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The Hon Grant Robertson
Minister of Finance
Parliament Buildings
Wellington

CC:
Sam Tendeter, Minister's Office
Grant Spencer, Acting Governor RBNZ
Professor Neil Quigley, Chair RBNZ

Note: This copy includes a 20 January, 2018 Addendum on Central Banking & ADI Supervision

The RBNZ and Regulation of the Banking Sector

Dear Minister,

Overview

It is important that you are reviewing the RBNZ's mandate and economic objectives but I am concerned that the critical issues of its overall capability, performance and regulation of the banking sector may not be included or get the attention that they urgently need.

New Zealand has an unfortunate history of weak/incompetent government regulation and oversight, of complacency and failing to hold people and organisations to account. Two important examples (there are many others) are occupational health and safety; and the non-bank finance sector. The first cost many lives and injuries over many years and the second billions of dollars of personal savings and wealth during the GFC. In both cases governments had failed to act effectively to put appropriate legislation in place or the capability to effectively administer even the existing legislation; and key agencies failed to respond effectively even when crises were evident - with disastrous consequences in both cases.

I am seriously concerned that we are on the same path with the RBNZ and the regulation of the banking sector, with a similar potential for bad outcomes.

My comments below apply primarily to the RBNZ's role as the banking regulator.

I consider that I have the experience, skills and capability to make informed judgements on these matters having been a bank director for 17 years and chairman for 12 years in New

Zealand, had major bank governance roles in Australia for 12 years, had considerable involvement with the bank regulator in each country and had numerous governance and related roles in both countries since 1967 (see Attachment 1).

Because of my concerns I have engaged directly with the RBNZ on this matter for some time now – including as Chairman of one of the main banks, and particularly over the last few years - with little/no success. RBNZ staff acknowledge my concerns but seem determined to continue with their weak and unacceptably risky regulatory regime; and successive RBNZ boards have been in my judgement both complacent and lacking any real understanding of banking at the coal face.

I have strongly emphasised the lengthy list of issues identified by the IMF in its recent review of the New Zealand banking sector as needing attention (not for the first time); and the recent measures (BEAR) being introduced by APRA and the Australian Government – which are very much in line with my recommendations but with little/no effect although **"the Bank is considering closely the IMF recommendations that additional supervision resources are needed to implement the Bank's supervision model effectively" (RBNZ 2017 Annual Report).** Given the significance of the IMF's comments I consider the RBNZ's response naïve, complacent and entirely unacceptable. It reflects a culture which is unacceptable in a bank regulator.

For this and other reasons (see below) I consider it inappropriate and anomalous that RBNZ is both the central bank and the regulator of the NZ banking system. The two functions are quite different and require different skills and capabilities**. I therefore recommend that the Financial Markets Authority be designated as the bank regulator and that appropriate arrangement be made for it to develop the requisite "fit for purpose" policies and capability; and take over the function asap.** It is after all the "financial markets authority" and this separation is common globally, including in Australia.

The Problem

The present position is that the RBNZ does not know whether the banks which it has licensed to operate in New Zealand are abiding by the terms of their banking licences. The banks are simply required to attest that they are but there is no review, examination or audit process, which is naïve in the extreme! This is not tiddlywinks!

Amongst these licensed banks a number have related US and European banks which have now paid billions of dollars in recent years in penalties to regulators for their inappropriate actions – often outwardly fraudulent/illegal, during the GFC or otherwise (such as corrupting LIBOR), to avoid prosecution or admission of guilt or as penalties/compensation. These issues are widely known and have seriously damaged the reputations and credibility of these banks, but RBNZ simply accepts their attestations!

They also include the main Australian banks which have so outraged the Australian public by their behaviour over many years that a Royal Commission (or similar) is now being strongly advocated, supported by some 70% of the population. These banks have a history of inappropriate behaviour and of increasing profit and executive remuneration by fraudulent or otherwise inappropriate means. The House of Representatives Coleman Report, a review

of the Australian banks, noted that “the major banks have a poor compliance culture and have repeatedly failed to protect the interests of consumers”. It also noted that in spite of this no individuals have had their employment terminated.

Reflecting this a new accountability regime is being introduced in Australia which reflects the UK’s initiatives to establish a more appropriate accountability standards regime for banks – which is aimed at lifting the responsibility and accountability of the most senior and influential directors. Similarly, the Australian BEAR regulations will introduce heightened responsibility and accountability for the most senior and influential executives and directors within the banks.
This addresses a critical weakness in Australian banking – the failure of the main bank boards to deal effectively with inappropriate management cultures in parts of their banks, even when major issues have become public.

Most recently, in recent months it appears that all of the four main Australian banks have now paid millions of dollars in penalties for rigging the key interbank interest rate trade (BBSW – the equivalent of LIBOR) to increase bank profits and executive remuneration. Top bank employees are recorded engaging in the fraud. While these actions often reflect the actions of employees and not bank policies not all do; and a critical issue is the failure of the leadership of the banks to act effectively to address this culture and other related problems.

I was amazed to recently read that Westpac in New Zealand was using to a significant extent unauthorised models to undertake the critical task of stress testing its prudential position. I was pleased to see that RBNZ had imposed penalties, but shocked that this breach had been occurring since 2008!

A key difference between bank regulation in Australia and New Zealand is that APRA (and ASIC with a different role) actively enquires, probes, tests and challenges and identifies issues. The RBNZ does none of this so everything looks fine - but the reality is they simply do not know! They simply rely on attestation, in circumstances in which it is simply not credible!

So, why does all of this matter? Well these are the banks that own and ultimately control the New Zealand banks including the 4 main banks, that have representatives on the New Zealand banks boards and organise/control many of the senior executive appointments, their systems and processes and policies – and most importantly how they respond to a crisis. Moreover, the chairs of the New Zealand banks customarily sit on the boards of these banks (especially the Australian banks) – as I did, and are directly part of the leadership of these banks.

All of this is against the background of heightened geo-political risks, the outrageous behaviour of the banks generally in relation to the GFC, the failure of many regulators to act effectively on a timely basis, the global wash of liquidity, housing related imbalances and the sharp rise in many asset prices and debt - especially household debt.

It is of particular importance that the New Zealand boards of the New Zealand licensed banks are required to make all important decisions in relation to and in the best interest of the New Zealand bank; and are expressly not allowed to act in the interests of a holding

company – such as the parent bank. But the RBNZ simply does not know if this is being complied with – again a critical issue. It simply – again and naively relies on attestation without audit or other serious testing or enquiry.
In all my time as a director/Chairman of one of the 4 I was never formally interviewed or tested on regulatory matters.

Key questions are is the NZ board appointing directors or are they being effectively appointed by Australia. Who appoints the CEO and other key executives; and the chair? Does the NZ board manage its own balance sheet, set the prudential margins and manage important issues. Does it actually have the capability to do this independent from the parent bank? Who does the banks' planning, sets targets and approves plans and strategies and how are these aligned/coordinated with the parent bank?
Is the key relationship between the NZ CEO and the Group CEO, rather than with the NZ chair – and are they simply another member of the Group executive committee?
These are critical issues but the RBNZ simply does not know the answers – which is not good enough!

Further, where the chair of the New Zealand bank is also on the board of the parent bank are they acting unequivocally in the best interest of the New Zealand bank or are they inappropriately influenced by the parent. Is their legal position compromised to the extent that it is untenable? What do the parent board's minutes show? Again RBNZ does not know! My view is that they are unacceptably conflicted and should not be members of other boards within the Group.

I have emphasised the importance of these issues to the RBNZ and emphasised that I do not think the NZ bank boards currently have the capability to govern their banks independent from their Group; and that they are not "fit for purpose" bank boards with the requisite professional and expert skills and capabilities that this requires. Significantly in Australia APRA is now working directly to raise the level of skills and capability on the Australian bank boards because of the same concerns – with the parent banks!

I am also concerned that there appears to be a significant erosion of the expertise and capability in the management of the New Zealand banks, particularly with a loss of the necessary expert technical skills to properly manage a bank, particularly on a standalone basis.

The RBNZ has a history of hands off-regulation and seems determined not to change although this approach is clearly not "fit for purpose" - and probably never was.

Having had a close involvement with both the Australian and New Zealand regulators and their systems and processes my view is that the New Zealand approach is weak and ineffective and leaves the New Zealand bank customers seriously exposed.

In addition the OBR policy adopted by the RBNZ entails a serious moral hazard for the RBNZ. They have deliberately put the bank customers, especially depositors in a position of high exposure, which they then should, at the very least mitigate by effective regulation – but they don't. They have the power to do so whereas the banks' customers clearly do not and so are fully exposed by OBR to an unacceptable level of risk.

Specifically, customers have no influence on the appointment of bank directors to ensure that they are competent and make astute decisions, especially in the many areas of risk that they must deal with – when the banks have a disturbing history of accepting higher levels of risk to increase profits and executive remuneration.

The responsibility for this failure to act effectively lies with the Governor and their management team, with the RBNZ Board and with successive ministers and their governments.
I am particularly critical of the RBNZ Board which is accountable for "reviewing the performance of the Governor and the Bank". I see no evidence that the RBNZ Board does this work, or that it has the requisite skills and capabilities to do this effectively. Why has it not insisted on urgent actions to address the matters raised by the IMF and others? In past discussions with RBNZ boards I have expressed the view that they are weak, ineffective and lacking in understanding of the reality of banking and the risks involved. That is still my view.

It is useful to comment further on the role of the Board.
In the hierarchy of organisations boards are a level above management. They appoint the CEO (Governor), monitor and as necessary manage their performance – and that of their management team and hold them to account. So, the requisite skills and capabilities of RBNZ directors must include the ability to challenge the Governor and his team on many aspects of banking, central banking and the regulation of the banking system. Directors will have a mix of skills and capabilities but the capability of the whole Board must include a genuine ability to challenge management on a considerable range of technical and professional issues. It is not enough that directors can ask questions of the Governor and management; they must be able to propose and debate alternative views and challenge with a high degree of professionalism and expertise.
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This is no different to the role of any board but with the RBNZ (and bank boards generally) the requisite level of technical skill and capability is at a very high level if the board is to be effective. Based on the information provided by the RBNZ on its directors the RBNZ Board falls well short of satisfying this criterion. In other circumstances it might be regarded as a capable board but banking regulation is different!

The RBNZ's own guidelines (BS14 Corporate Governance) also give strong grounds for concern about its approach to the supervision of licensed banks:

- The RBNZ "aims to ensure that shareholders, board of directors and senior executives have strong incentives to run the bank prudently in the interests of financial stability". "incentive"? This is not PlaySchool - they **must** run the bank prudently….!
- "….. the board (of a bank) will take decisions in the best interest of the bank". What about customers, particularly depositors who are critical for the banks viability, for the stability of the financial system and who have a right to be protected.
  Well, they can be hung out to dry – dog tucker which is particularly inappropriate given their exposure under OBR!
- "…that the interests of the shareholders (of the banks) are properly represented". Again, nothing about depositors or other customers! I would have thought that

"shareholders" are well capable of looking after themselves but customers are in no position to do so.
The RBNZ consistently ignores the interests of customers, which will often differ from those of the bank, as is highlighted by many of the recent performance failures of banks as they seek to increase profits by inappropriate/illegal means.

- "…. it needs to be satisfied that there will be sufficient separation between the bank and its owners" but it makes no credible effort to be satisfied – it simply relies on attestation from an industry that routinely demonstrates that it cannot be trusted.
- The same comment applies to the provision allowing the chair of a bank to be a director of the parent bank, when the chair is absolutely conflicted and should not be allowed to be a director of any other bank in the group.
- Given the membership of the boards of NZ licensed banks the RBNZ is not enforcing Guideline 17 (3) – "the board collectively should have adequate knowledge and experience relevant to each of the material financial activities the bank intends to pursue…..". In my judgement there are serious weaknesses in the capability of the NZ bank boards, particularly in their understanding of financial markets, banking and risk.

- In contrast APRA emphasises the protection of "beneficiaries" basically the customers, and particularly bank depositors in this context.

The contrast between APRA and RBNZ is marked in many respects, APRA being much more astute, proactive and effective as a regulator and their policies are much better targeted and more astute. They prioritise customers rather than ignoring them:

- "….APRA aims to ensure that the risks undertaken by the institutions it supervises are clearly identified and well managed and that the likelihood of financial losses to consumers are minimised. In this way APRA acts to protect the interests of depositors……and to promote the stability of the Australian financial system".
- "APRA is an independent statutory authority established for the purpose of prudential supervision of financial institutions and for promoting financial stability in Australia. In performing this role APRA is responsible for, in particular, protecting the interests of depositors……collectively referred to as APRA's beneficiaries. Protecting the financial interests of these beneficiaries lies at the centre of APRA's mission".

A very different approach!

Conclusions

Overall I have concluded that:

- There are serious issues which need to be addressed in the NZ banking system.
- The RBNZ as a bank regulator is in many important respects unacceptably complacent, weak and ineffective. It does not know whether the NZ licensed banks

are complying with important conditions in their banking licences and does not prioritise the interests of bank customers.
- It is not a learning organisation and is not capable of addressing its weaknesses – so change/improvements have to be imposed on it.
- Ministers of finance have been accepting of this situation and have failed to act.
- Comparison with the Australian regulator (the Australian Prudential Regulatory Authority – APRA) highlights the RBNZ's weaknesses and failings, including its critical lack of focus on the position of bank customers, especially depositors.
- The relative strength and effectiveness of APRA represent a very real risk to the depositors and other customers of the New Zealand banks in the event of crises.
- In a "business as usual" context these issues may not seem serious, but this is exactly when things have to be put right. When the going gets tough its too late and it will be the NZ customers of the NZ banks that are at greatest risk with no-one acting in their best interest.

Recommendation

I recommend that:

- The role of the RBNZ be limited to central banking and that the regulation of the banking sector be transferred to the Financial Markets Authority, appropriately empowered, resourced and held to account.
- That the future regulation of the NZ licensed banks be improved, reflecting the concerns that I have expressed in this letter - particularly that the interests of depositors be the highest priority.
- That there be an independent review of OBR with the objective of shifting to a fairer and more effective approach to protecting the interests of depositors and other bank customers.

Yours sincerely

Kerry McDonald

20 January 2018

Addendum 1 to my 20 December, 2017 Submission
I was asked to comment in more detail on -

Central Banking versus Bank (ADI) Supervision:

- Many exemplar countries (eg: US, England, Japan, Canada, France, Germany, Switzerland, Australia) separate these functions, for very good reasons.
- The RBNZ does both, in my view ineffectively. It is a high risk situation which the IMF has criticised in its latest (2017) review.

- RBNZ should cease to be the bank supervisor/regulator and concentrate on its policy oriented role – particularly monetary policy; and on the overall stability of the financial system and the protection of depositors.
- There are many relevant matters of detail that could be debated on this issue but I am focussed on dominant determinants of the need for separation.
- Most importantly the two functions are fundamentally different. They require quite different skills and capabilities and to operate effectively need very different cultures. In organisation terms this is a critical and often challenging issue which I have extensive knowledge and experience of.
- Central banking is primarily about developing and implementing policy in the face of uncertainty and incomplete data. This is fundamentally complex work because it is subjective, uncertain and imprecise and requires astute analysis and judgement. It should includes a leadership role in relation to Macro Prudential Tools, in a team-based context.
- Bank (more strictly Authorised Deposit-taking Institutions) supervision is much more objective and based on clear principles, more hard data, checking facts and reviewing/auditing performance against more explicit parameters. This work is fundamentally very different and generally less complex- but just as important!
- Failure to deal effectively with such differences in organisation terms is all too common and typically very damaging.
- The RBNZ's traditional and primary orientation is "central banking", in terms of its culture, leadership, staffing and work priorities – which means banking supervision is a secondary priority and one it is not well equipped for and does less effectively.
- A further important consideration is that Australia's separate agencies clearly reflect these differences leaving New Zealand's single agency covering both at a serious disadvantage.
- RBNZ considers that it deals with APRA as an equal but this is not the case – it is much weaker, less effective and less credible and I expect that this is reflected in the very limited (token?) nature of the collaboration agreement between APRA and RBNZ.
- In addition APRA has the added advantage and leverage of regulating the parent banks, not relatively small subsidiaries.
- In the past this might have mattered less but still been a serious issue but the evident lessening of goodwill between the two countries materially increases the risk to NZ that when difficulties arise Australia (APRA) will be less accommodating of NZ's interests, to the detriment of NZ depositors.
- It was bad enough during the GFC when Australia gave NZ only 1 hours warning (partners?) that it was following the Irish policy initiative, causing NZ to panic and make serious and very costly policy errors.
- It is essential for NZ and NZ bank depositors that the NZ banking system regulator can engage with APRA as an equal, in all important respects or close to it, particularly when financial systems are facing heightened stress and risk.
- If I was in APRA's shoes I would be frustrated by the weakness of New Zealand's bank supervision but somewhat comforted by being in a comparatively stronger position in any serious dispute.
- RBNZ, across governance and management, lacks the cutting edge capability, particularly technical to engage with an organisation like APRA and achieve results

that are in the best interest of both NZ and Australian depositors, rather than just the Australian depositors!

Separation of Responsibilities

This list is indicative but reasonable:

1 Supervision of ADIs

- Relevant legislation
- Licensing ADIs
- A risk-based approach to supervision
- Prudential standards – capital adequacy, liquidity, risks/mitigation, large exposures, securitisation, derivatives
- On site/off site analysis by supervisors with in depth knowledge supported by specialist risk experts; including probability and impact rating and system capability and response
- Aggregate risk exposures and Intra-group risks
- Astute risk judgements and effective actions
- Audit
- Disclosure
- Outsourcing
- Business continuity
- Governance, including fit and proper, capability and performance
- Reporting
- Statistics
- Basel requirements

2 Central Banking

- Monetary policy, in the context of overall economic etc policy, including Macro Prudential Tools
- Policy analysis
- Lender of last resort
- Issues/manages currency
- Manages fx/gold reserves
- Works to maintain a strong financial system and protect depositors

Appendix 1
Relevant experience Kerry McDonald:
Economist 1965 - 1981 working in NZ, Australia, the UK and elsewhere, including Director of NZIER (and Chief Economist of Comalco Limited).

Senior executive/managing director of Comalco/CRA/Rio Tinto, working in NZ, Australia, Japan, SE Asia, Canada, USA, Venezuella and elsewhere, including working on major projects with large international banks.
An independent director of numerous listed (Australia, NZ, London, New York, Toronto) companies and other organisations from 1981.
Appointed a director of BNZ in 1991 by NZ Government to help prepare it for sale.
Appointed a director of BNZ by NAB following its purchase in 1992.
Chairman of BNZ 1996 – 2008
NAB governance roles from 1996 – 2008: an Overseas Chairman, then Advisor to the NAB Board, then director of NAB.
Chairman BNZ Partners Wellington 2012 – 2016.
Bank business and private customer.