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: 4 December 2012

To: Minister of Finance

DRAFT OF MEMORANDUM OF UNDERSTANDING ON MACRO-PRUDENTIAL POLICY

1. As you will be aware, the Reserve Bank and the Treasury have been considering governance arrangements for the conduct of macro-prudential policy. As part of this work, we have prepared a draft Memorandum of Understanding, which would be an agreement between you and the Bank on the objectives and operating guidelines for macro-prudential policy. A draft memorandum is attached for your consideration.

2. The purpose of the memorandum would be to:

   - Agree the main objective of macro-prudential policy, which would be to increase the resilience of the domestic financial system to the risks arising from credit, asset or liquidity shocks;

   - List the macro-prudential instruments that the Reserve Bank believes could have a useful role to play in the New Zealand context;

   - Note the Reserve Bank's prudential powers under which macro-prudential policy could be conducted;

   - Note our expectation that macro-prudential policy instruments would be deployed infrequently and typically for large credit and asset price cycles;

   - Outline the Reserve Bank's accountabilities and set expectations around the regular publication of the Bank's risk assessment framework and macro-prudential indicators; and

   - Establish expectations about the Reserve Bank's regular consultation with you on matters related to macro-prudential policy.

3. We believe the memorandum would assist in achieving greater public clarity on the role and instruments of macro-prudential policy. While this would be an important step in formalising the macro-prudential framework, agreement would be followed by further public consultation on the instruments and operational details of macro-prudential policy in the New Year.

4. We would welcome your comments on the draft memorandum and an opportunity to discuss it with you at the next Financial System Issues Meeting on 5 December.

Bernard Hodgetts, Head - Financial Stability, Reserve Bank, 04 471 3781
Joanne Hughes, Manager, Financial Markets, The Treasury, [1]

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MEMORANDUM OF UNDERSTANDING BETWEEN THE MINISTER OF FINANCE AND THE GOVERNOR OF THE RESERVE BANK OF NEW ZEALAND

MACRO-PRUDENTIAL POLICY AND OPERATING GUIDELINES

This agreement between the Minister of Finance (the Minister) and the Governor of the Reserve Bank of New Zealand (the Bank) defines macro-prudential policy and the operating guidelines that the Bank shall operate under when considering the use of macro-prudential policy.

The international practice of macro-prudential policy is a developing area and it is expected that the Bank's macro-prudential policy framework will evolve over time. Accordingly, this agreement may be amended from time to time.

The proper purpose for macro-prudential policy that underlies this agreement is provided for in Section 1b of the Reserve Bank of New Zealand Act 1989 (the Act), which requires the Bank to be responsible for "promoting the maintenance of a sound and efficient financial system". In conducting macro-prudential policy, the Bank seeks to reduce or manage the risks to the financial system arising from extremes in the credit cycle or developments in liquidity conditions and global debt markets, through the use of the prudential instruments listed below.

Effective macro-prudential policy depends on the timely use of instruments. This memorandum of understanding (the Memorandum) provides clarity over the purpose and instruments of macro-prudential policy, so that emerging systemic risks are able to be addressed in a timely manner.

This agreement covers the application of macro-prudential policy instruments to the registered banks, which account for the major share of domestic lending to households and businesses in New Zealand. However, it is acknowledged that, in some circumstances, it may be desirable to apply macro-prudential instruments more widely. The Bank will advise the Minister of any proposed changes to the macro-prudential framework that would extend the use of macro-prudential instruments to non-banks, including any changes to the Bank's powers or involvement of other agencies that might be required.

The Minister and the Governor agree as follows:

1. Objective of macro-prudential policy

The objective of the Bank's macro-prudential policy is to increase the resilience of the domestic financial system and counter instability in the domestic financial system arising from credit, asset price or liquidity shocks. The instruments of macro-prudential policy are designed to provide additional buffers to the financial system (e.g. through changes in capital, lending and liquidity requirements) that vary with the macro-credit cycle. They may also help dampen extremes in the credit cycle and capital market flows. As such, these instruments can play a useful secondary role in stabilising the macro economy. As a result, the Reserve Bank will consider any interaction with monetary policy settings when implementing macro-prudential policy and will explain the implications, if any, for monetary policy.

2. Operating guidelines

This agreement confirms the guidelines the Bank will operate under, in discharging its obligations under the Act.

2.1 List of macro-prudential instruments

The following macro-prudential instruments are considered useful in the New Zealand context for addressing the systemic risks of financial instability:

2.1.1. Adjustments to the Core Funding Ratio – a minimum core funding ratio requirement that could vary the proportion of lending the banks are required to fund out of stable ‘core’ funding sources over the cycle, and is intended to reduce the vulnerability of the banking sector to disruptions in funding markets.

2.1.2 Countercyclical Capital Buffer – an additional capital requirement that may be applied in times when excess private sector credit growth is judged to be leading to a build-up of system-wide risk. The buffer would be able to be released when the credit cycle turns down, helping to reduce the risk of a sharp contraction in the availability of credit.

2.1.3 Adjustments to sectoral capital requirements – an additional capital requirement that may be applied to a specific sector in which excess private sector credit growth is judged to be leading to a build-up of system-wide risk.

2.1.4 Quantitative restrictions on the share of high loan-to-value ratio (LVR) loans to the residential property sector. These could include:

- Restrictions on the share of high-LVR lending that banks may undertake;
- Outright limits on the proportion of the value of the residential property that can be borrowed to create a minimum equity buffer for the lender;
- Adjustments to the capital requirements for housing loans according to LVRs.

Development of any additional macro-prudential instruments will be undertaken in consultation with the Treasury, given the Treasury’s role in advising the Government on risks to the Crown’s balance sheet.

2.2 Operation of macro-prudential instruments

The Bank will assess financial system developments, and monitor risks to the system. The Bank will publish information on its risk assessment framework, including the macro-prudential indicators that are used to guide its macro-prudential policy settings. Where significant risks are judged to be emerging, a case for macro-prudential intervention – in the form of deployment of a macro-prudential policy instrument or instruments – will be considered by the Bank. Macro-prudential instruments are however expected to be used infrequently, and typically for large credit and asset price cycles. In most instances macro-prudential instruments will reinforce the stance of monetary policy.

The selection of macro-prudential instrument(s) will depend on the type of risk being addressed.

The decision on macro-prudential intervention will be taken by the Governor.

2.3 Relevant legislation

This section sets out the Bank's prudential powers over the registered banks. Under section 67 of part 5 of the Act, the Bank is charged with undertaking "prudential supervision of registered banks".

Under section 68 of part 5 of the Act, the Bank is conferred with powers for the purpose of "promoting the maintenance of a sound and efficient financial system".

Under section 74 of part 5 of the Act, the Bank may impose conditions of registration relating to a range of specified matters, including "carrying on business in prudent manner".

Section 78 of the Act – Carrying on business in prudent manner. The Bank is confined to considering, inter alia, the following matters:

- (1)(c) "capital in relation to the size and nature of the business or proposed business" – allows the imposition of a counter-cyclical capital buffer and/or sectoral risk weights in the conditions of registration;
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- (1)(fa) – "risk management systems and policies or proposed risk management systems and policies" allows the imposition of the Core Funding Ratio in the conditions of registration.

Section 78(1)(fa) of the Act provides the basis for the implementation of quantitative restrictions on housing loan-to-value ratio limits.

Under section 68B of the Act, "the Minister may direct the Bank to have regard to a government policy" that relates to the Bank's functions under Part 5.

3. Consultation

The Bank will keep the Minister and the Treasury regularly informed on its thinking on significant policy developments relating to macro-prudential policy, and of emerging risks to the financial system.

The Bank will consult with the Minister and the Treasury from the point where macro-prudential intervention is under active consideration, and will inform the Minister and the Treasury prior to making any decision on deployment of a macro-prudential policy instrument.

The Bank will consult with the registered banks prior to deployment of a macro-prudential policy instrument in the manner required under Section 74(3) of the Act.

The Bank will advise the Minister if it considers further legislative change is required to give full effect to any of the instruments outlined in Section 2.1.

4. Reporting and accountability

The Bank's Financial Stability Report will report on matters relating to the soundness and efficiency of the financial system including any build-up of systemic risk, and the reasons for, and impact of, any use by the Bank of macro-prudential policy instruments.

The Bank shall be fully accountable to the Board, Minister and Parliament for its advice and actions in implementing macro-prudential policy, under the normal conventions outlined by the Reserve Bank Act.

The appropriateness and effectiveness of macro-prudential policy decisions will be reviewed on a regular basis. This will include an assessment of the key judgements that led to decisions on whether or not to adjust macro-prudential policy. The Bank will report the results of its assessment in its Financial Stability Report.

The Minister and the Bank agree that a review of the macro-prudential framework shall be conducted after five years.

Hon Mr Bill English	Mr Graeme Wheeler
Minister of Finance	Governor
	Reserve Bank of New Zealand

Dated 2012