

RESERVE BANK OF NEW ZEALAND ACT 1989

This article, prepared by Stephen Dawe, describes the main features of the recently enacted Reserve Bank of New Zealand Act 1989. It discusses the two major areas of reform contained in the legislation (monetary policy and prudential supervision) and outlines why the Act was needed. The Act came into force on 1 February 1990.

SUMMARY OF THE NEW LEGISLATION

The 1989 legislation implements changes consistent with Government's broader public sector reforms aimed at improving performance through clearer objectives and increased accountability. In particular, the principal purpose of the new Reserve Bank Act is to formally recognise price stability as the primary objective of monetary policy, to give a greater degree of autonomy to the Reserve Bank in its pursuit of that objective and to make the Bank more accountable for its actions. While price stability is set as the statutory objective for the Bank's monetary policy, the Government retains ultimate power, by Order in Council, to substitute alternative economic objectives.

The Act also more clearly sets out the Bank's other functions which are:

- registering and undertaking prudential supervision of banks (Part V);
- implementing Government exchange rate policy (sections 17 through 22);
- providing exchange rate policy advice (section 23);
- managing New Zealand's foreign reserves (section 24);
- issuing currency (sections 25-30);
- acting as lender of last resort for the financial system (section 31);
- operating as settlement bank for the financial system (section 32);
- providing financial sector policy advice (section 33);
- providing Government banking services (section 34); and
- operating a commercial registry (section 35).

In the area of prudential supervision, the Act limits the application of those provisions to registered banks only (compared to a less well defined group of 'specified institutions' under the previous Act), and extends the ability of the Bank to require New Zealand banks to comply with certain prudential guidelines. Additionally, the Act provides for a new financial disclosure and advertising regime for registered banks.

The Act also makes the Bank more accountable for its use of public funds. A five year funding agreement must be agreed for the Bank's expenditure. Under the old legislative arrangements there was no formal external restriction on the Reserve Bank's expenditure. Scrutiny of the Bank's performance is also increased by requirements to publish information about its monetary and prudential policies, to provide more detail in the Bank's Annual Report and Accounts and by opening the Bank's activities to regular scrutiny by a Parliamentary Select Committee.

AIMS OF REFORM

In the area of implementing monetary policy, the new legislation will not alter the current approach being adopted by the Reserve Bank. Rather, the new legislation formalises some of the essential elements of monetary policy as it has been practised since 1985, with the main change aimed at improving the transparency and consistency of monetary policy.

In particular, the new Act puts in place a statutory commitment to achieving price stability as well as providing an environment in which the right incentives exist for this to be accomplished.

Under the old legislation monetary policy could be aimed at a number of sometimes conflicting objectives. In addition, the Bank could be directed by the Minister of Finance to follow a particular policy without that directive being released publicly.

The old legislative framework therefore caused a number of problems. First, there was little chance that monetary policy would continue to be aimed at any single objective over the long term. The new Act is more likely to achieve policy consistency over time. Second, the old Act attempted to target monetary policy at statutory objectives over which monetary policy can have little or no long-term effect. In the medium term, monetary policy is generally regarded as the major determinant of inflation but it is not considered to have a significant sustainable effect on real sector variables such as output and employment, although it may have a short-term effect on such variables. In the longer term, therefore, the best that monetary policy can do is achieve price stability. This in turn will contribute to "... promoting the highest level of production and trade and full employment...", the ultimate economic objectives which were previously included as statutory objectives for monetary policy.

Thirdly, the new legislation provides for consistency between the aims of and the actions undertaken in implementing monetary policy. Under the old legislation, because Ministers could direct the Bank without the need for public disclosure, there was no public scrutiny as to the nature of the monetary policy being pursued by the Bank. In the past it was possible for the public to be told monetary policy was being directed at a certain objective when monetary policy was effectively being directed toward another. Such inconsistencies were not always obvious and only became apparent when, typically, inflation began trending up again. Under the new Act, the clearer division of responsibilities between the Minister and the Governor, and the greater requirements for public disclosure, will minimise the risk of such inconsistencies.

Fourthly, because there was no clear objective for monetary policy, and no requirement for the Bank to report on its implementation of monetary policy, there was little accountability for the Bank's implementation of monetary policy. This problem was exacerbated by statutory references to 'the Bank' (in which it was not clear whether it meant the body corporate, the Board of Directors, the Governor or the staff), which meant no individual could be called to account for the Bank's outputs. The new Act is aimed at clarifying this. The Governor is responsible for ensuring the Bank carries out its functions and the Board acts as the Minister's agent to monitor the Governor's and the Bank's performance.

These factors are considered to have contributed to past uncertainty about the commitment of the Bank and the Government to their stated path of achieving price stability. The new Act, by stating a statutory commitment to stabilising prices, is aimed at eliminating that uncertainty. Furthermore, the framework in the new legislation means any departure from price stability must be communicated openly to the public. It is hoped the new framework will raise confidence in the medium-term consistency of monetary policy and provide greater certainty for decision-makers. This should help lower the costs of correcting inflationary shocks and enhance the ongoing stability of prices, resulting in an improvement in economic performance.

Turning to prudential supervision, changes have been made to provisions which were inserted by the Reserve Bank of New Zealand Amendment Act 1986. The 1986 amendment allowed the introduction of new registered banks and introduced

a system of prudential supervision of registered banks and certain other financial institutions – collectively referred to as ‘specified institutions’. The objective of prudential supervision has always been to protect New Zealand’s financial system – not individual institutions. The changes made by the new Act are aimed at enhancing the Bank’s ability to fulfil this objective in the light of experience with the initial (1986) supervisory regime and the emergence of a more uniform approach internationally to banking supervision.

The Bank has always believed that the health of the financial system could best be protected by the provision of an open and competitive environment which encourages financial institutions to respond to the needs of savers and borrowers. The aim of prudential supervision is to assist in providing such an environment while at the same time reducing the potential for damage to the banking system and the wider economy that may arise from individual institutional failures. The need for a supervision policy arises because the banking industry has characteristics which are not seen in other industries. In particular, the banking system is highly interdependent and very reliant on public confidence. Furthermore, the banks operate New Zealand’s payments system and play a central role in the broader financial intermediation system. These factors together make the overall financial system vulnerable to individual bank failures. They also suggest that individual institutions are unlikely to take full account of the potential system-wide costs of risk-taking behaviour.

In 1986 there were only four banks in New Zealand. In order for the Reserve Bank to effectively supervise the financial system, prudential supervision had to be concerned with all major financial institutions whether they were banks or not. Since the 1986 legislation was introduced the base of the New Zealand banking sector has broadened. Most of the large non-bank financial institutions have become or are applying to become registered banks and registered banks now more clearly represent the substance of the New Zealand financial system.

Moreover, under the old Act the risk of contagion effects spreading from non-bank failures into the banking system may have been increased because of a misperception in some quarters that all supervised institutions were subject to similar ‘safety standards’. By defining the boundary more clearly, it is hoped the public’s understanding of the Bank’s supervisory role may be improved. Thus, any potential contagion effects on banks arising from the failure of non-banks should be minimised by the clearer distinction between banks and non-banks.

A further benefit of the new coverage is that prudential supervision will be voluntary in the sense that no institution has to become a bank. With the new prudential system requiring compliance to specific standards it was not considered appropriate to continue with compulsory supervision of selected non-banks. This provides a guard against the supervision regime becoming excessively onerous as the supervision net would start to shrink over time if the private costs of supervision began to outweigh the benefits of being registered.

The prudential provisions of the new Act are aimed at replacing the previous system of *monitoring* and *failure management* with a supervisory system that attempts to reduce the probability of major damage to the banking system by placing some limits on risk-taking by individual banks. Under the old Act the Reserve Bank could not lay down prudential standards for the four former trading banks or for supervised non-banks; the areas where standards could be set were narrow; and there was no ability to impose new prudential standards on banks once they had been registered. This ‘monitoring’ approach to supervision limited the Reserve Bank’s ability to control risks in the system, even when they were obvious. The intent with the new legislation is to develop a supervision policy that is clearly defined and well understood

by both the public and the financial sector.

A final difficulty with the previous monitoring approach was its inconsistency with the emerging international approach to supervision, as developed since 1986 by the authorities of the major financial powers – under the auspices of the Bank for International Settlements (BIS). New Zealand banks have clearly indicated a desire for the BIS framework to form the basis for bank registration in New Zealand. The new Act enables such a framework to be implemented.

Another catalyst for reform was the Bank's belief that the soundness of the financial system could be better enhanced by encouraging greater market scrutiny of banks. In particular, the Bank considered that balance sheet requirements under the new supervisory regime should be made fully consistent with requirements for financial disclosure and advertising by banks, previously contained in provisions of the Securities Act 1978. A high degree of market monitoring is conducive to sound investment decision-making by all participants in financial markets and should enhance the degree of market discipline on banks.

MAIN STATUTORY PROVISIONS

Monetary Policy

Consistent with the aim of greater policy transparency and better accountability of the main parties involved, sections 8 through to 15 of the new Reserve Bank Act set out in some detail the respective roles of the Government, the Bank and the Bank's Governor for the formulation and implementation of monetary policy.

Section 8 specifies the Bank's primary function. It reads:

8. Primary function of Bank – The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices.

The new provision is far more focused than in the old Act. It narrows the focus of monetary policy to one outcome – price stability. But what do the words mean?

There are three components to the objective: stability; the general level of prices; and achieving and maintaining.

In the context of prices, a pure application of 'stability' equates with zero inflation. However, because of mathematical and measurement biases in the construction of most price indices it is generally accepted that a low positive rate of measured price inflation is consistent with 'price stability'. The interpretation favoured by the Reserve Bank is 0 to 2 per cent growth per annum in consumer prices.

However, the use of the phrase 'the general level of prices', means that inflation in the Consumers Price Index (CPI) will not be the sole indicator of inflation performance. While the policy targets agreed between the Governor and the Minister have been specified in terms of the official CPI, a range of other indices will also be utilised to assess the underlying trend of prices in the economy.

The use of the words 'achieving and maintaining' implies two steps in getting to sustainable price stability. The first is reduce inflation to an acceptable level. This process has been taking place using the current monetary policy framework since 1985. Once inflation is at an acceptable level it should then be kept there. This is generally interpreted to mean that once inflation reaches zero to 2 per cent, monetary policy instruments should be targeted to keeping inflation within that band.

Sections 9 and 11 provide the mechanism, first, for specifying what outcomes the Government expects from the Bank's monetary policy and, secondly, for holding the Governor accountable for achieving these outcomes. Section 9 provides for the Minister and the Governor of the Bank to fix economic targets for the implementation of monetary policy. Zero to 2 per cent inflation by December 1992 has been set as the first policy target agreed between the Governor and the Minister of Finance on 2 March 1990. When determining the time period over which low inflation is to be achieved, a Minister will take into account the impact of monetary policy on other economic policy objectives. Each agreement will also set out the major assumptions underlying the policy targets. In particular, the agreement will describe the sort of shocks that could cause temporary deviations from the target inflation path. The contents of the policy target agreement must be recorded in writing; tabled at the Bank's board; published in the Gazette; and tabled in Parliament. These requirements are to provide an opportunity for public scrutiny and debate of the quantified inflation targets. The same requirements apply if, for any reason, the policy targets are subsequently altered. Section 11 holds the Governor accountable for ensuring the targets are achieved.

Section 10 places an obligation on the Bank to "have regard to the efficiency and soundness of the financial system" when formulating and implementing monetary policy. This implies the Bank should not adopt control mechanisms or manage monetary policy in such a way as to cause instability or inefficiency in financial markets. Furthermore, section 10 also places an explicit obligation on the Bank to try and influence other policy makers and individuals whose actions may have a bearing on the achievement and maintenance of price stability.

Section 12 is another significant section of the Act. It provides the legislative basis for the Government to continue to have ultimate control over monetary policy. It enables the Government, by Order in Council, to direct the Reserve Bank to implement monetary policy for an economic objective other than price stability for a period of up to twelve months. Any Order must be tabled in Parliament. Once an Order is made, new policy targets consistent with the Order, must be fixed for the period of the Order. If the Government wishes to direct monetary policy to another economic objective for a period longer than twelve months this can be achieved by subsequent Orders being made. The section therefore upholds the right of the Government to determine economic policy – but in an open and transparent manner.

Section 15 is crucial to holding the Bank and the Governor accountable for the outcome of monetary policy. The Governor is required, at least every six months, to produce a policy statement that reviews the monetary policy of the previous six months and outlines how monetary policy is to be implemented over the next six months consistent with the Bank's stated inflation objective. Compared to the policy target agreement, the policy statements will contain more detail in terms of the particular instruments the Bank intends using; and what the Bank considers to be appropriate or likely ranges for various economic indicators over the next six month period and beyond. Policy statements must be published; must be tabled in Parliament; and may be discussed by a Parliamentary Select Committee. These requirements are once again aimed at increasing public scrutiny of how the Reserve Bank conducts its monetary policy.

From the outline above it can be seen the major changes for monetary policy introduced by the new legislation are as follows:

- monetary policy is explicitly recognised as the primary function of the Reserve Bank;
- monetary policy must be targeted at the objective of maintaining a stable price level;

- the Government's specific inflation objectives are to be set out in a published policy targets agreement between the Governor of the Bank and the Minister of Finance;
- the Bank must publish its intentions with regard to the implementation of monetary policy in regular six-monthly statements;
- any move away from the published targets is subject to public scrutiny and debate;
- the Governor of the Reserve Bank is held accountable for the outcome of monetary policy.

Bank Registration/Prudential Supervision

Part V of the Act outlines the Bank's role in bank registration and prudential supervision.

The Act makes some modifications to the provisions in the old Act which were inserted by the Reserve Bank of New Zealand Amendment Act 1986. Although, under the new legislation, the Bank will still have a responsibility for maintaining the health of the financial system, there are some changes made to the 1986 regime. The first of these relates to the institutions covered by the Bank's prudential supervision. The second involves a shift in emphasis from the previous monitoring approach to a more pro-active approach to prudential supervision. Thirdly, the Act includes an empowering provision whereby registered bank activities can be largely removed from the application of the Securities Act 1978 and instead be covered by corresponding provisions in the Reserve Bank Act. Before discussing these changes in detail it is worth focusing on the policy of Reserve Bank prudential supervision as reflected in section 68 of the legislation. This section reads:

- 68. Exercise of Powers Under this Part** – The powers conferred on the Governor-General, the Minister, and the Bank, by this Part of this Act shall be exercised for the purposes of –
- (a) promoting the maintenance of a sound and efficient financial system; or
 - (b) avoiding significant damage to the financial system that could result from the failure of a registered bank.

The section says that prudential supervision is to be concerned with the general health and efficiency of the financial system. The provision does not suggest in any way that prudential supervision is to act as a system of deposit guarantees. While banks will be required to maintain certain minimum prudential standards, it remains an intention of the Act that banks' directors should retain the primary role in overseeing the management of their institutions, and that depositors must take responsibility for investing their funds prudently. To provide otherwise would lead to increased risk-taking and, ultimately, damage to the financial system as a result of the less vigilant approach to investment decisions that would result. The consumer protection benefits flowing from prudential supervision are more an indirect consequence of a system aimed at increasing the safety of the banking sector as a whole. As the Minister of Finance stated during the second reading of the legislation in Parliament, "depositors, creditors and shareholders should not come seeking redress from the Reserve Bank, or the Crown, if they suffer a loss because of the failure of a registered bank".

As mentioned, the first substantive change to prudential supervision relates to the institutions subject to it. Under the new legislation, prudential supervision is limited to registered banks only, after an initial transition period of 12 months during which all existing 'specified institutions' continue to be supervised. This change to the legislation does not, in practice, represent a major change from the previous situation. Most institutions previously supervised by the Bank will continue to be supervised under the new Act, as a result of a number of previous non-bank institutions

having become registered banks since 1987.

The change to this narrower focus for the coverage of prudential supervision tempts questions about why institutions should become registered banks and how the Reserve Bank will be able to protect the soundness of New Zealand's financial system in the event of the collapse of a large non-bank.

Under the approach reflected in the legislation, it is expected that the core of the New Zealand financial system will comprise registered banks for the following reasons:

- only registered banks can include the word 'bank' in their name, and be involved in relationships with the central bank and other banks, for example in connection with potential liquidity support arrangements (as outlined in the Reserve Bank's 1989 Annual Report);
- exemption from the Securities Act 1978 trust deed requirement; and
- a funding advantage based on the 20 per cent weighting of inter-bank exposures in the international capital adequacy framework (instead of 100 per cent for a bank's exposure to non-banks).

With the core of the financial system subject to the banking supervision arrangements, it is unlikely that the failure of a non-bank financial institution would threaten the stability of the overall financial system, particularly given the intention to introduce exposure limits on lending by registered banks to individual customers.

The second change to prudential supervision involves the specification of a clearer legislative structure for the Bank's supervisory role. Section 78 of the Act provides a statutory outline of the aspects of banks' prudential management which the Reserve Bank must address. These relate to capital, loan concentration, risk exposures, separation of business interests, internal controls and accounting systems and such other matters as may be prescribed by Order in Council. Failure to adhere to the standards laid down by the Bank in these areas is a ground for the Bank to recommend to the Minister of Finance that registration be cancelled. Also the Bank may give directions to a bank about how it must conduct its business if it is not complying with the standards required.

The third area of change concerns public disclosure of information by registered banks. Sections 81 to 92 of the Act put in place the legislative basis for a new financial disclosure and advertising regime to replace that contained in the Securities Act as it applies to banks. This step reflects a desire to be able to use disclosure as a mechanism to reinforce market disciplines, by facilitating greater scrutiny, by peers and analysts, of registered banks. Also, the Act makes provision for the introduction of a mandatory requirement that banks be rated by a rating agency. It is hoped that regulated disclosure, by reinforcing market disciplines, will allow the prudential standards to be set in a way which is not over-bearing on the normal profit maximising behaviours of banks. Disclosure requirements should provide banks with incentives to maintain additional comfort buffers above what would be viewed as minimum prudential standards.

OTHER FUNCTIONS

Foreign Exchange Issues

Sections 16 to 24 outline the respective powers of the Bank, the Governor and the Minister in the foreign exchange market.

The Act continues the Bank's role as an agent for the Crown's dealing in the foreign exchange market. It does not repeat the earlier statutory powers enabling the

implementation of exchange control nor does it provide for regulations to be made to authorise foreign exchange dealers.

However, sections 17 and 18 provide a statutory basis for future governments to implement alternative exchange rate systems. Section 17 enables the Bank to be directed to deal in foreign exchange within guidelines laid down by the Minister of Finance. Section 18 permits the Minister to fix the rate at which the Bank must buy and sell foreign exchange. The cost of funding these policies must be met by the Crown and must be shown explicitly in the Bank's annual accounts.

Section 22 largely repeats the previous provision relating to the Governor's power to suspend business in the New Zealand foreign exchange market. It amends the earlier provision by dispensing with the requirement to obtain Ministerial consent before implementing the suspension power, but new limiting criteria are also imposed. The section has also been changed to apply to registered banks – in recognition of their importance in the foreign exchange market and the fact that foreign exchange dealers will no longer be authorised.

Section 23 places an explicit duty on the Bank to advise the Government on foreign exchange matters and section 24 gives the Bank explicit authority to manage the Crown's foreign reserves.

Currency

Sections 25-30 of the Act continue the Bank's sole right to issue bank notes and extends this to coin.

Lender of last resort/Settlement account services

Sections 31 and 32 set out the Bank's responsibilities in respect of the wholesale banking market, permitting the Bank to act as a settlement bank and lender of last resort to the financial system.

Government Banking

Section 34 (in conjunction with section 18 of the Public Finance Act 1989) removes the Reserve Bank's statutory monopoly to provide banking services to the Crown.

CONCLUSION

The Reserve Bank of New Zealand Act 1989 is a landmark piece of legislation. The reforms contained in it are unique and have attracted widespread interest internationally amongst official, banking and academic communities.

The Act makes the Reserve Bank more independent, and accountable, for the formulation and implementation of monetary policy. Monetary policy is targeted to one objective – the achievement and maintenance of price stability. The Bank is given control of the day to day implementation of monetary policy free from political interference; subject to the overriding principle that Government ultimately must be able to determine economic policy. The objective of the legislation is not to make the Bank independent from the wishes of the Government of the day, but to ensure that any changes in policy are made in an open and transparent manner.

The Act also focuses more sharply the Bank's other functions with some significant changes in the area of prudential supervision designed to protect the integrity of the financial system by promoting prudent behaviour on the part of banks and their depositors.