Submission by

BusinessNZ

GROWING PROSPERITY AND POTENTIAL

to the

Reserve Bank Act Review

on the

Phase 2 of the Reserve Bank Act Review

Consultation Paper

December 2018

PHASE 2 OF THE RESERVE BANK ACT REVIEW CONSULTATION PAPER SUBMISSION BY BUSINESSNZ[1]

1.0 INTRODUCTION

1.1 BusinessNZ welcomes the opportunity to comment on the Phase 2 of the Reserve Bank Act Review Consultation Paper ("the Consultation Paper").

1.2 BusinessNZ would like to congratulate the Review Team on the clarity and quality of the consultation paper in setting out the pros and cons of the options for change.

1.3 BusinessNZ welcomed the opportunity to meet with the Review team to discuss the various issues outlined in the consultation paper and provide some initial thinking on the implications of the potential changes. This submission follows up on those discussions.

1.4 BusinessNZ notes this round of consultation focuses on five key issues:

- Objectives: What high-level financial objectives should the Reserve Bank have?
- Regulatory Perimeter: What financial firms should the Reserve Bank regulate and how should the regulatory perimeter be set?
- Depositor Protection: Should there be depositor protection in New Zealand?
- Separation: Should the regulation of financial firms remain with the Reserve Bank?
- Governance: How should the Reserve Bank be governed, including who should make the Reserve Bank's decisions?

1.5 This submission is in two sections. Section one focuses on the role of a sound financial system in promoting NZ's economic well-being. Section 2 looks more specifically at issues 3 and 4 above in respect to depositor protection and regulation of financial firms.

1.6 BusinessNZ would welcome the opportunity to meet again with the Review Team to discuss the content of this submission, if the Review Team felt that this would be useful.

[1] Background information on BusinessNZ is attached as Appendix 1.

RECOMMENDATIONS

BusinessNZ **recommends** that:

The Reserve Bank's high level policy objective should remain focused on promoting the maintenance of a sound and efficient financial system, as is currently the case. The Reserve Bank should not be specifically tasked with trying to promote competition, consumer protection, or potentially trying to grow (or diminish) particular sectors of the economy. These issues are better dealt with through specific legislative mechanisms such as the Commerce Commission, Fair Trading Act etc.

BusinessNZ **recommends** that:

Any moves towards the adoption of a Mandatory Deposit Protection insurance scheme should be taken with caution, given the potential for unintended consequences outlined in this submission.

BusinessNZ **recommends** that:

Actions other than regulation should be considered to encourage the development of appropriate financial literacy skills, including education initiatives and website-based advice services to help with understanding the risk and return associated with particular investments. These initiatives should be taken not only in respect to bank deposits but also in respect to the broader risks (both financial and non-financial) individuals face as part of everyday life.

BusinessNZ **recommends** that:

Any move to remove the prudential regulation of banks, insurers and non-bank deposit-takers from the Reserve Bank needs to satisfy the test that such a change would provide net benefits to NZ's financial system and to household and commercial investors (compared with the status quo).

2.0 SECTION ONE: <u>GENERAL DISCUSSION</u>

2.1 BusinessNZ considers sound macro-prudential policy important to the entire economy, with minimising risks to the banking system fundamental to the soundness of NZ's financial system.

2.2 The NZ financial system came through the Global Financial Crisis (GFC) in reasonably good shape compared with those of many other countries, in no small part reflecting the soundness and quality of NZ's regulatory systems. Certainly, there was fall-out associated with the collapse of a number of finance companies but overall, the financial system managed reasonably well.

2.3 Notwithstanding the financial system's reasonable performance, it is entirely appropriate for the Reserve Bank to look seriously at the soundness of its current prudential management systems to see if anything more can be done to manage risk successfully. But in doing so it should keep in mind that there is an optimal amount of resource to be used in reducing risk, given risk cannot be completely eliminated or if at all, not without great cost. For example, requiring greater financial stability could come at the significant cost of increasing the aggregate cost of capital.

2.4 Although further risk reduction may be possible (for example through proposals to investigate depositor protection), beyond a certain point the marginal cost of taking action becomes progressively higher, while the potential returns reduce.

2.5 From an economic perspective, risk involves:

(a) More resources, including time and money, spent on risk reduction; and
(b) Determining the desired level of risk - reconciling the increased cost with what must be given up since by their actions, most people demonstrate a level of risk well short of zero.

2.6 It is important any changes to macro-prudential policy the Government may make to the Reserve Bank Act reflect the above points, particularly where a proposed change may have an unintended impact, including an impact on economic efficiency or equity.

2.7 BusinessNZ strongly believes that in relation to financial stability, the Reserve Bank's role is to focus on regulatory efficiency. The Reserve Bank should not be trying to promote competition, consumer protection, or potentially, to grow (or diminish) particular sectors of the economy. These issues are better dealt with through specific legislative mechanisms such as the Commerce Commission, Fair Trading Act etc.

2.8 As a general principle, Business New Zealand considers individuals and companies should bear the full costs associated with their behaviour (i.e. costs should be internalised) or they will over-consume resources if costs can be shifted on to third parties. Mandatory depositor insurance is no different in this respect. If they are to make rational decisions regarding risk and return, people should ideally bear the costs (and benefits) associated with specific options/outcomes. On the other hand, forcing individuals and companies to pay more than any costs they already incur (i.e. through a requirement to obtain mandatory insurance rather than self-insure or use normal market mechanisms to monitor bank behaviour), will see further costs imposed on those who willingly monitor their own investments, an outcome which will ultimately be reflected in a higher price of capital (and/or lower returns) to consumers.

BusinessNZ **recommends** that:

The Reserve Bank's high level policy objective should remain focused on promoting the maintenance of a sound and efficient financial system, as is currently the case. The Reserve Bank should not be specifically tasked with trying to promote competition, consumer protection, or potentially trying to grow (or diminish) particular sectors of the economy. These issues are better dealt with through specific legislative mechanisms such as the Commerce Commission, Fair Trading Act etc.

3.0 SECTION TWO: SPECIFIC COMMENTS

3.1 While the consultation paper poses a number of questions, this submission deals with broad issues arising from the discussion on depositor protection and whether or not the regulation of financial firms should remain with the Reserve Bank.

Depositor Protection: Should there be depositor protection in New Zealand?

3.2 Before coming to any decision as to the merits or otherwise of regulations to introduce deposit insurance, it is crucial policymakers take a step back and ask some fundamental questions. These include – but are not limited to:

- Is there a problem *in New Zealand* with current systems; including self-insurance options (i.e. are there significant issues of "market failure" which need to be addressed)?
- If there is a problem, is the problem significant?
- What are the costs and benefits (including unintended costs) of the proposals outlined in the Consultation Paper?

- Will the proposal to adopt mandatory insurance effectively address the alleged problem (and if so at what cost)?
- What are the potential options for improving outcomes which don't impose significant costs (e.g. by improving information to market participants)?

3.3 In order to justify government intervention, there must be a clear case of market failure and the market failure problem must be significant. Moreover, there is a need to be certain any regulatory action taken will address the alleged problem in a cost effective manner.

3.4 Given markets are generally faster at self-correcting than are government intervention efforts, the onus must be on government to prove beyond reasonable doubt that the benefits of intervention (of the type proposed) will exceed the costs, including any unintended costs consequent upon regulation.

3.5 The Consultation Paper outlines potential reasons for protecting depositors and also some of the risks associated with same. The pros and cons are clearly outlined in the paper and so are not repeated here; suffice it to say BusinessNZ considers the risks to be potentially significant, particularly if protection for bank depositors opens the flood-gates to requests for protection from all other kinds of investments that happen to go wrong. In short, where do the boundaries start and end?

3.6 A major risk outlined on page 54 of the Consultation Paper and backed up by empirical evidence, is the potential for depositors to take a lax approach to monitoring bank behaviour with banks shielded from deposit runs having less incentive to act prudently. *"This is known as 'moral hazard', and can give rise to excessive risk taking by protected depositors (who may invest in less financially sound banks than otherwise) and their banks (which may invest in higher-risk ventures).*

3.7 The above would increase rather than reduce banking system risk but risk reduction is surely is part of proponents' objective in supporting the adoption of mandatory deposit insurance.

3.8 That the proposed protections are directed only to banks, with other financial institutions not affected, could be considered inequitable and could encourage greater lending in less regulated sectors of the economy – something which is not necessarily desirable. The net effect would likely be to increase the cost of capital to sectors considered to pose a risk to the financial system.

3.9 Since different banks will have different market shares and often specialise in lending to specific sectors, the implications for the banks themselves will need to be examined carefully to avoid any undue impact on both particular banks and the sectors they lend to.

3.10 Arguably, a reasonable amount of time will be needed if undue disruption to banks, individuals and businesses is to be avoided and they can plan ahead with a reasonable degree of certainty knowing the rules are not going to change abruptly.

3.11 The question of whether or not government should proceed with depositor protection legislation can be examined at two levels – both equally important. The first concerns the concept itself, the second, the practical implications of trying to design such a system. This submission focuses particularly on the first – the concept, although it alludes to some of the problems inherent in designing a system that minimises unintended consequences.

The Concept of Depositor Protection

3.12 On p52 the Consultation Paper states that: *"A 2011 Government inquiry into finance company failures during the GFC found that depositors often had no understanding of the risks they were assuming, and the FMA's 2018 investor attitudes survey found that only 42 percent of New Zealanders understood the trade-off between investment risks and return." (p.52).* This situation is truly concerning.

3.13 It is understood that other surveys have also found around 50 percent of New Zealanders think their bank deposits are explicitly underwritten by government guarantees. A similar number consider "KiwiSaver" too is guaranteed by government.

3.14 The above results show a clear need to put more resources into improving the financial literacy of broad sections of the population. Nevertheless, investor naivety does not justify imposing mandatory insurance to (at least partially) protect individual depositors.

3.15 There are many, many areas of life involving risk where individuals must bear both the costs (and benefits) of bad (or good) investment decisions.

3.16 It has to be asked why the focus is on mandatory insurance when individuals are not required to obtain compulsory insurance for other activities which could impose significant costs on them personally, on their families, and ultimately on the general public (taxpayers) via social welfare benefit payments and public health expenditure. While individuals can, and often do, insure for risks of this kind, taking out insurance is still entirely voluntary.

3.17 Many people fail to obtain appropriate cover for a whole host of possible risks (e.g. loss of employment income, health difficulties, property damage as a result of storms etc.) all of which could impose significant costs. Taken to the extreme, one could argue that those who undertake risky activities e.g. are obese or adopt a sedentary lifestyle should have to take out mandatory health insurance to minimise the cost to taxpayers in case expensive health treatment is needed later in life. While voluntary insurance is available both for health-related and many other risks, generally it is not compulsory (apart from ACC levies covering workplace accidents, accidents to earners outside the workplace and motor vehicle accidents, with the taxpayer picking up the bill for personal injuries to non-earners).[2]

3.18 Recent reports (from Stuff) of travellers who fall ill while overseas found around 30 percent failed to get travel insurance (or travel insurance adequate enough to cover most eventualities).

3.19 While it is accepted some may not be able to take out travel insurance due to a pre-existing condition (a pre-existing heart condition, for example), the Government has not (we understand) seen fit to pay such people's costs should a major event necessitate a costly intervention in order to return to NZ or to pay for treatment in an overseas facility. The burden, rightly or wrongly, generally remains with the person in question and their family although the local community might sometimes rally round and raise funds. For families in this situation the costs can be massive, usually significantly more so than if, potentially, a bank were to get into difficulty.

3.20 Going into business involves significant risks - market demand, fluctuations in exchange rates, changing consumer preferences etc. and in some industries the risks can be very high. The recent mycoplasma bovis outbreak and milk price reductions in the dairy industry are good examples. Individuals, farmers and investors must manage these risks in an appropriate manner and adopt appropriate risk mitigation options (including insurance). Insurance is certainly one option for managing risks (but an expensive option in some cases).

3.21 While it is accepted the purpose of mandatory depositor insurance is to ensure (specified) "individuals" are adequately compensated should a bank fail, the same can be argued of any individual activity that imposes significant costs on third parties (generally taxpayers). But in the latter case the costs are dispersed among all taxpayers, not sheeted home to particular individuals. And for a variety of reasons, government has not seen fit to require individuals or households to obtain insurance to cover all the real or perceived risks they could face.

[2] There may be cases where insurance is also required in respect to membership of some professional associations and in respect to some occupational regulation.

3.21 There has been some push over the years to require greater use of compulsory insurance in a range of situations (including proposals for compulsory third party insurance against motor vehicle accidents) but for many reasons, including the potential for unintended consequences, the government of the day has not followed through with such proposals.

3.22 Arguably many other risks (perceived and real) would be significantly more harmful to individuals and their families than the prospect (remote as it might be) of a bank collapse. "KiwiSaver" schemes collapsing (or at least taking a substantial hit) would likely be much more damaging to ongoing financial health, particularly as the Reserve Bank already has an established policy on Open Bank Resolution, well explained in the Consultation Document. The OBR, although not used in NZ to date, seems a sound system for dealing with bank difficulty issues, without, as is mandatory depositor insurance, trying to reinvent the wheel.

3.23 The Consultation Document states that New Zealand and Israel are the only OECD countries without depositor protection and Israel has indicated its intention to introduce deposit insurance (p.50). This is not in itself necessarily an argument for NZ to follow suit. A country's history, its institutions and customs need to be clearly put in the mix before concluding it would be in NZ's best interests also to go down this track.

3.24 Further, advocating for the adoption of mandatory deposit insurance is essentially anomalous in light of the current OBR arrangements for depositors' "haircuts" should banks get into difficulty.

3.25 The only justification for haircuts is to reduce the risk of moral hazard and if they haven't done that, why have them? And if they have, why is deposit insurance contemplated?

3.26 Is the answer that regulators do not have much faith in the OBR regime (i.e. haircuts) and are therefore trying to regulate on top of regulation because regulation has not removed the potential risk it was intended to address? The outcome could be significant regulation on top of existing regulation which not only fails to deal with risk but simply adds to the cost of credit and reduces returns to deposit holders.

3.27 The danger as mentioned earlier is so-called "market failure" overtaken by "regulatory failure". Regulatory action must address any alleged problems in a cost effective manner. When it comes to policy development, regulation on top of regulation is hardly a good starting point.

3.28 BusinessNZ strongly adheres to the idea of *travelling up the regulatory pyramid,* that is, considering non-regulatory options first, moving "up the pyramid" to generic light-handed options and introducing more stringent measures only if clearly warranted.

3.29 Two inevitable consequences flow from not taking the regulatory pyramid approach. First, putting aside the question of whether changes are required in the first place, no regulatory change should impose more cost on already compliant and best practice businesses in a particular sector but make little or no difference elsewhere. That would represent a fundamental policy failure given there would be little reward for significant harm.

3.30 Second, BusinessNZ is concerned any change could create a "waterbed effect", with regulatory solutions in one area producing a different problem elsewhere. This effect is alluded to earlier in this submission.

3.31 Given all the matters cited, Business NZ considers mandatory depositor insurance should not be introduced at this time. This conclusion notwithstanding, Business NZ considers there may be merit in providing individuals and businesses with greater information about the risks of investing, the potential returns and the need to ensure adequate risk management techniques are utilised to minimise the possibility of significant failure. This information campaign should not necessarily apply only to individuals making deposits with bank deposit risks but to risk generally, particularly so given many people appear not to be fully informed about the benefits and costs associated with property or health insurance or the many other risks individuals and businesses face on a daily basis.

The Practical Implications of trying to design such a scheme?

3.32 The Government needs to be aware that requiring compulsory depositor insurance (protection) will require it to explain why a great many other compulsory insurance obligations are not also imposed on individuals and households. Picking mandatory depositor insurance out from a host of other so-called issues perceived as deserving is unlikely to sit well with the NZ public, quite apart from sending a signal that implicitly (if not explicitly) government is there to bail out anyone whose finances are affected by an adverse event.

3.33 Mandatory depositor insurance will also see preferential treatment for some (first cab off the rank as it were) leaving less security for other investors. As with anything in life – there is no such thing as a free lunch here.

3.34 People and organisations often lose monies owed when companies collapse (or in the rare case where a bank gets into difficultly). They generally consider themselves "more deserving" of payment than others are.

3.35 The simple fact is priority for one group will be at the expense of other creditors who will have even less chance of recovering what they are owed. Preferential treatment in the case of bank collapse automatically increases the risk for remaining creditors for whom debt recovery will be far less likely, forcing a change in wholesale investors' and other shareholders' behaviour to compensate for the increased risk.

3.36 In general terms, wholesale investors and other shareholders will require security over their investments or alternatively higher returns to compensate for a real or perceived risk of bank failure. While many factors impact on the cost of credit, including financial sector competitiveness, in general the greater the security over deposits a bank can offer, the lower the interest rate. Vice versa, the lower the level of security, the higher the interest rate to compensate for the risk of non-payment. In some cases the risk may be too high for wholesale depositors or other bank shareholders to cost-effectively manage risk; hence they will restrict their lending to banks and the cost of credit will increase. So in essence, safeguarding some investors with mandatory deposit legislation will see risks popping out in the form of reduced returns to deposit holders (and high costs through mandatory insurance charges). The cost of credit to householders and businesses will increase as wholesale investors and others perceive an increased risk of losing monies owed should a bank collapse.

3.37 Given NZ's relatively high level of household debt (currently around 160 percent of household income and rising), any percentage point increase in the cost of credit will also affect the annual cost of mortgage repayments. In aggregate, this could have a significant impact across the economy.

3.38 BusinessNZ notes the Consultation Document talks about the potential for some "safeguards" to arguably minimise the above adverse impacts (e.g. capping payments to depositors).

3.39 But as stated earlier, the result would be other creditors in a less secure position, typically with three adverse outcomes. First, the cost of credit would increase (on the margin) to compensate for risk. Second, credit availability would diminish. Third, potentially pressure would be placed on government either to underwrite or require mandatory insurance for a whole host of other potentially risky events.

3.38 Putting aside the potential impact on cost and availability of credit, many issues would need to be worked through if a mandatory deposit insurance scheme were to get off the ground. Some would be significant - would the scheme cover only banks or all-deposit taking institutions, where would the boundaries lie, what would a suitable cap be, should there be a threshold before the scheme cuts in and who would underwrite it, should premiums be set based on risk and by whom, who would be responsible for administering the scheme – the list goes on. None are trivial and detailed thinking would be needed before a model could be developed that would "protect" investors minus the many unintended consequences such a scheme could otherwise entail.

3.39 BusinessNZ accepts that at this stage of the policy development process, a reasonable understanding of the costs and/or benefits of the proposal may be lacking but it is crucial that before proceeding to the next stage, reasonably accurate information is obtained. The process should not proceed simply on the basis of a "perceived" problem without first examining its intended, as well as its possibly unintended, costs. It would also be helpful to know how such a proposal fits within the broader context of voluntary insurance in general.

BusinessNZ **recommends** that:

Any moves towards the adoption of a Mandatory Deposit Protection insurance scheme should be made with caution, given the potential for unintended consequences as outlined in this submission.

Business New Zealand **recommends** that:

Actions other than regulation should be considered to encourage the development of appropriate financial literacy skills, including education initiatives and website-based advice services to help with understanding the risk and return associated with particular investments. These initiatives should be taken not only in respect to bank deposits but also in respect to the broader risks (both financial and non-financial) people face as part of everyday life.

Separation: Should prudential regulation and supervision be separated from the Reserve Bank?

3.40 The Consultation Paper questions whether or not it is still appropriate to locate prudential regulation and supervision alongside monetary policy and other functions in the Reserve Bank.

3.41 BusinessNZ notes the Consultation Paper provides examples of what happens in a number of overseas jurisdictions with a number of different models.

3.42 On balance, BusinessNZ does not have strong views whether the current regime, giving the Reserve Bank responsibility for prudential regulation and supervision, should continue, or whether these functions should be moved to another overarching regulatory agency. There are clearly pros and cons, although on balance it can be said the Bank has, over the years, carried out these functions with reasonable efficiency – contributing, at least in part, to NZ's strong and clear fiscal and monetary policy regimes long upheld around the world as representing best practice.

3.43 In many countries, the prudential supervisory authority is separate from the central bank, often as a result of comprehensive reviews of previous regimes. While NZ has arguably not had a serious debate about the merits of separation, it should be noted that for a range of reasons, the country did not face some of the crisis issues post-GFC that many other countries faced. NZ came through the GFC largely unscathed (apart from the demise of a number of finance companies) and many of the issues arising from or the causes of those collapses have since been adequately dealt with.

3.44 Removing the Reserve Bank's prudential and supervisory roles also risks the unintended consequences of change made for change's sake.

3.45 Notwithstanding the above, one argument in favour of separating the Reserve Bank's prudential and supervisory functions is the potential for a conflict of interest between its core monetary policy role and a requirement to set in place an appropriate prudential and supervisory structure. The Bank would be more focused than currently on monetary policy implementation if it did not have to perform several functions. In the worst case, the Bank could be seen as a referee and player in the same market, something not generally to be encouraged as good policy. On the other hand, there is no indication the Bank has not performed both functions to a level which could be considered exemplary (given the risks involved in setting policy to take into account potential events). Certainly there has been no dropping of the ball, as it were.

3.46 On balance, BusinessNZ does not see an overwhelming reason to change the status quo and move the prudential and supervisory roles from the Reserve Bank to another agency.

3.47 Much like the case for and against mandatory depositor insurance, just because most other OECD countries operate differently from NZ does not of itself mean this country should follow suit. Making any significant change must provide demonstrable net benefits. To date, BusinessNZ has seen no evidence justifying change.

BusinessNZ **recommends** that:

Any move to remove the prudential regulation of banks, insurers and non-bank deposit-takers from the Reserve Bank needs to satisfy the test that such a change would provide net benefits to NZ's financial system and to both household and commercial investors (compared with the status quo).

Appendix One - Background information on BusinessNZ

BusinessNZ

GROWING PROSPERITY AND POTENTIAL

BusinessNZ is New Zealand's largest business advocacy body, representing:

- Regional business groups EMA, Business Central, Canterbury Employers' Chamber of Commerce, and Employers Otago Southland
- Major Companies Group of New Zealand's largest businesses
- Gold Group of medium sized businesses
- Affiliated Industries Group of national industry associations
- ExportNZ representing New Zealand exporting enterprises
- ManufacturingNZ representing New Zealand manufacturing enterprises
- Sustainable Business Council of enterprises leading sustainable business practice
- BusinessNZ Energy Council of enterprises leading sustainable energy production and use
- Buy NZ Made representing producers, retailers and consumers of New Zealand-made goods

BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy and services for enterprise, BusinessNZ contributes to Government, tripartite working parties and international bodies including the International Labour Organisation (ILO), the International Organisation of Employers (IOE) and the Business and Industry Advisory Council (BIAC) to the Organisation for Economic Cooperation and Development (OECD).