Bulletin

Vol. 80, No. 11

December 2017

RESERVE BANK

OF NEW ZEALAND

TE PŪTEA MATUA

Reserve Bank of New Zealand *Bulletin*

Subscribe online: https://www.rbnz.govt.nz/email-updates

For back issues visit: https://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin

ISSN 1177-8644

Independence with accountability: financial system regulation and the Reserve Bank

Dr Chris Hunt[1]

This article discusses the rationale for various financial system-related functions and objectives to be 'delegated' to an independent agency, whether a central bank (as in the case of the Reserve Bank) or a separate supervisory authority. The delegation of these tasks marks a form of pre-commitment on the part of government to the long-run goal of financial stability. This pre-commitment helps reduce the risk of politicisation of policy making and the 'time inconsistency' problem – where government may understand the long-term benefits to society from financial stability, but may act in contrary ways over the short-term.

However, the decision-makers heading these agencies are unelected. To compensate for this and the potential creation of a 'democratic deficit', independent agencies must demonstrate that they contribute to better outcomes than would otherwise prevail if they were not independent, while enshrining a high degree of 'procedural legitimacy' based on robust accountability arrangements. In the financial policy sphere, the construction of robust accountability arrangements can be challenging. Financial system objectives such as 'soundness' and 'efficiency' are not easily amenable to quantification.

1 Prudential Supervision Department, Reserve Bank. The author would like to thank John Yeabsley, NZIER, for acting as an external peer review for this article. Any errors or omissions are those of the author.

1 Introduction

Regulation is a pervasive feature of modern societies. From food safety to the regulation of utilities such as telecommunications, regulation affects New Zealanders' lives as much as the traditional redistributional role of government (taxation and social spending) (Productivity Commission 2014, p. 2). New Zealand has about 200 regulatory regimes, directly employing between 10,000 and 14,000 people. Increasingly this regulation is taking place outside of government departments and within separate organisations that sit at varying degrees of arm's length from government – a phenomenon variously described as 'agentification', an 'unbundling of government', or the rise of 'independent regulatory authorities' (IRAs) (Guidi 2015; Maggetti 2010; Moran 2002; Quintyn 2009; Thatcher 2002). Done well, regulation is an "important tool for preserving and advancing the public interest" (Productivity Commission 2014, p.1). But if poorly executed, or if regulatory regimes are badly designed, 'regulatory failures' can have important and significant negative consequences.

This article examines one species of IRAs – financial sector regulatory authorities – with a focus on the set of financial sector responsibilities that the Reserve Bank has been given. We examine the reasons why government might give or 'delegate' certain objectives, functions and powers to an agency that operates largely free from direct political control.

The delegation of financial system objectives to autonomous statutory agencies reflects a pre-commitment on the part of government to achieve the broader long-run goal of financial stability. This delegation addresses the classic 'time inconsistency problem', where despite understanding that society will be better off in the long-run if the objective of financial stability is realised, a government's political imperatives over the short-term may prevent this long-run goal ever being achieved. Thus, freeing financial policy from the political cycle is a key argument underpinning regulatory autonomy and this helps to promote a stable and consistent regulatory environment. The political cycle can also be influenced by powerful private interests tied to the financial sector and by more populist sentiment. The insulation of policy-making and supervision from the indirect influence of these interests on the executive branch of government provides another rationale for independence.

However, the reassignment of powers from democratic institutions (Parliament, government ministers) to unelected bodies creates a 'democratic deficit' and raises the issue of how to compensate for a lack of political legitimacy (Maggetti, 2010). There are two potential solutions to this problem. Firstly, legitimacy can be created if it can be demonstrated that the outcomes from delegation are superior to what would prevail if government were to undertake regulation directly. Secondly, a strong accountability framework can create legitimacy if the public can see that regulatory decisions take place in a way that is fair and transparent. Accountability also helps ensure that the agent (e.g. the financial regulator) discharges its functions in a way that satisfies those who have delegated the objectives in the first place.

Accountability is fundamental to the governance of IRAs which may act with self-interest rather than aligning with society's goals, or be subject to 'capture' from the financial institutions they regulate. And even a well-intentioned agency may not perform its functions in the manner envisaged by government (or society), particularly if the purpose it has been given is broad. Constructing robust accountability arrangements for a set of financial system-related functions is particularly challenging. Financial system goals are typically defined in a fairly general way, and multiple objectives can at times conflict. Concepts such as financial system 'soundness' and 'efficiency' are not easily translated into a single, quantifiable benchmark against which performance can be monitored. For these reasons, specific accountability arrangements that exist to govern monetary policy performance, for example, may not easily translate across to the financial stability area. In the case of the latter, greater emphasis should be placed on *ex ante* forms of accountability tied to the robustness and transparency of the decision making process itself, rather than on *ex post* performance metrics. As one commentator describes it, independent financial regulators should not be 'cheap copies' of arrangements that exist for monetary policy (Quintyn, 2009).

This article is published against the background of the new Government's recently announced terms of reference for a review of the Reserve Bank of New Zealand Act 1989. Phase One of the review will focus on monetary policy, while Phase Two will consider whether other areas of Reserve Bank responsibility might warrant further investigation as part of this review. An important guiding principle for both stages is that the 'operational independence of the Reserve Bank remain paramount and will be protected'.

There are also several other motivating factors for this article. Firstly, the Reserve Bank has tended to place a greater focus on the institutional and governance arrangements for monetary policy – certainly in its public communications.[2] This article seeks to address the governance of the financial system functions for which the Reserve Bank has responsibility.

Secondly, high profile policy decisions such as the Reserve Bank's loan-to-value restrictions (LVRs) have led to heightened interest in the Reserve Bank's policymaking autonomy and the associated safeguards in the form of accountability and transparency arrangements tied to the macro-prudential policy framework.

Thirdly, regulatory independence is also a topic that continues to be a focus internationally. The recent Australian Financial System Inquiry (or 'Murray Report') for example, noted that 'Australia needs strong, independent and accountable regulators to help maintain trust and confidence in the financial system' (Australian Government 2015).

And at home, New Zealand's financial sector has been recently peer reviewed by the IMF as part of its Financial Sector Assessment Programme (FSAP).[3] This review has included an assessment of whether New Zealand's financial regulators (the Reserve Bank and the Financial Markets Authority) sit at an appropriate degree of arm's length from government. The IMF upheld the principle of regulatory independence for the Reserve Bank. One of its recommendations was that there should be greater clarity of the responsibilities of the Treasury and RBNZ on financial sector issues to 'reinforce the role of RBNZ as prudential regulator and supervisor'.

2 By contrast, there have been several monetary policy-specific governance articles that have been published recently in the Reserve Bank's *Bulletin*. See, for example, Ford, Kendall and Richardson (2015); Wood and Reddell (2014); Aldridge and Wood (2014), and; Graham and Smith (2012).

3 See Hunt (2016a, 2017) for an overview of the aims of the New Zealand FSAP and its subsequent outcomes.

2 Conceptual preliminaries – a simple 'delegation' model

A natural starting point for answering the question about why financial sector regulation should be conducted at arm's length from the executive and legislative branches of government, is the underlying reason why society chooses to 'regulate' various aspects of social and economic activity in the first instance. The answer lies in regulation as a response to situations of 'market failure': instances where, left alone, unfettered markets produce sub-optimal outcomes for society. Monopoly or anti-competitive behaviour, various information problems, negative externalities and 'public goods' are all standard examples of market failure.

To the extent that it addresses these problems, regulation is "indispensable to the proper functioning of economies and societies" (New Zealand Productivity Commission, 2014, p. 1). Regulation itself may be conducted by agencies or departments that are part of the executive branch of government, institutions that are at more distance from government (IRAs), or if circumstances allow, regulation can be undertaken by various non-state organisations such as industry groups or self-regulatory bodies.

The financial system is subject to several important market failures, from informational asymmetries through to the significant costs imposed on society from the failure of a large or systemically important financial institution. In response, society (via those acting on their behalf – i.e., government) has vested the task of promoting financial stability, or some other financial system-specific objective (such as regulating market conduct or consumer protection) to an institution sitting outside the executive, with powers commensurate with achieving such objectives.

In the public sector governance literature, a 'principal' has *delegated* a specific set of tasks or objectives to an 'agent' who sits at arm's length (for various reasons that are discussed in the next section). A welfare-maximising regulatory authority will act in line with the wishes of the principals (voters, the executive, Parliament) and seek to achieve the various financial system-related objectives with which it has been tasked.[4] However, the practical difficulties of aligning the behaviour of the agent with the interests of the principals gives rise to the classic 'principal-agent' problem – the presence of significant 'agency costs' associated with either shirking (minimising efforts) or slippage (shifting outcomes away from the principal's preferred objectives towards that of the agent's) (Conzelmann *et al*, 2010).[5]

To address these costs a 'contract' needs to be specified that helps align the behaviour of the agent with the interests of the principals. A first best solution is the formulation of a 'complete contract' which specifies the consequences of every possible state of the world should the agent deviate from the objectives laid out by the principal – the agent becomes perfectly <u>accountable</u> for their actions. Examples of complete contingent contracts are of course rare in the real world and this suggests that ensuring accountability is not always straightforward. In the context of financial sector regulation such contracts are particularly difficult, since objectives such as 'promoting' or 'maintaining' financial stability are often open to wide interpretation, and not typically amenable to a single quantifiable metric against which to benchmark performance.[6]

This, then, is the problem of accountability, and arises because the delegation of objectives without a certain degree of autonomy or discretion of the agent is unworkable. Indeed, the more powers that are delegated to an agency tasked with ensuring financial stability, the more important accountability becomes (Quintyn and Taylor, 2004, p. 8). As Masciandaro, Pansini and Quintyn (2011) argue, "independent supervisors need an elaborate set of accountability arrangements to offset the fact that for financial supervision a very specific contract (in a principal-agent sense) is impossible, given the great range of contingencies that can occur in supervision" (p. 6).

Accountability is also a more general solution to another problem created by delegation to unelected or 'non-majoritarian' institutions – the lack of legitimacy. Political principals transfer tasks to an agent, but not legitimacy. Indeed the rise of IRAs leads to a 'net loss' of legitimacy across the political system (Maggetti 2010, p. 3). There are two ways this loss (defined also as a 'democratic deficit') can be offset. Firstly, 'output oriented legitimacy' can be created if it can be established by the public that the outcomes of delegating to IRAs are better than the alternative.[7] This speaks directly to the various reasons that will be canvassed in the next section around enhanced time-consistency of regulatory policies and the better use of expert-based knowledge in the decision making process.

4 Note this agent, or 'regulator' could be a central bank tasked with a set of financial stability-related functions (as in the case of New Zealand) or a separate agency.

5 One should also note that the interests of principals can change over time. In democratic systems the executive branch of government, for example, is periodically refreshed via the translation of voter preferences, and both the interests of the public and the executive may diverge from the objectives originally delegated by the legislature to the regulatory agency.

6 This problem is accentuated the more complex or multifaceted the objectives are, e.g. the Reserve Bank's objective of promoting the 'soundness and efficiency of the financial system.

7 Major regulatory failures by IRAs (such as financial sector regulation in the lead up to the GFC) suggests that independence alone is not necessarily a sufficient condition for positive outcomes, and that establishing empirically the benefits of IRAs is not straightforward.

Secondly, enhanced accountability arrangements can create 'procedural legitimacy' where "decisions may be accepted because of the process they [the IRAs] use – notably whether they make decisions transparently, stay within their legislative mandate, are accountable, use due process or have expertise" (Thatcher 2002, p. 958).

3 The case for independent financial regulators

3.1 Overview

The New Zealand Productivity Commission's 2014 inquiry, *Regulating Institutions and Practices*, provides a useful summary of the various conceptual arguments for 'delegating' regulation to an independent agency, most of which are apposite for financial sector regulation.

It is important to emphasise at the outset that 'independence versus government control' is not an either/or binary outcome. There is a spectrum of arm's length outcomes along which delegation can be given and regulatory regimes constructed.

Following the Productivity Commission's framework, more independence is desirable when the following factors are evident:

- *Regulatory decision making imposes visible (short-term) costs, but accrues benefits that are long-term and likely to be undervalued due to the focus on the electoral cycle.* Financial regulation imposes short-term costs on regulated entities to achieve a long-term objective. In the case of prudential regulation (and the Reserve Bank's role) this is promoting the maintenance of a sound and efficient financial system. If financial sector regulation were located within, or controlled by, the executive branch of government, a 'commitment problem' immediately arises even if elected officials understand the long-term benefits to society that are attached to having a stable financial system. In other words, the electoral cycle and the desire to be re-elected creates a powerful incentive for politicians to renege on this long-term commitment (and relatedly, any commitments of previous governments).[8] Pre-commitment via delegation to independent agencies imposes a high-cost on future governments to renege (Guidi 2010, p. 1198).

- *Decisions weigh a powerful private interest (or set of interests) against a dispersed public interest.* The finance industry may be a powerful interest group with deep pockets, potentially able to lever such power over the executive branch of government – and this pressure can be more acute where the sector is dominated by a few large players as in the case of New Zealand's banking system.

- *Decisions require a substantial degree of technical expertise or expert judgement*. Financial regulation is, at times, a highly technical subject area and with regulators insulated from political concerns, subject matter experts will typically have greater leeway to use technical knowledge to support more robust decision making. In principle it is possible for this expertise to be located within a government department, or for government to use the financial regulators as 'expert advisers' while retaining

8 In one sense delegation to independent agencies doesn't solve the commitment problem – rather it relocates it (Trillas 2010, p. 8). Government still needs to commit to respect the regulatory independence of the agencies concerned, and there may be reasons why this could be difficult to do in certain circumstances.

responsibility for decisions. However, the potential politicisation of technical advice is an ever present threat.[9]

- *Decisions where the causal relationship between policy instruments and the desired outcome (the transmission mechanism) is complex and uncertain.* This is particularly the case with financial sector regulation where the transmission mechanism involving regulatory rules and supervisory actions, and the outcomes associated with 'soundness and efficiency' are very complex. Regulatory inventions can have all sorts of unintended consequences as a result of the behavioural response of various financial market participants, and because financial regulators work in an environment where the pace of innovation and change can be rapid. Moreover, the appearance of financial stability (i.e. the absence of a crisis) does not necessarily signal that the instruments of regulation and supervision are working as intended – risks and vulnerabilities can build over a long period of time. However, this latter point presents a challenge for holding independent regulators accountable for their actions – a subject we will return to in section 4.

- *A consistent approach over the long run is needed to create a stable environment.* Financial market participants, including entities that are directly regulated, often undertake decisions that have medium to long term consequences for their own business. A stable and consistent approach to regulation and supervision provides a necessary condition for such decisions. By contrast, potentially ad hoc decision making on the part of successive elected governments is not conducive for long-term decision making for market participants. That said, independent regulators themselves need to ensure a consistent approach is applied across any regulated sector so that the playing field is 'level'.

- *Government and non-government entities are under the same framework.* Ensuring neutrality between government-owned (or backed) entities (e.g. state-owned enterprises such as Kiwibank) that compete with those that are not, is important across the financial sector to reduce the risk of favouritism.

- *Decisions need to be taken expeditiously.* Policy-makers need to respond quickly and flexibly to risks developing in the financial system and this can be done most effectively in an agency given appropriate powers. The potential for inertia in governmental decision making is particularly problematic for policies that are sensitive to the financial cycle such as macro-prudential policy. Delayed decision making could inhibit the ability to mitigate risk and indeed potentially worsen financial stability outcomes.

- *It is important for public confidence that regulation is seen as impartial.* A domestic and international consensus has developed over time that places a great deal of weight on the benefits of delegating the responsibility for regulation and supervision to autonomous agencies. Public confidence in the financial system is bolstered by this autonomy. However, this public confidence, and the legitimacy this confers, is contingent on the outcomes that are achieved by any independent regulator. Episodes such as the GFC are an illustration of how this public confidence can quickly dissipate.

9 Kamber, Karadegikli and Smith (2015) note that until the Reserve Bank Act 1989, an 'expert-adviser' model had prevailed in New Zealand, with the Reserve Bank the location of technical expertise for a broad monetary stabilisation function, but with government the ultimate decision-maker (p. 406). This framework did not produce favourable macro-economic outcomes given the high level of inflation that was observed during the 1970s and 1980s.

On the other hand, there are situations where less autonomy may be legitimate. For example:

- *Where decisions involve clear value judgements (and are less technocratic in nature), these might be more appropriately undertaken by elected officials.* Admittedly the boundary between 'value judgements' and 'technical expertise' is not hard and fast. Financial regulators operate in a world of complexity and uncertainty so a significant amount of judgement is required, even for what might appear as mundane technical decisions. More obviously, decisions such as those related to taxation and social welfare spending are examples of value judgements, and since they involve the significant exercise of 'coercive State power' and have large distributional effects, such decisions are not delegated to independent agencies overseen by unelected officials. It should be acknowledged that financial sector regulation also affects the property rights of individuals and regulated entities and hence has distributional impacts (by constraining or facilitating certain types of business activity), while regulators often have the power to take action that results in a monetary cost for regulated entities. It is therefore necessary that the exercise of this power is balanced with strong accountability and the sense that such activities are undertaken in a fair and transparent way.

- *Political control could be necessary to guard against 'regulatory capture' (where an independent agency might minimise industry costs, or apply rules inconsistently to favour individual institutions).* Regulatory capture is an ever present threat in the financial sector, particularly given the risk of a 'revolving door' between those employed within regulatory agencies and the entities they regulate. That said, reputational costs for decision-makers within the supervisory agency can be a powerful mechanism to help mitigate the appearance of favouritism, but other more formal mechanisms exist such as conflict of interest policies, and a level of remuneration within regulatory agencies that is not significantly lower than that available in the regulated sector. The alternative – more political control – does not necessarily solve the problem of regulatory capture, since regulated entities may direct their lobbying energies more forcibly towards politicians.

- *Where decisions have implications for the government's fiscal position or that are integral to a government's economic strategy.* The spectre of a failure of a major financial institution, and the possibility of public funds being used to rescue the institution, suggest there is a legitimate role for government in the broad area of crisis management and resolution. The New Zealand framework, for example, takes this interest into account, where several actions that the Reserve Bank can undertake in this area require the consent of the Minister of Finance (see section 3.4). There are also a number of mechanisms where the views of government, or government strategy, can be taken into account by independent financial regulators such as the Reserve Bank. This includes 'Letters of expectations', the *Statement of Intent* (*SoI*) process and statutory clauses to 'have regard to' government policy.

An additional practical problem with regulatory agencies that are insulated from the political process is that they paradoxically may be too insulated and lack the skills and tools needed to push through much-needed reforms through the political process (Trillas 2010). That said, the opposite is equally likely where an independent agency that is seen as credible should be able to influence both public opinion and the political 'principals'.

As a general conclusion, the Productivity Commission observes that ‘for most regulatory regimes in New Zealand the scale will be weighed towards *more independence*, although there will be a number of regimes where less independence is warranted [emphasis added]’ (p 220). This balance towards greater independence and long-term stability of the regulatory environment underpins New Zealand’s financial sector regulatory arrangements.

In practice the independence of regulatory agencies in the financial system is never absolute, nor are such agencies truly separate from the political process. First off, IRAs operate under laws which define the broad objectives the agency must endeavour to achieve, and which Parliament can change. Secondly, government typically exerts some form of constraint on a regulatory agency’s budget, while often having the ability to make key appointments. Thirdly, branches of government typically monitor the activity and performance of the regulatory agency, and there are several ways that the views of government can be taken into account. Fourthly, there are certain functions where the executive branch of government may retain a legitimate decision making interest and where the agency’s autonomy is circumscribed. Fifthly, a regulator may be willing to impose self-constraints on its ability to act if the benefits are seen to be greater legitimacy or political support.[10] Lastly, legal frameworks in many jurisdictions allow for overt political intervention, either via powers of direction or override options.

On the matter of overt political intervention, the Productivity Commission notes, “[w]hile political interference in independent regulatory regimes is undesirable, providing transparent mechanisms for political intervention is preferable to undertaking more fundamental and ad hoc regulatory reform to solve political problems” (2014, p.8). Indeed, such mechanisms may, paradoxically, enhance independence by making ministers accountable for their interventions to Parliament, and therefore to the public at large. On the other hand, absolute constraints on ministerial interference may lead to arbitrary legislation as a result of temporary political frustration, and this would be detrimental to a stable and predictable regulatory environment.

3.2 Dimensions of independence

The IMF has highlighted four key dimensions of agency independence in relation to the financial sector: institutional independence, regulatory independence, supervisory independence and budgetary independence.[11]

Institutional independence refers to the agency’s status outside the executive and legislative branches of government. The critical elements of institutional independence involve:

- The terms of appointment, and more critically, dismissal of senior staff: independence is enhanced if there are clear rules for appointment and dismissal to avoid any arbitrary intervention from the executive. Independence may be stronger if both the executive and legislature (or another body) are involved in the appointment process (i.e. a double veto process). Tenure periods that are longer than the electoral cycle are also helpful.

10 One example here is the Memorandum of Understanding signed in 2013 between the Reserve Bank and the Minister of Finance governing the operation of the new area of macro-prudential policy. The MoU constrains the ability of the Reserve Bank to intervene for a macro-prudential purpose by limiting such intervention to four policy tools and to registered banks alone. Any change to the number of tools or application of the policy to non-banks requires the agreement of the Minister of Finance.

11 See Quintyn and Taylor (2004), Quintyn, Ramirez and Taylor (2007) and Masciandro, Quintyn and Taylor (2008). The New Zealand Productivity Commission (2014) drew explicitly on this work.

- The agency's governance structure: multi-member decision making bodies (*cf* single decision-maker models) provide potentially greater consistency and continuity over time and a greater counter-weight against ministerial influence (BIS 2009, p. 5).

- Scope of political involvement in decision making: this may arise from executive or parliamentary membership on decision making boards, or specific statutory powers allowing government intervention (via powers of direction or override mechanisms).

<u>Regulatory independence</u> defines the ability to autonomously set prudential rules and regulations within the parameters set by the relevant legislation. Lack of regulatory autonomy reduces the ability to react quickly and flexibly if such rules are mainly a product of the political and legislative process. Moreover, the involvement of the political process can contaminate rules that are technical in nature with political considerations (Quintyn, Ramirez and Taylor 2007, p. 9).On the other hand, the distinction between technical/operational rules, and the political specification of objectives, is not always clear cut.

<u>Supervisory independence</u> relates to the ability of the agency to exercise judgement on matters such as licensing, the nature of inspections of financial institutions, sanctioning and the enforcement of sanctions. Legal protection for supervisors in the course of their duties is also a critical element of supervisory independence and a safeguard against regulatory capture.

<u>Budgetary independence</u> refers to the role of the executive and legislative branches of government in determining an agency's budget. Agencies that enjoy a high degree of budgetary independence have a greater chance of withstanding political interference. Funding from industry via levies typically reduces risks of political interference, although this may create its own set of risks in terms of a dependence on industry and may lead to regulatory capture (Quintyn and Taylor, 2004).

The IMF authors acknowledge that this framework measures only formal, legally defined aspects of independence. As several commentators note, legal status and the powers defined by statute provide a necessary but not sufficient condition for actual independence (Black and Jacobzone 2009, New Zealand Productivity Commission 2014). In addition, independence will be heavily influenced by an agency's internal culture, leadership and the relationships it has established over time. Indeed an agency's reputation and the credibility it has built in the course of acting independently over a long period may offset some formal 'weaknesses' in the agency's institutional design. For example, ministerial powers of direction or override may exist in statute but be used rarely. The weakness attributed to a single decision-maker might be offset by a strong internal culture that promotes *de facto* collective decision making, while a single decision-maker is likely to face heavy reputational costs if they are not seen to be acting in an appropriately autonomous manner (vis-à-vis the Minister).

3.3 The evolution of financial sector regulatory independence

The case for delegating powers to an independent agency tasked with ensuring financial stability (and/or related objectives) developed in earnest from the early 1990s. Before that, the organisational structure of regulation and supervision was widely viewed as unimportant in both theory and practice (Quintyn, Ramirez and Taylor, 2007). The one major exception was in the US, which has a long tradition of independent agencies going back to the 1930s New Deal efforts to build an efficient and effective bureaucracy (Gadinis 2013a, p. 337). The post-war US literature was particularly concerned about whether these agencies could be truly independent from the interests they regulate (i.e. 'capture), and with the issue of regulatory 'failure' (Moran 2002; Thatcher 2002).

Other countries followed the US lead over the course of the late 1980s and early 1990s due in part to financial sector deregulation and liberalisation. Liberalisation changed the game of supervision from compliance checking in very tightly regulated financial systems, to ensuring that the new-found ability of financial institutions to take risks in more open and competitive financial systems did not undermine stability. This change was in the wider context of a redefinition of the role of the State in economic activity, which prompted broader public sector reforms, including the spread of independent agencies in other segments of the economy (e.g. central banks in relation to monetary policy; competition policy; telecommunications etc.). In Europe the impetus for independent agencies was also driven by a top-down process at the EU level (Maggetti 2010; Moran 2002).

The monetary policy analogue was particularly important in this regard. The success of independent central banks in fighting inflation had positive spillovers to financial sector regulation. Indeed, many of the arguments used to justify the operational independence of monetary policy and insulation from political pressures are equally relevant in financial sector regulation. As Quintyn and Taylor (2004) describe, '[b]anking regulatory independence is to financial stability what central bank independence is to monetary policy' (p. 3).

Over the course of the 2000s the IMF was also documenting evidence that independent regulatory agencies made for healthier financial systems based on empirical observations from (mainly) developing country financial crises (Quintyn and Taylor 2004, Hupkes, Quintyn and Taylor 2005 & 2006). Political interference in financial sector regulation had not only weakened regulation in general, it was argued, but also had resulted in delayed recognition of stress events and ultimately higher costs borne by taxpayers in these countries.

In addition to making the case for independence via cross-country research, the IMF was also embedding the principle in their surveillance role, via the Financial Sector Assessment Programmes (FSAPs).[12] FSAPs themselves draw from the methodology and principles developed in international standard setting bodies encompassing the banking and insurance sectors, financial market infrastructure and capital markets. For example, the second *Basel Core Principle for Effective Banking Supervision* states that the supervisor should "possess operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor". Similarly, the International Association of Insurance Supervisors' (IAIS) second principle states that "the supervisor, in the exercise of its functions and powers is: operationally independent, accountable and transparent; protects confidential information; has appropriate legal protection; has adequate resources; and meets high professional standards". Principle number two of the IOSCO standards covering capital market regulation also upholds that the regulator should be operationally independent and accountable in the exercise of its functions and powers.

The global financial crisis (GFC) has been somewhat mixed for arguments tied to regulatory independence. For example, revisiting some of their earlier conclusions, IMF researchers Masciandaro, Pansini and Quintyn (2011) found that the degree of <u>formal</u> regulatory and

12 New Zealand was subject to its second FSAP over the latter half of 2016. The first occurred in 2003-04. See Hunt (2016a and 2017).

supervisory autonomy did not have any significant impact on financial system resilience. The authors concluded that what mattered more is *de facto* independence, the result of long-established corporate cultures that have helped to brace the institution against various forms of capture – whether interference from government or from regulated financial institutions (p. 19).

By contrast Dincer and Eichengreen (2012) examine 140 countries between 1998 and 2010 and conclude that non-performing loans (NPLs) are typically lower in regimes where the regulator is independent, suggesting that there is indeed some relationship between formal governance arrangements and economic outcomes. This result is echoed by Doumpes, Gaganis and Pasiouras (2015). Moreover, according to Dincer and Eichengreen, where the regulator is independent and is the central bank, the financial system is more conservatively regulated (as proxied by higher capital ratios and lower measures of bank credit growth).

Gadinis (2013a&b) argues that in the post-GFC environment the independent agency paradigm has come under attack. Examining the banking laws of 15 jurisdictions, he detects a perceptible increase in political involvement over regulatory and supervisory matters (2013a, p. 333). Gadinis acknowledges that this growing political involvement is mainly related to the development of (or improved clarity around) crisis management, where governments have a more legitimate interest and role.

Supporting Gadinis' general viewpoint is the variety of institutional models that have been developed supporting the new function of macro-prudential policy. In a number of jurisdictions, government plays an important role in decision making.

The counter-argument to Gadinis, as evidenced below, is that regulatory independence continues to be upheld as a fundamental principle of good governance and regulatory design in the post-crisis period. The IMF continues to reinforce the importance of regulator autonomy in the FSAPs, while recent revisions to the various international standards for banking, insurance and capital market regulation have not in any way diluted operational independence as a fundamental maxim. The IMF has also argued, in developing a set of principles for good governance of macro-prudential policy, that government should not play a lead role and that decision making should be vested in some independent body (FSB, IMF & BIS 2011, Nier *et al* 2011, IMF 2013a&b, IMF 2014). Moreover, there are several examples where new regulatory agencies have been created that have preserved an arm's length relationship with the executive (albeit with strong accountability structures in support):

- The UK Treasury, in its summary of submissions in response to proposals for the reform of UK financial sector regulation, argued that "[w]hile it is clearly right for the Treasury to be directly involved in any matters which involve risk to the public finances, the Government sees the independence of the regulatory structure – particularly in normal 'business as usual' periods – as an essential element of efficient and stable financial services and markets" (2010, p. 6).

- The recently concluded *Financial System Inquiry* in Australia has reaffirmed independence of its financial sector regulators as integral to the trust and confidence in the financial system. The Australian Government will be considering changes in the way it funds APRA (the prudential regulator) and ASIC (the market conduct regulator) to support budgetary independence of these two agencies.

- One of the guiding principles of the new single supervisory mechanism (SSM) in the European context (that since late 2014 tasks the European Central Bank (ECB) with supervising 'significant banks') is independence.

3.4 Independence and the scope of Reserve Bank powers

The Reserve Bank carries out a number of financial system-related functions, listed in table 1. The scope of these functions has evolved over time. The prudential regulation and supervision of registered banks dates back to 1986 with the passage of the Reserve Bank of New Zealand Amendment Act (this amended an earlier 1964 Reserve Bank Act).[13] This Act was subsequently superseded by the passage of the Reserve Bank of New Zealand Act 1989. Additional functions have been added over time (either by amending the 1989 Act or by passing separate legislation). In the case of macro-prudential policy, this new policy area involves the use of existing powers and prudential tools, but in a different way to the traditional approach (tools that are turned 'on' and 'off' depending on the state of the financial cycle and associated financial system risks and vulnerabilities).

With respect to the financial system, one of the two key purposes of the Reserve Bank as set out in the 1989 Act is promoting the maintenance of a sound and efficient financial system. The other is stability in the general level of prices (section 1A).[14]

13 See Hunt (2016b).

14 Section 1A was added to the Act via a 2008 amendment. This was designed to elevate the prominence of financial sector functions and objectives. This change was also accompanied by several new accountability requirements (see section 4).

The New Zealand Parliament has conferred on the Reserve Bank a set of powers that enable the performance of financial system-related functions in order to achieve the objectives highlighted in table 1. The 1989 Act provides the Reserve Bank with a considerable degree of independence, although this varies across the sectors the Reserve Bank regulates and supervises, and subject to certain qualifications such as in the area of crisis management.

It should also be acknowledged that the main aim of the architects of the 1989 Act was to give greater autonomy to the Reserve Bank with respect to monetary policy, by providing clear objectives and accompanying accountability arrangements. The initial focus of the Reserve Bank Board, for example, was directed mainly at the Reserve Bank's 'primary function'. This focus has broadened over time, with the assumption of additional financial system functions, and greater attention to accountability arrangements for these functions.

Table 2 summarises the Reserve Bank's set of financial system-related powers within the framework set of by the IMF and discussed in section 3.2.[15]

<u>Institutional independence:</u> The 1989 Act establishes the Reserve Bank as a body corporate (and the same body corporate as under the previous Reserve Bank of New Zealand Act 1964). The State Services Commission (SSC) states on its website that the Reserve Bank is "a stand-alone agency within the State Services that does not fall under any State Services category". The relevant comparator group, however, are Crown entities. Crown entities are legally separate from the Crown

15 Note Masciandro, Quintyn and Taylor (2008) use this framework to construct 'independence' and 'accountability' indices for 55 countries, including New Zealand. New Zealand's Reserve Bank scored 0.74 for independence, slightly higher than the sample mean of 0.69. The study did not provide New Zealand's scores for the individual dimensions of independence.

Table 1
Reserve Bank financial system functions, objectives and powers

Function	Objective(s)	Powers
Registration, regulation & prudential supervision of banks • Registration • Regulating activity (changes to conditions of registration) • Supervising banks (including investigations) • Crisis management	• "promoting the maintenance of a sound & efficient financial system"; or • "avoiding significant damage to the financial system that could result from the failure of a registered bank"	Part 5, RBNZ Act 1989
Macro-prudential policy • Develop framework (including specific tools) • Apply instruments to registered banks when necessary	• "promoting the maintenance of a sound & efficient financial system" [statutory purpose under the 1989 Act] • "Increase resilience of financial system and counter instability arising from credit, asset price or liquidity shocks" (MoU between RBNZ & Minister of Finance, May 2013)	Part 5, RBNZ Act 1989
Licensing, regulation & prudential supervision of insurers • Licensing • Regulating activity (including solvency requirements) • Supervising insurers (including investigations) • Crisis management	• "promote the maintenance of a sound & efficient insurance sector; and" • "promote public confidence in the insurance sector"	Parts 2-5, Insurance (Prudential Supervision) Act 2010
Act as the prudential regulator and licensing authority for non-bank deposit-takers • Licensing • Imposing regulations (via Orders-in-Council) • Monitoring & enforcement	• "promoting the maintenance of a sound & efficient financial system; and" • "avoiding significant damage to the financial system that could result from a failure of an NBDT"	Parts 2-4, NBDT Act 2013

(continued on p.16)

(continued from p.15)

Function	Objective(s)	Powers
Supervising banks, life insurers and NBDTs with respect to obligations under anti-money laundering & counter terrorist financing Act • Monitor & assess level of risk • Monitor reporting entities for compliance with Act • Provide guidance to entities to assist compliance • Investigate & enforce compliance • Cooperate with domestic & international counterparts to ensure consistent, effective & efficient implementation of Act	• "to detect & deter money laundering & financing of terrorism; and" • "to maintain & enhance NZ's international reputation by adopting, where appropriate in the NZ context, recommendations issued by the Financial Action Task Force; and" • "to contribute to public confidence in the financial system"	Parts 2-4, Anti-money Laundering & Countering Financing of Terrorism Act 2009
Dealing in foreign exchange	• To fulfil any obligations under the 1989 Act (e.g. promoting the maintenance of a sound & efficient financial system)	Sections 16, 39 RBNZ Act 1989
Acting as lender of last resort for the financial system	• "maintaining the soundness of the financial system"	Section 31 RBNZ Act 1989
Provision of settlement account services for financial institutions	• No explicit objective; subject to terms & conditions determined by agreement	Sections 32, 39 RBNZ Act 1989
Oversight of payment systems • monitoring	• "promoting the maintenance of a sound & efficient financial system"	Part 5B, RBNZ Act 1989
Designation of settlement systems • providing finality of settlement & netting arrangements for those settlement systems that opt-in.	• "promoting the maintenance of a sound & efficient financial system; and" • "avoiding significant damage to the financial system that could result from the failure of a participant in a settlement system"	Part 5C, RBNZ Act 1989
Monetary policy	• "have regard to the efficiency & soundness of the financial system"	Parts 1 and 2, RBNZ Act

Table 2
Independence criteria and Reserve Bank's financial system-related powers

Criteria	New Zealand context
Institutional independence	
Agency has a legal basis (in law etc.)	Yes
The law states that the institution is independent	No
Appointment of senior personnel by executive & legislative branches of government	No (only executive has role)
The decision making body a board (not a single person)	No
All agency staff have legal immunity for actions done in good faith	Yes
No parliamentarians sitting on policy boards (committees)	Yes
Law/Act does not give Minister of Finance right to intervene in policy decisions made by agency	Yes
Law defines clear criteria for dismissal of head of agency	Yes
Regulatory independence	
The agency can autonomously issue legally binding prudential regulations for the sector	Varies by sector
Supervisory independence	
Agency has sole right to issue licences	Yes
Agency the sole right to withdraw licences	Varies by sector
Agency has sole right to impose sanctions on a supervised institution	No (but depends what is meant by 'sanctions')
Agency has right to enforce supervisory sanctions	Yes
Budgetary independence	
Agency funded via fees from supervised entities	No
Agency need not submit budget to government for prior approval	No
Autonomy in defining salaries and salary structure of staff	Yes
Autonomously hire staff	Yes
Autonomously define internal, organisational structure	Yes

Source: Masciandro, Quintyn and Taylor (2008), RBNZ.

and designed to carry out public functions at arm's length from the Crown, albeit at varying degrees.[16] Crown entities include other financial regulators such as the FMA and Commerce Commission, and other entities such as the Accident Compensation Corporation (ACC), Public Trust and the NZ Superannuation Fund.

Institutional independence is buttressed by legal immunity provided to staff acting in good faith. Moreover, the Minister of Finance does not have the power to directly override financial policy settings other than through changes in primary legislation. However, section 68B of the RBNZ Act 1989 gives the Minister the power to direct the Reserve Bank to 'have regard' to government policy and hence provides a channel to explicitly influence policy (as does the *Statement of Intent* process where the Reserve Bank must say how it has taken into account any of the Minister's comments).[17] The *SoI* process is based on equivalent provisions for Crown Entities.

The Act is clear about the appointment and dismissal of senior personnel and this also helps underpin institutional independence. Section 49 allows for the dismissal of the Governor (the sole decision-maker) if the Reserve Bank is not adequately carrying out any of its functions, or if the Governor is not adequately carrying out the responsibilities of office. There are no specific financial system-related performance criteria against which the Governor can be dismissed, unlike in the case of monetary policy (failure to achieve the price stability objective as laid out in the *Policy Targets Agreement*).

16 There are three classes of Crown entities: independent Crown entities, autonomous Crown entities and Crown agents. These classes differ with respect to the mechanisms of board member appointment and the extent to which they are subject to government direction. Note for the FMA and Commerce Commission, both independent Crown entities, there is no power of government direction (either to 'have regard to' or to 'give effect to').

17 The Minister's section 68B power has not been used to-date. There are equivalent provisions in insurance legislation (section 13, IPSA 2010) and for non-bank deposit-takers (section 9, NBDT Act 2013).

The Reserve Bank's current single decision-maker model was established to support institutional independence and clear lines of accountability. Multi-member decision making bodies may act to temper any tendency towards inconsistency or unpredictability; and on the other hand, to provide a somewhat more formal counter-weight against ministerial or government interference. It is likely easier for government to influence and/or dismiss a single person, as opposed to a body that potentially includes both 'insiders' and 'externals'.

In practice, major regulatory and supervisory decisions at the Reserve Bank are undertaken by an informal Governing Committee (thereby proxying some of the general benefits of collective decision making in terms of fostering a diversity of views). There are also reputational risks both to the Governor as the single decision-maker, and the Reserve Bank, if these decisions are seen to have been unduly influenced by the political process.

Regulatory independence: The Reserve Bank has considerable policy discretion to set rules and develop policy, although these must be exercised consistent with the purposes laid out in the various Acts listed in table 1. The powers do vary by sector.

Under the RBNZ Act 1989 the setting of prudential rules for banks is mainly through setting conditions of registration. Conditions may be set in relation to any of the matters referred to in sections 73, 73A and 78 of the Act. Although disclosure rules for banks are set by Orders-in-Council (OiC), which are made 'on the advice of the Minister in accordance with a recommendation of the Reserve Bank' – in practice the Minister tends not to depart from the Bank's recommendation. The OiC process is slower and less flexible than the process for changing conditions of registration, in part because it involves Cabinet consideration of the proposed OiC.

In the area of macro-prudential policy, intervention with respect to the banking system is derived from existing powers under Part 5 of the Act. The Reserve Bank's scope to use its powers for macro-prudential policy is limited by the terms of a 2013 Memorandum of Understanding with the Minister of Finance. This was a mutually agreed constraint on macro-prudential policy, recognising the political sensitivity of such policy and aiming to help build legitimacy for the new policy framework. Additional tools require the agreement of the Minister, as does extending the framework to non-banks.

Under the statutory framework for the insurance sector the Reserve Bank can issue solvency standards. The Reserve Bank may also issue fit and proper person standards that set out the matters to take into account when considering the appropriate characteristics of an insurer's directors and relevant officers (including the appointed actuary). Standards are issued by notice signed by the Governor and are presented to Parliament. A solvency standard is a form of subordinate legislation and therefore subject to a number of procedures, such as review by Parliament. The Reserve Bank may also impose conditions of licence on insurers in a similar, but more constrained, way as for banks.

For NBDTs, capital rules are set by regulations made by the Governor-General on the advice of the Minister (and drafted by the Parliamentary Counsel Office), and must be approved by Cabinet. Advice of the Minister of Finance to the Governor-General must be given in accordance with the recommendations from the Reserve Bank.

The Reserve Bank has no direct role in developing rules associated with AMLCFT.

One important gap in the Reserve Bank's set of financial system responsibilities vis-à-vis the objectives it has been tasked, is the absence of a robust – by international standards – regulatory framework governing financial market infrastructure (payment systems, securities settlement systems, central counterparties and trade repositories). Cabinet has recently agreed to a set of proposals designed to address this gap, including more powers to oversee 'systemically important' FMIs.

There are avenues for the Minister to influence the development of regulatory policy. Changes to legislation are obvious examples, as the Minister has to be content to take proposed changes to Cabinet and introduce them to Parliament. Standards and regulations can be disallowed by Parliament, and regulations made by OiC will need Cabinet approval. Section 68B powers (and the insurance and NBDT equivalents) have already been noted. In addition, the Minister sends an annual letter of expectation which includes comments on regulation and financial system issues more generally. The Reserve Bank also consults with the Minister's Office during the formation of regulatory policy that does not involve any legislative changes or OiCs. It is through this practice that the Minister's (and hence the Government's) views can potentially inform the content of prudential rules.

<u>Supervisory independence:</u> The Reserve Bank has considerable operational autonomy in the formulation and application of registration and licence conditions. The Minister has no formal role in licensing or registering entities, setting conditions of licensing/registration, granting exemptions to certain classes or individual entities, or selecting the choices of how to deal with a weak or non-compliant regulated entity (except as discussed below in relation to crisis management). In practice, however, the Reserve Bank keeps the Minister and Treasury apprised of developments about entities with particular issues which may eventually lead to government guarantees or public funds used to rescue a financial institution in trouble. The Minister's *Letter of Expectations* also states that the Minister expects to be informed as soon as practicable if the Reserve

Bank considers that any significant regulated institution faces a material risk of financial difficulty, or where there is a material likelihood of a recommendation that the Minister exercise any powers.

In terms of 'sanctions' the Reserve Bank can autonomously use prudential tools to impose requirements designed to affect the behaviour of an individual regulated entity. More generally, the Reserve Bank uses moral suasion through public warnings as a soft sanctioning mechanism. However, sanctions in the form of fines or prison sentences must be sought from the courts. There are also some sanctions in relation to a failing entity that require the consent of the Minister of Finance.

The management and resolution of a distressed bank is an important exception in relation to the autonomy of the Reserve Bank vis-à-vis registered banks, where some of these powers can be exercised only with the consent of the Minister of Finance. For example:

- The registration of a bank can be cancelled only by the Reserve Bank on the direction of the Minister following a recommendation from the Reserve Bank. Note, the Minister is not involved in the cancellation of an insurer or NBDT licence.

- The Minister must consent to a Reserve Bank direction in response to potential insolvency or any other serious circumstances related to a bank (this does not apply to directions under IPSA 2010 or the NBDT Act 2013).

- Statutory management under the RBNZ Act and IPSA 2010 is effected via an OiC on the advice of the Minister to the Governor-General, in accordance with the recommendation of the Reserve Bank.

- Various options under statutory management are also effected by an OiC or the consent of the Minister.

Budgetary independence: The Reserve Bank receives no direct funding through the central government budgetary process. Rather, the Reserve Bank's income comes from the return on its investments, funded by the issue of currency, deposits (held by banks and the Crown) and equity (held by Government).

A five-year funding agreement is agreed between the Governor and the Minister of Finance. This sets out the expectations of the level of operating expenses, and certain items of income, within which the Reserve Bank is expected to manage its operations. The parties may vary the provisions of the agreement or terminate an agreement (section 159). The span of the agreement allows scope for some degree of budgetary independence. The Reserve Bank has autonomy in structuring the organisation as it sees fit, hiring staff, and defining the salary structure (albeit within the confines of the five-year budget). The ability to vary the agreement within a given 5-year window allows some flexibility in funding arrangements if the Reserve Bank's functions or circumstances were to change over this time.

The Reserve Bank is not funded to any significant extent via fees from regulated entities.[18]

18 One-off fees are charged in the application process related to bank registration (with differences for local incorporation and branches), in the process for designation of settlement systems, and for covered bond registration. IPSA also allows for fees to be prescribed for a number of tasks such as licensing, transfer approvals and voluntary liquidation.

4 Accountability

4.1 Accountability – an overview

Section 2 introduced the concept of accountability and its relationship to independence. Accountability, in a general sense, can be thought of as a “relation between an actor and a forum, in which the actor has an obligation to explain and justify his or her conduct, the forum can pose questions and pass judgement, and the actor may face consequences” (Mark Bovens quoted in Conzelmann *et al* 2010, p. 2).

However, accountability is not synonymous with ‘control’. Indeed control implies that delegation is half-hearted or incomplete and can undermine the effectiveness of the agency in achieving the objectives set out in legislation. Furthermore, control arrangements undermine the credibility of independence arrangements and can make some genuine accountability arrangements less relevant (Quintyn, Ramirez and Taylor 2007, p. 5). Nevertheless, accountability is established through a variety of mechanisms in such a way that “no one controls the independent agency, yet the agency is under control” (Hupkes, Quintyn and Taylor 2005, p. 5). Designed appropriately, accountability serves a number of roles:

- The classic function of accountability is to provide *public oversight*, where the ultimate responsibility for the consequences for delegation rests with the principals (the legislature or executive). The allocation of powers to the agency is limited to those necessary for it to achieve its objectives. And in democratic societies it is an unquestioned tenet that unelected public officials are answerable to those that are directly accountable to the electorate. Accountability is an integral part of what constitutes good governance within public sector organisations.

- *Maintaining and enhancing legitimacy*: accountability permits an agency to explain its mandate to the broader public, provide a public forum in which different stakeholders can make views about policies, and helps transform this public understanding into reputation. Accountability therefore generates legitimacy and legitimacy in turn supports independence.

- *Improving performance:* seen from the standpoint of the agency, well designed accountability arrangements can promote good performance by providing a focus for the organisation, while helping to ensure that powers are applied consistently (i.e. are predictable) and proportionately.

Good accountability arrangements start with a clear legal basis with powers and functions conferred by Parliament. This outlines the mandate of the agency and the limits of its powers, as well as a basis for its expected performance. The agency should also have a clear purpose, with this integral to measuring performance. Generally speaking, legislative frameworks that minimise the number of objectives and possible trade-offs are preferable, or frameworks that provide a clear hierarchy of objectives. Both help support consistent and predictable decision making (Productivity Commission 2014, p. 184). Regulatory regimes with clear objectives are also more likely to enjoy high levels of compliance and credibility.

Table 3
Accountability criteria for financial sector regulation and the Reserve Bank

Criteria	New Zealand context
Mandate	
Agency's mandate defined in enabling legislation	Yes
Accountability to the legislative branch	
Obligation in law to present annual report to legislative branch	Yes (but via Minister of Finance)
Law provides possibility of regular hearings before committees	No (but occurs by Parliamentary convention)
Accountability to legislature isn't delegated to Minister of Finance	No
Accountability to executive branch	
Obligation in law to present annual report to executive branch	Yes
Law provides for possibility of regular briefings with Minister of Finance	Yes
Law provides for ad hoc hearings	Yes
Accountability to judicial branch	
Supervised entities have right to appeal supervisory decisions to courts	No
Distinct judicial processes are in place to handle these appeals	No
Appeals are handled by specialised judges	No
Law provides for penalties for faulty supervision	No
Budgetary accountability	
Process whereby agency presents and discusses its budget *ex post*	Yes
Transparency	
Practice of disclosure of supervisory policies and decisions (website)	Yes
Agency has issued a mission statement	Yes
Annual report is available to general public	Yes
Possibility of general inquiries by general public (email, ombudsman)	Yes
Law provides for a consumer consultation board in framework of regulation and supervision	No
Other	
Law requires a formal *ex ante* consultation process with industry about new regulations	Yes
Law requires a formal consultation process with public at large about new regulations	Yes (but only in relation to changes in disclosure requirements)
Agency has internal audit in place	Yes
Agency has an external audit in place	Yes

Source: Masciandro, Quintyn and Taylor (2008), RBNZ.

The relationship between the executive, legislative and judicial branches of government must be defined. This includes matters on which the agency must inform or consult the Minister or seek approval; the procedures by which the legislative holds the agency to account; and the ways the exercise of powers can be subject to judicial review in order to maintain the rule of law. Moreover, decision making must be transparent to the extent permitted by confidentiality.

But ensuring accountability is not straightforward. Actors operate in an environment with multiple stakeholders (the 'forum' can be wide), while the contract between any specific principal and the agent is often difficult to specify given multiple and possibly conflicting objectives, and where these objectives may be non-measurable (see a comparison between the Reserve Bank's financial system-related functions and monetary policy in section 4.3). As Quintyn (2009) observes, as a general rule, "the less specific and measureable the mandate, the more elaborate accountability arrangements should be" (p. 283).

4.2 Accountability arrangements at the Reserve Bank

Table 3 summarises the various facets of accountability in the New Zealand context drawing from the framework developed by the IMF.[19]

Mandate: the various objectives tied to the Reserve Bank's financial sector functions are stated in the RBNZ Act 1989 and other enabling legislation. However, these objectives are fairly broad, allowing considerable discretion as to their pursuit. On their own, they provide an insufficient basis for holding the Reserve Bank to account.

19 Masciandaro, Quintyn and Taylor's 2008 study scored the Reserve Bank 0.71 against a sample mean of 0.51. Again, there was no breakdown of New Zealand's score against the various dimensions of accountability.

Accountability to the legislature: reporting requirements to Parliament are indirect, and come via more direct and formal accountability requirements to the executive (see below).

The Reserve Bank's *Statement of Intent* and *Annual Report* are tabled in Parliament, while the *Annual Report* and *Financial Stability Report* (*FSR*) are scrutinised by Parliament's Finance and Expenditure Committee (FEC). While there is no statutory requirement for FEC oversight in the RBNZ Act, the *FSR* must be presented to Parliament by the Minister, and Parliamentary convention (backed by standing orders) has established select committee review as a regular facet of accountability to the legislature.

Certain instruments issued by the Reserve Bank are referable to Parliament's Regulations Review Select Committee, notably solvency standards under IPSA, exemptions under the NBDT Act and OiCs made under section 81 of the RBNZ Act.

Accountability to the executive: the Minister of Finance is the primary principal to whom the Reserve Bank must give account. The Minister is also accountable to Parliament. The Minister may remove a Governor who is not adequately carrying out the Reserve Bank's functions or not discharging their duties adequately (section 49).

In 2008 an Amendment Act was introduced that contained a number of changes designed to improve the executive's oversight of Reserve Bank activities, both in general, and with respect to the Reserve Bank's financial system-related functions:

- Section 68B was introduced to provide a formal vehicle for the Minister to direct the Reserve Bank to have regard to government policy in the specific performance of any of the Reserve Bank's financial stability functions.

- The Minister can now formally request policy advice from the Reserve Bank on any matters connected with its functions (section 33).

- The Reserve Bank began publishing its *Financial Stability Report* (*FSR*) in 2004, and from 2008 this document assumed an accountability role with the Reserve Bank being required to deliver this to the Minister (who must then subsequently present it to Parliament (section 165A)). The *FSR* must contain the information necessary to allow an assessment to be made of the Reserve Bank's activities undertaken to achieve financial system outcomes. The Reserve Bank must also publish the *FSR* on its website, thereby enhancing transparency to the public at large.

- The Reserve Bank must carry out *regulatory impact assessments* of the policies implemented under its legislation before adoption, and at intervals afterwards (section 162AB), and give reports of these assessments to the Minister (except on policy that is of a minor or technical nature). The Minister may also specifically request a regulatory impact assessment report from the Reserve Bank at any time.

- The Reserve Bank must engage with the Minister and their views during the course of drafting of a *Statement of Intent* (*SoI*). The focus of the *SoI* has also been rebalanced to include all of the key operational areas of the Reserve Bank and to detail the specific impacts, outcomes or objectives the Reserve Bank seeks to achieve.

Under the 1989 Act, a key part of the executive monitoring function is undertaken by a board of directors (comprising between five and seven non-executive members, and the Governor). The board is the Minister's monitoring agent. The board reviews the performance of the Governor and can recommend to the Minister the Governor's dismissal (section 53(3)). The 2008 changes rebalanced the board's monitoring to include an explicit assessment of the Reserve Bank's functions tied to financial system soundness and efficiency (section 53(1)(a)(ii)).

In addition to formal statutory accountability requirements, there are several more informal non-statutory channels. The Reserve Bank has embedded a process of sharing consultation papers with the Minister at least two weeks ahead of planned release. This also includes sharing these papers with Treasury who may offer the Minister a second opinion. This gives the Minister an opportunity to better understand (and potentially inform the development of) new policy. The MoU on macro-prudential policy, signed in 2013, requires consultation with both the Minister and Treasury prior to any decisions being taken. The Reserve Bank also endeavours to keep the Minister regularly informed of the assessment of financial system risks and vulnerabilities, and highlight at an early stage any macro-prudential options being considered. The Reserve Bank also engages regularly with the Treasury in this regard, so it is well-positioned to give advice to the Minister.

<u>Judicial accountability:</u> Judicial accountability refers to the ability of regulated entities to appeal supervisory decisions. Under the RBNZ Act 1989 there is no specific access to *judicial appeals* for regulated entities, which would involve the courts scrutinising the merits and correctness of regulatory and supervisory decisions (i.e. passing judgement on the correctness of the decision itself). There is, however, access to *judicial reviews* which involve the courts scrutinising the process and legality of decision making. Typically the access to reviews is a sufficient marker of

good judicial accountability, since good decisions typically flow from good processes. Moreover, conducting merits reviews of technical prudential requirements may be challenging for a non-specialist judicial system.

Budgetary accountability: the board regularly reviews the Reserve Bank's financial performance via an audit committee. In addition, there is *ex post* legislative scrutiny of the Reserve Bank's financial accounts via FEC's role in reviewing the *Annual Report*.

Transparency: being open and transparent about regulatory policies is an important part of accountability to a wider set of stakeholders, including regulated entities and the public at large. As noted above, the Reserve Bank must publish every regulatory impact statement, while the *Annual Report*, *FSR* and *SoI* are published on the Reserve Bank's website. Section 75 of the 1989 Act also requires the Reserve Bank to publish a statement of prudential principles that outlines how it determines applications with respect to bank registration, and how conditions of registration are imposed, varied, or removed. There is a similar requirement under IPSA 2010 (section 54).

The Reserve Bank, as a matter of good practice, has recently begun publishing individual submissions related to the development of new regulatory policy (complementing the longer-standing publication of a summary of submissions). One outcome of the Reserve Bank's recent 'regulatory stocktake' is a commitment to more regular communication of regulatory policy (via increased use of policy workshops and forums, newsletters and more regular updates on the Reserve Bank's website). The Reserve Bank has also published a *Statement of policy-making approach*, consistent with the New Zealand Treasury's 'best practice regulation' guidance.

Publication of large numbers of on-the-record speeches, *Bulletin* articles and Analytical Notes provides another avenue to enhance transparency and communicate with a range of stakeholders across the financial sector.

The Reserve Bank also responds to routine information requests from the public and often makes information from Official Information Act (OIA) requests publicly available. Prudential information pertaining to individual financial institutions is excluded from the OIA.

Other accountability mechanisms: these include requirements to consult with stakeholders on the development of new policy. The Reserve Bank is legally required to consult with banks on any changes in its conditions of registration (and allow seven days to make submissions), and the same applies to an insurer's condition of licence. In practice the Reserve Bank has now committed (following its regulatory stocktake) to a standard 6-10 week consultation period, while always reserving the right to a shorter period if the changes being consulted on are urgent.

4.3 The financial stability and monetary policy 'contract' compared

It is useful to compare and contrast the Reserve Bank's financial system-related functions, powers and objectives to that of monetary policy (table 4). This will illustrate the potentially greater challenge in specifying a contract amenable to robust accountability arrangements in the financial policy sphere.

In terms of parallels between monetary policy and the Reserve Bank's financial system-related functions, the complexity and level of technical expertise required are broadly similar and provide one argument, among a number of others, for these functions to rest with an agency

Table 4
Reserve Bank financial sector policy and monetary policy compared

	Financial sector policy	Monetary policy
Statutory objective(s)	Multiple • "promoting the maintenance of a sound & efficient financial system" (s1, s68(a), s156B, 156K, s3(a) NBDT Act); • "maintaining soundness of the financial system (lender of last resort role, s31); • "avoiding significant damage to the financial system that could result from the failure of a registered bank" (s68(b)); • "avoiding significant damage to the financial system from failure of participant in settlement system" (s156K); • "avoiding significant damage to the financial system that could result from a failure of an NBDT" (s3(b), NBDT Act); • "promote the maintenance of a sound & efficient insurance sector" (s3(1)(a), IPSA 2010); • "promoting public confidence in the insurance sector" (s3(1)(b), IPSA 2010); • ensuring compliance with obligations of banks, NBDTs and insurers to deter and detect money laundering and terrorist; financing (s3(1), AML/CFT Act 2009) • Have regard to impact on financial stability in Australia (s68A).	Single • "promote stability in the general level of prices, while recognising the Crown's right to determine economic policy" (s1); • Have regard to the efficiency & soundness of financial system (s10).

(continued on p.27)

(continued from p.26)

	Financial sector policy	**Monetary policy**
Are objectives clear & amenable to quantification?	No • ‘Soundness’, ‘efficiency’, ‘significant damage’ subject to interpretation; • Potential conflict between objectives (e.g. soundness & efficiency); • Not possible to quantify goals/objectives; • *SoI*, speeches, *Bulletin* articles can help provide some clarity on statutory objectives; • MoU on macro-prudential policy defines specific objectives with respect to broader financial system goals and existing powers (also must consider interaction with monetary policy settings).	Yes • Defined outside Act in PTA; • Subject to constraints: have regard to efficiency & soundness of financial system, and avoiding unnecessary volatility in output, interest rates & exchange rate.
Powers to achieve objectives	Act(s) set out specific powers. • Defining range and limits of particular actions.	Very general powers • PTA sets out specific policy framework.
Scope of autonomy	• Some goal independence given general nature of statutory objectives; • Operational independence except for: some crisis management powers and changes in bank disclosure; and changes in prudential requirements for NBDTs; • No government override ability (but must have regard to any direction issued by Minister of Finance, s68B).	• No goal independence (although PTA set jointly between Minister of Finance & Governor); • Operational independence; • Government override ability (s12).

(continued on p.28)

(continued from p.27)

	Financial sector policy	**Monetary policy**
Governance arrangements	Single decision maker (Governor) supported by a non-statutory Governing Committee • Monitoring by oversight board (explicit since 2008).	Single decision maker (Governor) supported by a non-statutory Governing Committee • Monitoring by oversight board since 1989.
Decision making process	Ad hoc, as required • Supported by multiple analytical committees (ALCO, FSO, MFC) with no formal external involvement; • But external views on development of new policy sought through consultation with industry, public & Minister of Finance.	Prescribed frequency (*MPS* & OCR reviews) • Single supporting committee (MPC) with formal external involvement.
Removal of Governor	General criteria • "Bank not adequately carrying out its functions" (s49(2)(a)); • "Governor has not adequately discharged responsibilities of office" (s49(2)(b)).	Specific criteria (in addition to general criteria) • Inadequate performance in achieving policy targets agreement (s49(d)).

at arm's length from the executive. Other arguments include the classic 'time-inconsistency problem' and the desire to free both functions from being subject to the electoral cycle. There is also need for transparency of policy-making across both spheres, together with the need for appropriate accountability arrangements to enable an assessment of performance against the statutory objectives.

Specifically, in terms of objectives, the current policy-maker consensus is that the monetary policy function should be directed at a single objective – price stability – subject to taking into account various other considerations. A quantitative goal for price stability is specified in the Policy Targets Agreement (PTA).

By contrast financial system-related goals are multifaceted, not amenable to quantification and can be open to differing interpretation (although this is not unique to financial system goals, where many regulatory outcomes are hard to quantify). For these reasons the BIS (2009) argues that extra-statutory statements of objectives are an important means of clarifying broad statutory objectives, including ways of managing any trade-offs that might exist. In New Zealand, as elsewhere, there is no PTA-like document that provides a legally defined clarification and agreement (between the Governor and the Minister) of how general purposes such as 'promoting the maintenance of a sound and efficient financial system' or avoiding 'significant damage' should be interpreted, or translated into more specific objectives.

That said, the Reserve Bank has clarified over time through speeches and *Bulletin* articles on what soundness and efficiency means in practice, and given some guidance to the public on how the Reserve Bank thinks about the relationship between the two (see Bloor and Hunt 2011).

There are several other differences between monetary policy and the Reserve Bank's financial system functions and objectives that are worth noting:

- Specific powers. With financial sector functions, the Reserve Bank has broad regulatory (rule-making) power which does not arise in the monetary policy context. Robust accountability demands that these powers be specified in as much detail as possible (albeit without hindering the flexibility of the regulator to react to changing circumstances). By contrast the Act is largely silent on the specific powers the Reserve Bank has to implement monetary policy, implying wide 'instrument independence' to achieve the objectives laid out in the Act and PTA. This relates in part to the fact that monetary policy does not typically have the same impact on property rights as prudential policy.

- Arguably, there is more of a tension between transparency and confidentiality in financial policy. In the case of monetary policy, the commercial sensitivity around OCR decisions dissipates after the announcement. By contrast, the Reserve Bank must balance the commercial interests of regulated entities, against the benefits of supporting 'market discipline' by publishing institution-specific information. That said, the Reserve Bank must act and be seen to act in a non-arbitrary manner in the way it implements and enforces its supervisory powers. Therefore transparency is also integral to financial system-related accountability. Legitimacy is further enhanced through the consultation process tied to the development of new policies and the imposition of regulatory measures on regulated entities.

- There is no sanctioning and enforcement counterpart in monetary policy. The performance of these financial stability functions implies a need for transparency and accountability arrangements to ensure this set of powers is exercised appropriately and consistently across individual institutions in a way that protects the rights of citizens and does not unduly interfere with freedom of contract.

- The effect of policy action in the financial system sphere may be more difficult to gauge in normal times vis-à-vis the attainment of the broad statutory purposes (where outcomes may be observable only with a considerable delay and subject to a variety of narratives). For example, the absence of financial crises over time does not necessarily signal policy success, as financial imbalances can build up over a long period of time. By contrast, there is a somewhat clearer link between the Reserve Bank's monetary policy instrument, the OCR, and observed inflation outcomes (notwithstanding the impact on inflation of factors outside the Reserve Bank's control).

Given the differences between monetary policy and financial policy outlined above, the BIS (2011) argues that financial sector accountability mechanisms should be focussed more on the <u>decision making process</u> rather than <u>outcomes</u> per se. This is because of the more intrusive nature of financial sector policy, and the issues associated with observing outcomes (lack of quantification and very long lags). Put another way, there should be less reliance on *ex post* accountability mechanisms and more obligations placed on ensuring decision-makers are transparent about the basis for their actions.

5 Conclusion

This article has reviewed some of the arguments for delegating the financial system's prudential regulatory functions to an independent agency. These arguments largely overlap with those that lend credence to the operational autonomy of monetary authorities and the desire to achieve low and stable inflation outcomes. Both policy spheres are potentially subject to politicisation and the 'time inconsistency' problem where the executive understands the long-term benefits to society from price stability and financial stability, but may not always act in ways over the short-term that ensures the realisation of these objectives. In addition, both areas are technical in nature, where the benefits of expert judgement are best achieved through the independent pursuit of politically specified objectives.

The delegation of various financial system tasks to an autonomous body therefore reflects a form of pre-commitment on the part of government to the long-run goal of a sound and efficient financial system. In the financial policy sphere the construction of robust accountability arrangements is not straightforward given, in particular, the difficulties of quantification; and this warrants ongoing development and innovation.

References

Aldridge, T and A Wood (2014) ‘Monetary policy decision making and accountability structures: some cross-country comparisons’, Reserve Bank of New Zealand *Bulletin*, 77(1), pp. 15-30.

Australian Government (2015) *Improving Australia’s financial system: Government response to the Financial System Inquiry*, October.

— (2014) *The Financial System Inquiry: final report*, November.

Bascand, G (2015) ‘Central bank performance, financial management and institutional design, speech delivered to the *National Asset-Liability Management Europe Conference*, London, 12 March.

BIS (2011) *Central bank governance and financial stability*, a report by a study group, May.

— (2009) *Issues in the governance of central banks*, a report from the Central Bank Governance Group, May.

Black, J and S Jacobzone (2009) ‘Tools for regulatory quality and financial sector regulation: a cross-country perspective’, OECD *Working Papers on Public Governance*, No. 16.

Bloor, C and C Hunt (2011) ‘Understanding financial system efficiency in New Zealand’, Reserve Bank of New Zealand *Bulletin,* 74(2), pp. 26-38.

Conzelmann, T *et al* (2010) ‘Regulatory overhaul in the EU and the US following the crisis – what role for accountability?’, ECPR Standing Group on International Relations, Stockholm, 9-11 September.

Cukierman, A (2012) ‘Regulatory reforms and the independence of central banks and financial supervisors’, paper prepared for the 30th SUERE Colloquium, Zurich, 5-6 September.

Dalla Pellegrina, L, D Masciandaro and R Pansini (2013) ‘The central bank as prudential supervisor: does independence matter?’, *Journal of Financial Stability*, 9, pp. 415-427.

Dincer, N and B Eichengreen (2012) ‘The architecture and governance of financial, supervision: sources and implications’, *International Finance*, 15(3), pp. 309-325.

Doumpes, M, C Gaganis and F Pasiouras (2015) ‘Central bank independence, financial supervision structure and bank soundness: an empirical analysis around the crisis’, *Journal of Banking and Finance* (article in press).

Fischer, S (2015) ‘Central bank independence’, remarks at the 2015 Herbert Stein Memorial Lecture, Washington, DC, 4 November.

Ford, D, E Kendall and A Richardson (2015) ‘Evaluating monetary policy’, Reserve Bank of New Zealand *Bulletin*, 78(7), November.

FSB, IMF and BIS (2011) *Macroprudential policy tools and frameworks: progress report to G20*, 27 October.

Gadinis, S (2013a) ‘From independence to politics in financial regulation’, *California Law Review*, 101, pp. 327-406.

— (2013b) ‘The Financial Stability Board: the new politics of international financial regulation’, *Texas International Law Journal*, 48(2), pp. 157-176.

Goodhart, C (2000) ‘The organisational structure of banking supervision’, FSI *Occasional Papers*, BIS, November.

Graham, J and C Smith (2012) ‘A brief history of monetary policy objectives and independence in New Zealand’, Reserve Bank of New Zealand *Bulletin,* 75(1), pp. 28-37.

Guidi, M (2015) ‘The impact of independence on regulatory outcomes: the case of EU competition policy’, *Journal of Common Market Studies*, 53(6), pp. 1195-1213.

HM Treasury (2010) *A new approach to financial regulation: summary of consultation responses*, November.

Hunt, C (2017) ‘Outcomes of the 2016 New Zealand Financial Sector Assessment Programme (FSAP)’, Reserve Bank of New Zealand *Bulletin*, 80(6), July.

— (2016a) ‘The 2016 New Zealand Financial Sector Assessment Programme (FSAP)’, Reserve Bank of New Zealand *Bulletin*, 79(7), April.

— (2016b) ‘A short history of prudential regulation and supervision at the Reserve Bank’, Reserve Bank of New Zealand *Bulletin*, 79(14), August.

Hupkes, E, M Quintyn and M Taylor (2006) ‘Accountability arrangements for financial sector regulators’, IMF *Economic Issues*, 39.

— (2005) ‘The accountability of financial sector supervisors: principles and practice’, IMF *Working Paper*, WP/05/51, March.

IMF (2014) *Staff guidance note on macroprudential policy*, December.

— (2013a) *Implementing macroprudential policy: selected legal issues*, 17 June.

— (2013b) *Key aspects of macroprudential policy*, 10 June.

Kamber, G, O Karagedikli and C Smith (2015) ‘Applying an inflation targeting lens to macroprudential policy institutions’, *International Journal of Central Banking*, September.

Maggetti, M (2010) ‘Legitimacy and accountability of independent regulatory agencies: a critical review’, *Living Reviews in Democracy*, November.

Masciandaro, D, R Pansini and M Quintyn (2011) ‘The economic crisis: did financial supervision matter?’, IMF *Working Paper,* WP11/261, November.

Masciandaro, D, M Quintyn and M Taylor (2008) ‘Financial supervisory independence and accountability – exploring the determinants’, IMF *Working Paper*, WP/08/147, June.

Moran, M (2002) ‘Understanding the regulatory state’, *British Journal of Political Science*, 32, pp. 391-413.

New Zealand Productivity Commission (2014) *Regulatory institutions and practices*, June.

Nier, E (2009) ‘Financial stability frameworks and the role of the central banks: lessons from the crisis’, IMF *Working Paper*, WP/09/70, April.

Nier, E *et al* (2011) 'Institutional models for macroprudential policy', IMF *Staff Discussion Note*, SDN/11/18, November.

Quintyn, M (2009) 'Independent agencies: more than a cheap copy of independent central banks", *Constitutional Political Economy*, 20, pp. 267-295.

Quintyn, M, S Ramirez and M Taylor (2007) 'The fear of freedom: politicians and the independence and accountability of financial sector supervisors', IMF *Working Paper*, WP/07/25, February.

Quintyn, M and M Taylor (2004) 'Should financial regulators be independent?, IMF *Economic Issues*, No. 2, March.

Reserve Bank of New Zealand (2014) *Productivity Commission Inquiry into Regulatory Institutions and Practices: RBNZ response to draft*, 21 May.

Seelig, S and A Novoa (2009) 'Governance practices at financial regulatory and supervisory agencies', IMF *Working Paper*, WP/09/135.

Thatcher, M (2002) 'Regulation after delegation: independent regulatory agencies in Europe', *Journal of European Public Policy*, 9(6), pp. 954-972.

Trillas, F (2010) 'Independent regulators: theory, evidence and reform proposals', IESE *Working Paper*, WP-860, May.

Wood, A and M Reddell (2014) 'Documenting the goals of monetary policy: some cross-country comparisons', Reserve Bank of New Zealand *Bulletin*, 77(5), October.