
>
> (2)The Crown Entities Act 2004 applies to the Commission except to the extent that this Act expressly provides otherwise.

42. As a consequence, they are functioning as Commissioners in developing their reports, in response to the mandates given to them by the government, but when governing the operations of the organisation the same people operate as the board like any other Crown Entity.

43. In relation to the Reserve Bank, it therefore seems possible for it to be a Crown Entity as is proposed, but the statute could provide for the members of the board to operate with some specified statutory authorities in relation to the conduct of regulatory policies. This would reinforce however the importance of the law being as clear as is feasible about just what those regulatory authorities are, the principles and practices for the conduct and the manner in which they are held to account. We do not think it would be sufficient to allocate the powers of regulation to the board and leave it to them how to give effect to them—principles, capabilities and processes really matter in the conduct of regulatory policies. It is useful to recall that placing commercial functions of departments into the State-Owned Enterprise structure imported the entire body of company law whereas the Crown Entity framework is skeletal by comparison. The structural architecture around the Reserve Bank's regulatory functions needs to be tailored to suit, especially considering the unique and extensive regulatory powers it is to exercise.

44. While not offering detailed advice on how this might be done, we recommend that provision is made for these regulatory functions to be conducted in accordance with good practices of economic regulation elsewhere, that there is no statutory inhibition to the processes and decisions being subjected to challenge in the courts in the same way that Commerce Commission decisions are challenged. Further, that the Regulations Review Committee of the Parliament should have the same mandate for regulations under the Reserve Bank act as it does for regulations under other acts. These recommendations are in addition to our recommendations in this report on setting the objectives for the regulatory functions.

Accountability and oversight

45. The Consultation Document proposes that principles for the conduct of the regulatory functions be elucidated in some subsidiary instrument. We endorse this proposal and recommend that this instrument has some legal force in the event that Reserve Bank decisions might be reviewed in the courts.

46. The banking industry is very unlikely to seek to challenge Reserve Bank decisions in the courts given its complex and continuing relationship with the Reserve Bank over a wide range of issues. There is too much risk to the relationship as a whole to challenge the Reserve Bank on a particular intervention. This compares with the electricity industry where for example the Major Energy Users Group regularly challenges the decisions of the Commerce Commission and participates vigorously in the industry working groups sponsored by the Electricity Authority. By analogy we could see such working groups usefully being applied in the regulation of the banking industry as one element in establishing orderly, transparent and respectful exchanges with stakeholders about proposed regulations and the analysis which underlies them.

Treasury and RBNZ role clarity

47. The thrust of the Consultation Document is to pass to the Treasury the responsibility to monitor the performance of the Reserve Bank in relation to its legislation and how it is implemented. We do not think this is as simple a matter as it might superficially seem. The Minister most concerned with the Reserve Bank is the Minister of Finance, and the Treasury serves that Minister so the answer might seem obvious. However, although the Treasury took on responsibility for oversight of regulatory policy over 10 years ago, it has not been prominent in the exercise of this responsibility while the Ministry of Business Innovation & Employment (MBIE) has oversight of a range of regulatory functions.

48. Under the previous Reserve Bank Act the respective roles of the Reserve Bank and the Treasury were very clearly established over a difficult and lengthy transition. The Secretary to the Treasury, on his own advice, was removed from the board of the Reserve Bank leaving the Treasury in a position to offer a second opinion to the Minister of Finance on the conduct of monetary policy if it chose to. By the same token, the Reserve Bank's involvement in management of the government's finances was clarified in two respects. It became the agent of the Treasury in respect of government stock issuance and associated activities, while the Treasury created the New Zealand Debt Management Office which took over the management of the government's financial assets and liabilities in alignment with the government's debt objectives and risk tolerance. This separation put an end to what had previously been an untidy involvement of the Treasury in advice about short-term monetary policy operations and the subordination of the government's debt management objectives to concerns over short-term effects on certain interest rates. These arrangements were of course consequent on moving to a floating exchange rate, which meant the government no longer had to hold large amounts of foreign exchange in order to support the fixed exchange rate.

49. The new arrangements for monetary policy have placed a non-voting Treasury official on the statutory Monetary Policy Committee. The case for this seems to be to ensure that monetary

and fiscal policy are mutually well-informed and perhaps "coordinated" in some undefined sense. The position on the Monetary Policy Committee also provides a channel whereby the Minister of Finance can be kept informed of the Monetary Policy Committee's deliberations. The Code of Conduct of the Monetary Policy Committee does not imply any provisions in this regard but does authorise the provision of information "as required or permitted by law". We can reasonably assume there is a protocol to ensure that communications with the Committee and the Minister are done only through the Governor, but Treasury officials are bound to carry out any legal instruction from the Minister, which could include carrying a message to the Committee or providing information to the Minister about its deliberations.

50. Recently the Governor has brought to prominence the possibility of macro prudential regulation, which as he has observed, has fiscal implications. A hard-learned lesson from the past, that should not be forgotten, is that in the absence of sound processes and clear roles among the parties, monetary policy interventions can create huge liabilities for the taxpayer. In the past, these liabilities were not subject to the rigours of fiscal policy nor oversight by the Parliament under the Public Finance Act. The taxpayers absorbed a huge loss in the mid-1980s from a decision by the Minister of Finance to put what was in effect a one way bet for the speculators in the financial markets. We recommend that great care is taken to ensure that the respective roles of the Reserve Bank and the Treasury do not become blurred in the name of better coordination or in the evolution of macro prudential policy. Demands on public money must be channelled through conventional fiscal policy processes and accountability through to the Parliament.

51. We therefore have some reservations about the Treasury taking the role of monitoring the performance of the Reserve Bank in the conduct of its functions, as it has, or is likely to have, direct involvement in some exercises of the powers of the Reserve Bank Act and in some measure may end up monitoring its own performance or reviewing decisions it was involved in.

52. On the other hand, MBIE is likely to remain removed from the regulation of the banking industry and lacks the expertise that this very complex area of economic policy demands. So, there seems to us to be no straightforward answer to the question of how the Reserve Bank is monitored. If it is to be the Treasury, then we would urge that formal protocols are developed with the aim of ensuring that Treasury's engagement in activities authorised by the Reserve Bank Act, do not undermine fundamental clarity about the respective roles of the two organisations and that it is clear who is making the decisions—be it the Reserve Bank board, the Governor, the Monetary Policy Committee, the Treasury or the Minister of Finance.

Place of analysis in decision making

53. Against the background of these broader considerations we offer some comment grounded in our experience with the Reserve Bank's proposal to increase regulatory capital regulations on the banks, which we have reported on separately.

54. The conclusion of our previous report was that the proposal to raise bank regulatory capital to 16%, with associated decisions about smaller banks and the reliance on ordinary share capital, was not grounded in the analysis that the Reserve Bank had provided to the consultation

process. In short, although the Reserve Bank Act required it to balance stability and efficiency, it had promoted the stability objective above concern for efficiency and had provided insufficient analytical evidence in support of its conclusion to effectively double the capital requirement. The Reserve Bank had, in effect, taken on itself the responsibility to specify the risk appetite of New Zealanders and thereby imposed a somewhat arbitrary requirement to avoid a one in 200 year banking crisis.

55. As our report noted, such regulatory decisions are not generally made on the basis of analysis alone, as there is always an element of judgement needed to address all the uncertainty around the analysis. However, as we have explained in the earlier report—the approach taken by the Reserve Bank does not conform with best practices for the use of technical analysis to support regulatory decisions or the best processes towards making such decisions. It is not satisfactory, as has happened in this instance, to postpone the social cost benefit analysis and the regulatory impact analysis until after the decision has gained so much momentum it is barely conceivable that these pieces of work at the tail end could derail the proposal—even if that is what the analysis suggested. In effect, the Reserve Bank is saying that the cost benefit analysis does not deserve a crucial role in the decision.

56. No one is arguing against having a high degree of stability and confidence in the banking system nor contesting that the consequences of a major failure in the banking system impose very high economic and social costs. But the decision to be taken ultimately comes down to a very specific numerical regulation, for which rhetorical arguments are not much help in deciding. Further, the stress tests that have been overseen by the Reserve Bank do not point to serious problems in the current situation, so the proposal seems also to imply that the stress tests are unreliable in some sense, which is again a matter for analysis. If they are not believed they should be revised.

57. The overall picture is that the analytical work surrounding the proposed regulatory capital requirements is not grounding the decision prior to other judgements being imposed. The point we want to emphasise is that regulation is an endlessly repeating process, the success of which depends on learning over time to make better and better regulatory decisions. In this evolution, the development of more reliable and sophisticated analytical methods over time is very important for learning how to make better decisions. Regulatory decisions are not like laboratory experiments, as they take place in an evolving and changing environment, which means it is rarely certain in hindsight whether a particular regulation was a success or failure. All that can be done is to take cross bearings on the evidence and unpick the story following a regulatory change. In this process it is important as to what the analysis that was done at the time of that regulation showed. Was it in line with the decision that was taken? Was it overruled by the judgement of the regulator on other grounds? What information was unavailable at that time and which would have helped to make a better decision?

58. The Reserve Bank has a long history of employing top analytical talent in producing quality analytical material. Preserving and enhancing this tradition by investing in the people, their networks, evidence and analysis should be seen by the authorities as fundamentally important to the successful conduct of their current and emerging regulatory functions in the years ahead.

Strategic integration of regulatory interventions

59. A further point that we featured in the earlier report was that the sequence of decisions that the Reserve Bank had taken leading up to the capital regulation proposal had heavily influenced its development. As we noted there, the prior decisions about the OBR, the prohibition of hybrid instruments as qualifying capital and the imposition of the default method for risk weighting led to the capital proposal being more rigid than might have been the case if a different sequence of decision had been taken or these decisions taken in a wider strategic framework. Our report recognised that, in reality, regulators have to sequence their decisions and opportunities are rare for a broad-scale strategic review to consider a family of regulations at once. But, that said, the sequence of decisions taken in this instance seems to have been too restrictive in its effects on the proposal about capital regulations. There seems to have been lacking a broad strategic context in which these decisions were taken that might have led to a better sequencing of decisions and a more fruitful balancing of interventions on the basis of benefits and costs.

Court involvement

60. All decision-makers can make errors. Decisions by the Reserve Bank in its implementation of prudential management would, in certain circumstances, be amendable to judicial review, which is a common law review. Judicial review focuses principally on the process by which a decision was reached. The Court's consideration of the substance of the decision would be limited to whether or not the decision is "reasonable". The High Court may set aside decisions in certain circumstances (for example, if the decision-maker is biased or has acted outside his or her powers) or may also require the decision-maker to reconsider all or part of its original decision.

61. In other regulatory processes, a decision may also be appealed on its merits, that is, where the appellate body is entitled to reach its own independent view on the substance of the decision reached. An example of this form of appeal in New Zealand is that the High Court has jurisdiction to hear appeals on merit relating to Commerce Commission authorisations and clearances. When extending appeals on merit to include the details of the price control regulations, the Explanatory Note to the Bill commented as follows:

> Because of the importance of input methodologies [detailed rules the Commission would develop for setting prices], the Bill makes provision for merits review … This is in the form of an appeal to a High Court judge assisted by 2 expert lay members… The appeal provides accountability for the Commission, helps ensure that input methodologies deliver on the purpose statement, and promotes business confidence.

62. These objectives—accountability, ensuring that the proposed regulations deliver on the purpose statement, and promoting stakeholder confidence in the regulation—all apply to prudential regulation.

63. From an economic efficiency perspective, the justification for appeals on merit is correction of decision error. Social harm arising from uncorrected errors occurs in two primary forms. There

are direct effects. Prudential regulation directly affects the efficiency of the financial system and hence its contribution to the well-being of New Zealanders. Social harm also occurs from indirect effects. The credibility of the regulatory regime would be undermined if the financial sector, and its customers, perceived that regulatory decisions were based on uncorrected errors (even if the decision were legally correct). The potential effects on investment behaviour as a result of such uncertainty are pervasive.

64. There are several reasons why decisions on prudential regulation have an inherent risk of error.

a) Decisions on prudential regulation require interpretation and judgment of the purpose of those regulatory powers (as discussed above), but also of the facts, forecasts, models and data presented to or gathered by the Reserve Bank. These interpretations, and the data that underpin the judgments, are subject to error.

b) The threat of appeals on merit by an independent body such as the judiciary places a positive discipline on the quality of a regulator's decision, whether or not an appeal is lodged. The potential for appeal acts as a built-in check on regulator behaviour, since the prospect of an appeal provides incentives for regulators to produce carefully reasoned and balanced decisions.

c) Short-run political and administrative pressures can create further risks of error by a regulator. As an example, the High Court found that the former the Electricity Commission appeared to give more weight to a government deadline, which the Court found was not immutable, than to its obligations to consult adequately with industry.[5] If business managers and directors feel they need to second-guess changing political and administrative objectives, investment decisions are likely to be less efficient.

65. The potential benefits of appeal on merit are large. The costs are comparatively small. An appeal on a complex matter might cost several hundred thousand dollars but this is a small amount relative to the cost of poorly justified policy. For example, we assessed the economic costs of the Reserve Bank's capital proposals as exceeding the economic benefits by about $1.8 billion per annum. The risk that the appeal process might be used to delay desirable regulation can be managed by stipulating that the regulation decision is not stayed while the appeal is heard (this is the approach taken for appeals on merit to the Commerce Commission's input methodologies).

66. An appeal on merit should be available to any interested party, not just the entities directly regulated by the Reserve Bank. This would allow bank customers to ask the High Court to test merits of a decision by the Reserve Bank if they perceive prudential interventions were made in error to their detriment.

[5] Contact Energy Limited and Meridian Energy Limited v Electricity Commission and Transpower New Zealand Limited, CIV-2005-485-624.

5. Conclusion

We see the Phase 2 of the reform of the Reserve Bank Act as an opportunity to think deeply about, and make careful decisions about, the structure, conduct and performance of the Reserve Bank's extensive powers of regulation over its domain.

The points in this report we want to emphasise are as follows:

1. The wide powers that the Governor has for monetary policy are not appropriate for the extensive powers for prudential regulation that position entails.
2. The governance, processes, capability, accountability and transparency surrounding these regulatory functions should align with the best practices for the use of regulatory powers amongst other business regulators but allowing for the uniqueness of the powers of the Reserve Bank. These powers are very extensive by comparison and so the Reserve Bank should ideally be at the forefront of best practices in commercial regulation.
3. There should be a more clear statement of objectives that elucidates the purpose and scope of the use of the powers so that it is practically clear when the Reserve Bank's regulations are within the scope of the statute or otherwise.
4. We have serious concerns that the proposed objective in legislation would authorise the Reserve Bank to avoid real trade-offs between stability and the broad benefits of an industry that delivers financial services efficiently.
5. The act should provide for principles that guide the exercise of the powers of regulation.
6. Over the whole, the act should be constructed in a way that is amenable to overview by the Parliament and the courts.
7. Using the generic Crown Entity structure is logical, but attention should be given to whether the Board has powers and obligations that should be defined in statute because the Crown Entity structure is silent on vital issues that are specific to the Reserve Bank.
8. The details of the act should attend closely to the respective roles of the Reserve Bank, Treasury, the Reserve Bank Board and the Minister, especially where macro-prudential policies span monetary, fiscal and regulatory policies.
9. The clearer the roles in the point above are established, the more comfortable we would be about Treasury as the monitoring agency for the Reserve Bank.

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