The Treasury

Macro-prudential Policy Memorandum of Understanding Information Release

June 2013

Release Document

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RESERVE BANK OF NEW ZEALAND

THE TREASURY
Kaitohutohu Kaupapa Rawa

Date: 8 June 2012

To: Minister of Finance

Aide Memoire: Macro-prudential policy frameworks

This note is intended as background ahead of your meeting with the Reserve Bank and Treasury on 13 June.

Introduction

Both the Reserve Bank and the Treasury have previously reported to you on the use of macro-prudential instruments. Macro-prudential policy focuses on the use of various prudential instruments to promote a more stable and resilient financial system, particularly in response to strong domestic credit growth. The 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.[1] Some macro-prudential instruments may also assist in dampening both credit and asset price cycles, although this is not their primary role. These tools are likely to be used infrequently and only during extremes in the credit cycle (unlike monetary policy instruments). A particular challenge of macro-prudential policy is that the benefits (the absence of a systemic financial crisis) are typically long-term and hard to quantify, while the costs are often highly visible and immediate.

There has been considerable international interest in the use of macro-prudential instruments since the crisis and most advanced economies are now working to put formal macro-prudential policy frameworks in place. In New Zealand, the Reserve Bank already has powers under the Reserve Bank Act to use its prudential powers to maintain a sound and efficient financial system. However, as macro-prudential policy represents a new way in which these tools would be used, Treasury and the Reserve Bank are working together to determine the best institutional arrangements for the use of these policies. We expect to have final arrangements operational by the end of this year.

This aide-memoire summarises the Reserve Bank's proposed framework for the use of macro-prudential policy in New Zealand and some of the main alternative models being implemented internationally.

The Reserve Bank's Proposed Macro-prudential Framework

Given its existing mandate, and in view of the fact that the Reserve Bank is responsible for both monetary and financial stability, the Bank proposes to lead the implementation

[1] The Reserve Bank has identified four instruments that could have a role to play in managing future episodes of strong credit growth in New Zealand: a **counter-cyclical capital buffer**, adjustments to the minimum **core funding ratio**, **adjustments to sectoral risk weights** used to calculate bank capital requirements, and **limits on loan-to-value ratios**.

of macro-prudential policy. The key characteristics of the Reserve Bank's proposed framework are:

- **Decision making.** The Reserve Bank has established an internal Macro Financial Committee. The committee considers a broad range of financial indicators, which will be used to help inform any decision to use macro-prudential tools. The final decision would be made by the Governor.
- **Information sharing.** The Bank and Treasury would discuss credit developments regularly, including with the Minister, as part of the FSI meeting process. This would also help coordinate macroprudential policy with any other actions (e.g. fiscal actions) aimed at reducing excessive credit growth.
- **Consultation with Treasury / Minister.** As with monetary policy, the Bank suggests that Treasury should have substantial input into the design of the framework. The Reserve Bank proposes to consult with Treasury and the Minister of Finance at the point where there is a potential case for macro-prudential intervention, but suggests it should take the final decision after that consultation.

Under their proposed framework, the governance and accountability requirements will be the same as for its prudential policies, including:

- **Consultation with banks.** Most macro-prudential instruments would be adjusted by amending commercial banks' conditions of registration, requiring the Reserve Bank to consult before such action is taken (an order-in-council or legislative changes may be required to change requirements for non-bank deposit takers).
- **Reporting.** Financial conditions and policy decisions would be explained in the *Financial Stability Report*. There would also be regular reporting to the Finance and Expenditure Committee.
- **Board oversight.** The Reserve Bank Board would monitor the use of these policies through its regular mechanisms.
- **Transparency.** The Reserve Bank intends to publish the policy framework and decision-making process ahead of implementation.
- **Ministerial oversight.** The Minister may make comments related to this area within the Bank's Statement of Intent (to which the Bank must have regard), and also issue directions. Reviews and performance audits are also available. A memorandum of understanding could formalise objectives and list available tools.

The model's strengths are that it:

- Is simple and cost-effective;
- Makes use of existing expertise within the central bank;
- Allows all the major policies to be handled under one roof;
- Allows for independent and timely decision making; and
- Makes accountability clear.

The model's potential weaknesses are:

- No additional institutional mechanisms to challenge the "house views" formed within the central bank beyond those in the standard prudential policy process;
- Conflicting judgements between monetary and macro-prudential policies could affect public credibility of both;
- Continued concentration of these powers within the central bank, with existing accountability mechanisms noted above; and
- May be harder to coordinate across fiscal policy (e.g. macro-prudential taxes).

Alternative models and the role of Treasury

In addition to the Reserve Bank's framework proposal, the Treasury is also looking at how other countries are adopting institutional models for financial stability, including the use of macro-prudential instruments. While some principles for best practice are emerging, there is no 'one size fits all' approach as arrangements take account of country-specific circumstances.[2] Unlike New Zealand, many countries have separate monetary and prudential regulators, requiring more coordination. The US, for example, has developed a formal multi-agency committee for this reason.

Where the central bank is also the prudential regulator, macro-prudential use of prudential tools has often been made the responsibility of the central bank (e.g. Ireland, Czech Republic). Even in this model, the role of Treasuries vary from active (e.g. Singapore), to none (e.g. Ireland).

In the UK, the government and Treasury have a key role in framework design, but only participate passively in policy decisions – HM Treasury has a non-voting position on the new Bank of England Financial Policy Committee.

Some Treasury participation can have benefits of bringing alternative views to the table and enabling coordination with fiscal policy: some fiscal tools (e.g. certain taxes) could also potentially help build financial system resilience. On the other hand, too much Treasury participation might create a perception that decisions are not being made independently (which international experts suggest is important) – potentially this could be mitigated by making this a policy area Treasury works on independently of the Minister (similar to forecasting).

Next steps

The Reserve Bank and the Treasury are working together to ensure that an appropriate macro-prudential institutional framework along with governance and accountability measures will be in place by the end of this year. As part of this process, we will consider how the risks from a full-integration model could be minimised and the appropriate role for Treasury in the institutional arrangements. We will report to you again in August with a view to having formal arrangements in place and operational by the end of 2012.

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[2] Nier, E, J Osinski, L Jacome, and P Madrid (2011), "Institutional Models for Macro-prudential Policy", IMF Staff Discussion Note, November 1.

An overview of the macro-prudential policy framework

Increased economic activity →
- Increased asset prices
- Rapid increase in credit growth

→ Increase in systemic risk (particularly in banking sector) → **Consider using macro-prudential tools**

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

Mandate

Are asset prices and credit growth a threat to financial stability? ***(rarely the case, no signs at present)***

YES

Would the use of macro-prudential tools complement the monetary policy stance?

(if not, proceed with more caution)

Nature of imbalance → **Toolkit**

Nature of imbalance	Toolkit
Generalised credit growth and build-up of banking system risk?	• **Counter-cyclical capital buffer** • **Adjustable Core Funding Ratio**
Sectoral lending or asset market imbalance?	• **LVR restrictions** • **Sectoral capital risk weights**
High credit growth via non-bank lending channels?	• **Possible measures targeted at non-bank channels**

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

Initial consultations with Minister of Finance / EGI Ministers → RB/Treasury conclude work on framework → Consultation with Minister of Finance → Implementation and publication of framework

June ... ***December 2012***