The Treasury

Macro-prudential Policy Memorandum of Understanding Information Release

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Release Document

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Office of the Minister of Finance

Chair
Cabinet

FINAL MACRO-PRUDENTIAL POLICY FRAMEWORK

Proposal

1. This paper provides you with an update on the results of the public consultation on macro-prudential policy by the Reserve Bank of New Zealand.

Executive Summary

2. The Reserve Bank has now completed a public consultation on its proposed macro-prudential policy framework.

3. The policy framework includes a suite of four tools for the use of macro-prudential policies in New Zealand. They are:

    a. adjustments to the core funding ratio;
    b. the counter-cyclical capital buffer;
    c. adjustments to sectoral capital requirements;
    d. quantitative restrictions on the share of high loan-to-value ratio loans to the residential property sector.

4. The consultation has resulted in useful feedback that will help inform the Reserve Bank's detailed technical design and implementation of macro-prudential instruments. However, major modifications to the overall macro-prudential framework are not required.

5. Following the completion of the consultation, I now intend to sign a Memorandum of Understanding on Macro-prudential Policy with the Governor of the Reserve Bank and announce the framework in my Budget address (draft memorandum appended).

6. The Memorandum of Understanding:

    a. affirms the Reserve Bank as the independent macro-prudential authority;
    b. lists the tools that would be used for macro-prudential policymaking;
    c. outlines the decision-making process involved before the use of these tools;
    d. details the accountability arrangements that govern the Reserve Bank's operation of this policy.

Background

7. On 4 March I informed you of the Reserve Bank's intention to undertake a public consultation on its proposed framework for macro-prudential policy. The consultation document solicited views on the proposed objectives, instruments and decision-making framework and the potential costs of using macro-prudential policy instruments.

8. The consultation has provided useful feedback that will help the Reserve Bank's detailed technical design of its macro-prudential instruments over the coming weeks. However, the Bank does not believe major modifications to the proposed framework or scope of monitoring are required in light of the consultation. Accordingly, I intend to sign a Memorandum of Understanding with the Reserve Bank prior to the Budget.

9. This note briefly summarises the feedback from the consultation process and the Reserve Bank's responses on some of the points that have been raised. The Bank will publish a summary of submissions over the coming weeks that will consider these issues in further detail.

Comment

The proposed macro-prudential framework

10. Macro-prudential policy would aim to promote financial stability by:

    - Increasing the resilience of the financial system during periods of rapid credit growth and rising leverage or abundant liquidity; and

    - Dampening excessive growth in credit and asset prices.

11. The Reserve Bank proposed a suite of four tools for the conduct of macro-prudential policy in New Zealand, which include:

    a. adjustments to the Core Funding Ratio (CFR);

    b. the Counter-Cyclical Capital Buffer (CCB);

    c. adjustments to sectoral capital requirements (SCR);

    d. quantitative restrictions on the share of high loan-to-value ratio loans to the residential property sector (LVR restrictions). These could be either outright prohibitions, or "speed limits" on the share of lending e.g. only 5% of new housing lending can be for LVR greater than 90%.

12. The benefits of macro-prudential policy instruments come from reducing the risks to the financial system that can arise from unsustainable credit and asset price growth and rising household or business sector leverage. As many countries have experienced in recent years, boom-bust cycles in credit and asset prices can be extremely destabilising for banking systems and can create large economic costs. They can also pose a significant fiscal risk for the government balance sheet. While New Zealand was fortunate not to have experienced the major upheaval in its financial system seen in some countries, macro-prudential policy represents an

important step in reducing the financial system's vulnerability to any such instability in the future.

13. In principle, measures that promote greater financial system stability could be expected to assist in reducing New Zealand's risk premium. One rating agency has also noted that the macro-prudential policy framework could help limit downward pressure on the banks' ratings.

14. The Reserve Bank has noted that one or more of the above tools could be temporarily applied to banks in response to extremes in credit and asset price cycles. While each tool offers benefits in terms of the objectives set out above, there are costs and risks attached to them. These include:

    a. Risks of avoidance and the administrative costs associated with implementing and enforcing the instruments;

    b. Efficiency costs and other unintended consequences associated with regulation or restrictions;

    c. Possible financial sector disintermediation whereby lending shifts to non-bank lenders not subject to the instrument;

    d. Distributional considerations (for example the tools might impact more heavily on different socio-economic segments of the population).

15. Under the proposed framework, the Reserve Bank would consult with the Minister of Finance ahead of making macro-prudential policy decisions and keep the Minister regularly informed of any conditions that might warrant a future macro-prudential policy response. However, final policy decisions would rest with the Governor of the Reserve Bank. The Bank would account publicly for its assessments and decisions, primarily in its regular six-monthly Financial Stability Reports.

16. The Memorandum of Understanding between the Reserve Bank and myself would:

    a. Set out the objectives of macro-prudential policy and list the macro-prudential instruments;

    b. Outline the Reserve Bank's powers and governance and accountability mechanisms for the conduct of macro-prudential policy; and

    c. Require amendment should the Reserve Bank contemplate changes to the proposed framework e.g. by adding new policy instruments.

A summary of submissions to the macro-prudential consultation

Objectives

17. Submissions were generally supportive of the proposed objectives of macro-prudential policy. However, a few submitters questioned whether additional prudential regulation is needed, particularly given the increase in bank capital and liquidity requirements over recent times. The main rationale is that existing 'micro-prudential' regulation may still not be sufficient to contain a build-up in financial

system risk during extremes in the credit cycle, particularly where it involves substantial increases in asset prices or rising household or business sector leverage. It is not envisaged that macro-prudential tools would be used continuously.

18. Some submitters asked whether macro-prudential tools could more actively assist monetary policy goals, exchange rate management or housing affordability. The Reserve Bank believes such tools will generally support monetary policy but are unlikely to be as powerful as the Official Cash Rate. The tools are not well suited for directly pursuing other economic policy goals and, under its Act, such tools must be used for financial stability purposes. However, to the extent that macro-prudential tools are successful at dampening excessive housing credit and house price cycles they may contribute indirectly to broader policy goals, by keeping future house price growth more in line with economic fundamentals such as income growth.

Loan to Value Restrictions

19. Much of the focus in the submissions was on the use of LVR restrictions. Key concerns were around the potential adverse effects of LVR restrictions on first home buyers, small businesses (some of which borrow using housing as security) and the rebuilding of Christchurch. Some submitters suggested exemptions for such borrowers, or targeting LVR restrictions at regions where high LVR lending is more prevalent.

20. The Reserve Bank's aim would be to apply the restrictions only at times when high LVR lending was judged to be posing a significant risk to financial system stability, and for a limited period. The Reserve Bank advises that while some exemptions are likely to be required to avoid conflict with other Government policy objectives (such as for borrowers under the Welcome Home Loans scheme) or to avoid trapping borrowers with their existing lenders, setting broad exemptions could significantly dilute the effectiveness of the instrument. Targeting LVR restrictions to particular regions is potentially feasible but would entail significant practical difficulties and could create other distortions. Broad-based LVR restrictions are still likely to bite more in regions where credit and house price growth is strongest and house prices particularly elevated.

21. One variant of the LVR restriction proposed in the Reserve Bank's consultation paper would be to set a limit on the share of high LVR lending that banks can undertake in a given period. This would enable banks to continue providing some high LVR loans to creditworthy borrowers. There was support for this approach among the major banks in preference to an outright prohibition.

Avoidance/disintermediation risks

22. Submitters raised avoidance risks around LVR restrictions, including the potential for borrowers to use unsecured lending to top up their deposit, or 'gaming' through reclassification of lending away from housing or manipulation of loan valuations. Although borrowers could turn to unsecured lending, banks typically charge higher interest rates on such lending and have tighter credit processes, so there would still likely be some dampening effect on credit growth. The Reserve Bank will be tightening its policies around loan valuations and definitions to mitigate gaming risks.

23. It was suggested that the use of macro-prudential tools could displace lending away from banks towards lenders not subject to the instrument. For example, some lending could be picked up by finance companies funded through wholesale markets. The Reserve Bank acknowledges that some degree of disintermediation is likely when the tools are used. The Bank believes that the risks of disintermediation will be mitigated partly by its intention to use the instruments in a temporary and occasional fashion; also that disintermediation does not matter for the objective of increasing financial system resilience provided the lenders are not part of the core New Zealand financial system (e.g. if they are offshore). The Reserve Bank would monitor for signs of disintermediation, and would consider whether to extend the framework to non-banks once the core framework has been put in place.

Instrument effectiveness

24. Comments about effectiveness focused more on the objective of dampening the credit cycle than on the objective of increasing financial system resilience. Some submitters thought that LVR restrictions would be more effective at dampening the credit cycle and asset prices than instruments such as the counter-cyclical capital buffer or sectoral capital requirements. Faced with an additional capital requirement, some banks might make their buffer over the regulatory requirement smaller, so that actual capital may be largely unchanged. This would result in little impact on funding costs or interest rates for new lending. Moreover submitters suggested that the impact of additional capital or core funding requirements on lending rates would depend on a range of factors, including banks' internal policies and models, the state of equity and debt markets, competitive conditions in lending markets and general economic conditions.

25. These points are largely in line with the Reserve Bank's views. There are a range of factors that the Bank will need to assess – which may vary according to context – when choosing whether and when to deploy macro-prudential instruments, and when selecting an appropriate instrument. Capital and funding based tools may be more effective in building additional resilience into the financial system than directly dampening credit supply or demand, consistent with IMF findings on this topic.

Macro-prudential policy indicators

26. The Bank will publish guidance on the on the indicators and judgements that underlie its macro-prudential policy decisions in its regular Financial Stability Reports. Given the broad range of factors shaping financial system risk, the Bank does not believe it will be able to publish simple thresholds or trigger points for decisions in the manner sought by some submitters.

Conclusion

27. Over the next two months, the Reserve Bank will continue the detailed technical design of its macro-prudential instruments and will incorporate these into its Banking Supervision Handbook and banks' Conditions of Registration, which will set out the operational details of its various prudential requirements. Further consultation with the banks would occur as part of this process. The Reserve Bank has informed me that it does not consider that major modifications to the proposed macro-prudential policy framework are required in light of the submissions received.

28. I intend to sign a Memorandum of Understanding on Macro-prudential Policy with the Governor of the Reserve Bank and announce the framework in my Budget address.

Consultation

29. The Treasury was informed.

Financial implications

30. There are no direct financial implications arising from this paper. The costs of the Review will be met from existing department baselines.

Human Rights

31. There are no human rights implications arising from the paper.

Legislative Implications

32. There are no legislative implications from the proposal in this paper, as the Reserve Bank's existing powers are sufficient:

- Sections 1A(b) and 68 of the Reserve Bank Act (the 'Act') establish the purpose for the implementation of macro-prudential regulations on registered banks in New Zealand, which is to promote the maintenance of a sound and efficient financial system. The powers to implement or adjust countercyclical capital buffers, the minimum core funding ratio, sectoral capital requirements and restrictions on loan-to-value ratios for residential lending are referred to under section 78 of the Act.

- The implementation of any of the instruments listed above would be undertaken under section 74 of the Act, under which the Reserve Bank is able to impose conditions of registration on registered banks.

Regulatory Impact Analysis

33. As per Section 162AB of the Reserve Bank Act, the Reserve Bank will assess the expected regulatory impacts of any macro-prudential policy measures that it may adopt under Part 5 and Parts 5B to 5D of the Reserve Bank Act. It will also assess the regulatory impacts of these measures, at intervals appropriate to the nature of the policy being assessed. The Reserve Bank will provide reports on the assessments to the Minister of Finance and will use the Reserve Bank's semi-annual Financial Stability Report as the primary vehicle for publication of these regulatory impact assessments.

Gender Implications

34. There are no gender implications arising from this paper.

Disability Perspective

35. There are no disability implications arising from this paper.

Publicity

36. I propose to sign the Memorandum of Understanding with the Governor of the Reserve Bank and publicly announce the establishment of the framework.

37. Media enquiries will be handled by my offices, the Reserve Bank of New Zealand, and Treasury.

Recommendations

38. I recommend that Cabinet:

    1. **note** that the Reserve Bank has completed its public consultation on the macro-prudential policy framework.

    2. **note** that the consultation has resulted in some useful feedback that the Reserve Bank expects will help inform its detailed technical design and implementation of macro-prudential instruments.

    3. **note** that the Reserve Bank does not consider that major modifications to the macro-prudential framework are required in light of feedback received from the consultation.

    4. **note** the Reserve Bank's intention to publish a more detailed summary and analysis of submissions.

    5. **note** that the Minister of Finance will sign the Memorandum of Understanding with the Reserve Bank and announce the framework in the Budget address.

Hon. Bill English
Minister of Finance

Date:

Appendix

DRAFT

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 or segment in which excessive 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 new 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.

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 do not replace conventional prudential regulation but may be used from time to time to help manage the risks associated with the credit cycle. 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;
-
- (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

Minister of Finance

Mr Graeme Wheeler

Governor

Reserve Bank of New Zealand

Dated 2013