The Treasury

Macro-prudential Policy Memorandum of Understanding Information Release

June 2013

Release Document

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[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[2] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

RESERVE BANK OF NEW ZEALAND

THE TREASURY
Kaitohutohu Kaupapa Rawa

Date: 24 May 2012

To: The Prime Minister

Aide Memoire: Macro-prudential Policy

This note is intended as background ahead of your meeting with the Reserve Bank and Treasury on 28 May.

Introduction

The severity of the Global Financial Crisis was aggravated by the sustained boom in asset prices and credit that preceded it. Macro-prudential policy focuses on the use of prudential instruments to promote a more stable and resilient financial system, particularly in response to strong domestic credit growth.

Macro-prudential instruments usually take the form of additional buffers (such as capital or liquidity requirements) designed to provide the financial system with extra shock-absorbing capacity at times when this is desirable. Some macro-prudential instruments may also assist in dampening both credit and asset price cycles, although this is not their primary role.

There has been considerable international interest in the use of these tools since the crisis and most advanced economies are now working to put formal macro-prudential policy frameworks in place. The exact arrangements vary from country to country, as they depend almost entirely on the nature of financial regulation in each country. For example, a number of countries have separate monetary, prudential and financial conduct authorities, requiring them to create coordinating bodies to oversee macro-prudential policies. An example of this is the Financial Policy Committee in the UK. In other countries, such as Singapore, Ireland and the Netherlands, the central bank has sole authority over the use of macro-prudential policies.

In New Zealand, the Reserve Bank already has powers under the Reserve Bank Act to implement prudential instruments with the objective of maintaining financial system stability and efficiency. Given this existing mandate, and in view of the fact that the Reserve Bank is responsible for both monetary and financial stability, we would expect the Bank to take the lead in implementing macro-prudential policy.

Tools under consideration

Over the past two years, the Reserve Bank has been researching potential macro-prudential policy instruments and how they could be used in New Zealand. This work has identified four instruments that could have a role to play in managing future episodes of strong credit growth:

- **The Counter-Cyclical Capital Buffer.** This instrument is an additional capital requirement that could be imposed if credit is booming and removed when the credit cycle turns down, providing banks with additional loss-absorbing capacity. It is part of the new Basel III capital regime.

- **Core Funding Ratio (CFR).** Adjustments to the minimum Core Funding Ratio may have a role to play in dampening rapid lending growth, whilst also ensuring that growth in credit is funded from more stable sources.

- **Adjustments to sectoral risk weights used to calculate bank capital requirements.** Selective adjustment to risk weights may be appropriate if lending to particular sectors is excessive.

- **Limits on Loan-to-Value Ratios (LVRs).** Restrictions on LVRs for residential lending may be appropriate if rapid housing credit growth is associated with high LVR lending.

How and when would these tools be used?

The Reserve Bank has been developing a broad range of financial indicators, which will be used to help inform any decision to use macro-prudential tools. While most macro-prudential instruments for banks could be implemented through changes to conditions of bank registration, an order-in-council or legislative changes may be required to change capital or liquidity requirements for non-bank deposit takers.

The use of macro-prudential tools would represent a new approach to financial stability in New Zealand The Reserve Bank and Treasury are currently developing an explicit governance framework that will guide the decision making process around when and how these tools could be used to address financial imbalances. This will be agreed with the Minister of Finance as a basis for policy decisions going forward.

While specific arrangements are still to be determined, one possibility could be the establishment of a Memorandum of Understanding between the Reserve Bank and the Minister that would set out expectations, arrangements and accountability measures for the use of such tools. **We expect to have formal arrangements in place and operational by the end of 2012**.

These tools are likely to be used infrequently and only during extremes in the credit cycle. This contrasts with the regularity in usage of monetary policy instruments such as the Official Cash Rate. Given the expected infrequency of use, and given that credit booms tend to take a different form each time they occur, we would expect these arrangements to evolve as we learn from domestic and international experiences and best practices.

Accountability

The final governance arrangements will take into account the need for a transparent decision-making process. We expect to publish the policy framework and decision-making process ahead of implementation. In addition, we are evaluating various ex-

ante and ex-post measures that could be used to ensure accountability within the framework.

As the use of macro-prudential tools falls within the existing mandate of the Bank, the use of those tools would also be subject to existing reporting requirements, such as regular reporting to the Finance and Expenditure Committee and the publication of the *Financial Stability Report*.

Costs and Benefits

Macro-prudential tools may be helpful in managing financial system risk and leaning against the credit cycle. However, implementation of these policies also comes with challenges. In some circumstances they might not work as intended. Potential issues include:

- Enforcement - some macro-prudential instruments, such as LVR restrictions, may be subject to avoidance issues unless rigorously enforced.

- The risks of financial disintermediation – macro-prudential instruments could shift credit growth to sectors other than the banks. We might need to consider applying some instruments more widely than just to the banks.

- Cyclical variability – our work has noted that the effectiveness of the CFR and countercyclical buffer in slowing down credit growth could be limited if term debt and capital is easy to issue during booms.

- Equity and distributional issues – for example, LVR restrictions could have a bigger impact on new homebuyers.

- Reversing a macro-prudential intervention – while most tools would be applied during periods of excessive credit growth, there would be a need to switch them off at some point. Timing such reversals could be technically difficult.

Next steps

The Reserve Bank and Treasury will continue to work through specific institutional arrangements that would govern the use of macro-prudential policies. As part of this process we will be consulting with the Minister of Finance in mid-June. This will be followed by the submission of an information paper to the Cabinet Economic Growth and Infrastructure Committee by end-June. We expect to have final arrangements in place and published by the end of 2012.

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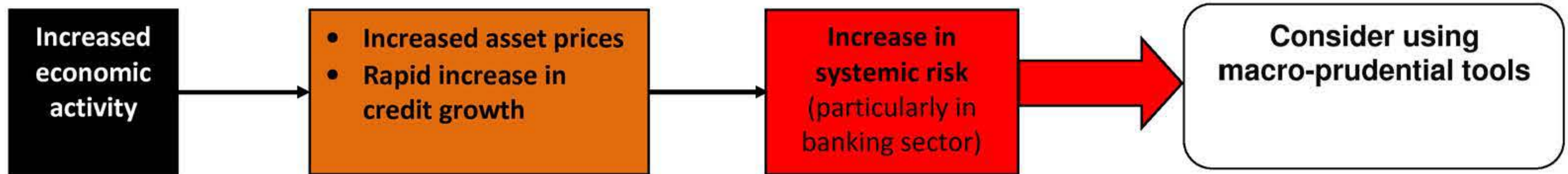
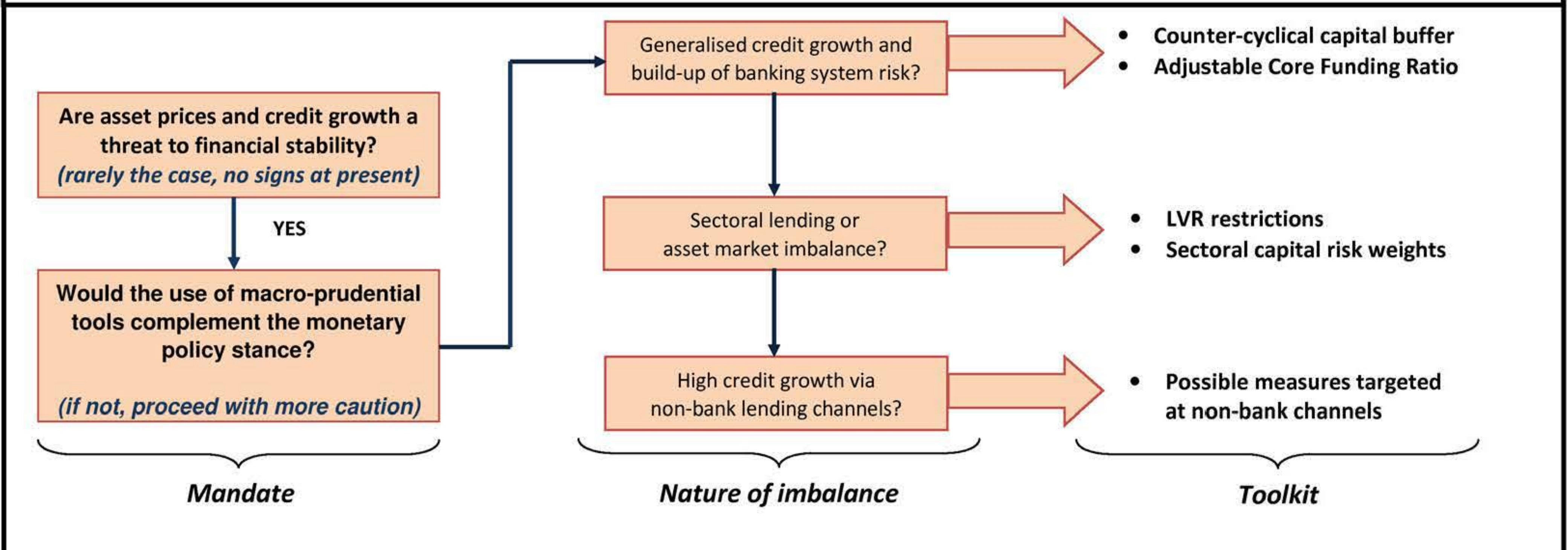
An overview of the macro-prudential policy framework



Core objective: Address systemic risk for a stable and resilient financial system

Primary Goal	**Provide financial system with extra shock-absorbing capacity**
(A more ambitious) Secondary Goal	**Reduce excessive lending during the upswing of the financial cycle**

The decision making process and toolkit



Options for institutional arrangements and accountability

International models

- **Common features:**
  - **Arms length from Government**
  - **Central Bank is a key player**
  - **Varying degrees of Treasury involvement**

- **Decision making rights vary, for example:**
  - **Joint decision-making committee**: *UK*
  - **Central Bank only**: *Ireland*
  - **Consultation, final decision with prudential authority**: *Australia*

Options to be explored for New Zealand

Reserve Bank's Proposed Framework

Decision Making Rights:	Reserve Bank (with framework for consultation with Treasury/Govt)
Governance Framework:	Memorandum of Understanding
Ex-ante accountability:	Existing requirements (e.g. RIA), reporting on conditions (Financial Stability Report)
Transparency options:	Publish decision making process; Consultation ahead of tool deployment;

Alternative Models to be Considered

Decision Making Rights:	Treasury participation (passive/active role)
Governance Framework:	Joint committee; explicit policy targets agreement;
Ex-ante accountability:	Publishing minutes of meetings
Ex-post accountability:	Framework evaluations; periodic performance reviews; international benchmarking

Next steps and timeline