The Treasury

Macro-prudential Policy Memorandum of Understanding Information Release

June 2013

Release Document

www.treasury.govt.nz/publications/informationreleases/financialsector/macro-prudentialmou

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this information release on the Macro-prudential MOU has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[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

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [2] appearing where information has been withheld in a release document refers to section 9(2)(f)(iv).

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

RESERVE BANK COVER SHEET

REPORT NUMBER	Please contact [1]
DATE	11 October 2011
SUBJECT	Macro-prudential Policy Instruments and Process
AUTHORISED BY	Alan Bollard, Governor
PREPARED BY	Bernard Hodgetts, Head of Macro-Financial Stability, 471-3781
ACTION SOUGHT	Information
TIMEFRAME	Routine
SECURITY CLEARANCE	Routine

MEMORANDUM FOR	**Minister of Finance**
FROM	Bernard Hodgetts, Head of Macro-Financial Stability
DATE	11 October 2011
SUBJECT	**Macro-prudential Policy Instruments and Process**
CONSIDERATION	For your information

---

1 Introduction

At the FSI meeting on 14 September you requested a note describing the macro-prudential policy instruments that the Bank believes have a potential role to play in New Zealand along with the process we would expect to adopt in using them.

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.

While not their primary role, some macro-prudential instruments may also have the effect of dampening the credit cycle and asset price cycles. This may also be helpful in promoting a more stable financial system. However, it has also been of special interest in New Zealand given previous work looking at supplementary monetary policy tools. All our work to date suggests there are no magic bullets here, but some tools may be helpful in managing the credit cycle in the right circumstances.

2 Macro-prudential instruments

We have identified four instruments that we believe could be helpful if and when we face periods of excessive credit growth in New Zealand in the future.

Core Funding Ratio (CFR)

The minimum CFR for banks is now an important part of bank regulation and should work to ensure that bank credit is funded using a greater proportion of retail deposits and longer-maturity term debt than in the past. In general, we would not envisage a need for frequent adjustments to the CFR.

However, were we to face excessive bank credit growth in the future, adjustments to the CFR could be warranted to further mitigate bank funding risks. Our work also suggests that increasing the CFR might help to lean against the excessive credit growth as it would reinforce demand for funding that is typically more expensive than that raised in short-term wholesale markets. This funding cost wedge might be helpful from a monetary policy viewpoint by enabling the OCR to be set lower than otherwise.

Counter-cyclical capital buffers (CCB)

Counter-cyclical capital buffers would involve the application of an additional capital requirement for banks, over and above the minimum Basel requirements, to help mitigate financial system risk arising from excessive bank credit growth. The CCB is part of the recent Basel III proposals. The Basel guidelines are that the buffer be an additional 2½ percent of risk weighted assets. The CCB would be built up during the upswing of the credit cycle and released during the subsequent downturn when banks might need it to absorb credit losses.

Basel guidelines are that the buffer be used only during episodes of exceptionally strong credit growth, not during a more benign cycle (when minimum capital requirements should suffice).

Whilst primarily intended to promote bank resilience to a credit boom, a CCB might help to rein-in credit and asset price cycles by increasing the banks' cost of funds. However, this remains contentious. The potency of the CCB as a tool to help dampen credit growth might be enhanced by a 'moral-suasion' effect as its deployment would send a highly-visible signal to banks, investors, rating agencies and depositors about the RBNZ's unease about credit growth.

Overlays to Basel II sectoral risk weights

Capital overlays (i.e. additional capital requirements) could also be applied on a more targeted basis if lending to particular sectors (eg housing or farming) became excessive. An overlay would help build lenders' resilience to systemic credit risks associated with high credit growth or indebted sectors by requiring them to hold additional capital against such lending.

One of the downsides of an overlay is that it potentially muddies the purpose of the existing Basel II risk weights. Under Basel II, banks are required to adopt 'through-the-cycle' estimates of risk which should be calibrated to economic downturn conditions. Thus in principle, an overlay should be unnecessary for soundness purposes as banks are expected to internalize the risks associated with lending to a particular sector. However, an overlay might still be desirable to deal with a period of irrational exuberance.

Loan-to-Value Ratio restrictions

While Loan-to-Value restrictions on residential borrowing have been widely used in Asia, other countries (eg Sweden, Canada) are increasingly adopting them. LVR restrictions can either be applied as a long-standing limit or 'switched-on' during periods of rapid credit growth characterized by high LVR lending. LVR caps could help to promote greater resilience of the financial system by reducing the accumulation of riskier, high LVR lending. They are also a highly visible and public way of signalling unease about the housing cycle and household debt.

LVR restrictions may assist in stabilizing the housing credit cycle and house price cycles to the extent some high LVR lending may no longer be undertaken. However, international evidence on their effectiveness as a stabilization tool is mixed. LVR caps have not prevented housing cycles in the countries that have used them, but some countries believe they have helped rein-in the cycle to some degree.

3 The Costs and Benefits of Macro-Prudential Policy

While each of the macro-prudential tools outlined above may provide useful benefits by building financial system resilience or leaning against the credit cycle, our work has also focused on the challenges of using such instruments and the circumstances in which they might not work as intended. Some of these issues include:

- Some macro-prudential instruments like LVR restrictions may be subject to avoidance issues unless enforced vigorously.

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

- Cyclical variability – our work has noted that the effectiveness of the CFR as a brake on credit growth could be reduced during a boom if global funding spreads become compressed.

- Equity and distributional issues – for example, LVRs can fall disproportionately 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. For example, a counter-cyclical buffer would be 'released' when there were clear signs that the credit cycle had peaked (this would allow institutions to draw on the extra capital during the subsequent downturn). Timing such reversals can be technically difficult and may conflict with the natural tendency of lenders and financial markets to become more risk averse during a downturn. This may make macro-prudential tools asymmetric in their effect – it may be easier to lean against credit cycles than it is to use such tools to encourage lending during a downturn.

We would need to weigh these issues carefully against the benefits of using any macro-prudential tools.

4 Powers, Governance and Implementation

Under the Reserve Bank Act, the Reserve Bank has powers to implement prudential regulations for banks (typically as a condition of registration) consistent with promoting the soundness and efficiency of the financial system. Variations in the Core Funding Ratio or changes to capital requirements would fall within the Reserve Bank's powers for banking regulation provided we were undertaking them for the purposes of promoting financial stability. Some instruments like LVR restrictions could affect broader economic objectives, such as housing affordability for new homebuyers, and we would need to ensure these issues were taken into account.

If we were to consider applying macro-prudential instruments to non-bank deposit takers, an Order in Council would be required to change capital or liquidity requirements. Other macro-prudential instruments for non-bank deposit takers, like LVR restrictions, would require a change in the Reserve Bank Act, because the Act sets out explicitly the areas for which regulations for deposit takers can be made. We do not have powers to apply prudential requirements of any kind on non-deposit taking lending institutions.

The Reserve Bank Act establishes a clear role for the Bank's Board in monitoring the use of macro-prudential tools as it requires the Board to review the Bank's performance of its various functions that relate to promoting the maintenance of a sound and efficient financial system. The Board has been taking a close interest in our work in this area. We would expect to account publicly on the use of macro-prudential instruments in our *Financial Stability Reports*.

We have been developing our internal processes to help guide decision-making on when macro-prudential interventions might be desirable and what form they should take. It is important to emphasise that we would expect use of macro-prudential tools (or adjustment to existing requirements such as the Core Funding Ratio) to be infrequent. In general, these tools would be deployed only during extremes in the credit cycle and not with the regularity of a monetary policy instrument like the Official Cash Rate. We expect the case for macro-prudential decisions to be considered by the Bank's Macro-Financial Committee, which was established in 2010. We would expect to keep you and Treasury informed about the use of any particular instrument.

Briefly, we would see four key steps in the macro-prudential policy process.

Establishing the Presence of Imbalances

The Bank's Macro-Financial Committee would need to establish the existence of imbalances in credit and asset markets that might warrant deploying macro-prudential instruments (in other words periods of "excessive" credit growth). To support this process, the Macro-Financial Committee now formally considers a range of indicators of credit and asset markets with the aim of reaching a view as to whether credit and asset prices trends might warrant some form of macro-prudential intervention.

Establishing the Case for Macro-Prudential Intervention

The second step would be to establish the case for macro-prudential intervention more fully (assuming we had identified a worsening credit market imbalance). We would need to satisfy ourselves the imbalance was not something that could be addressed more appropriately through monetary policy, or by an adjustment to micro-prudential regulation (such as a poorly calibrated Basel II risk weight).

Determining Possible Options

The third stage would be to select the appropriate macro-prudential instrument. Adjustments to the Core Funding Ratio or Countercyclical capital buffers might be best suited for applying during periods of generalised (excessive) credit growth. Instruments such as Loan-to-Value ratios or sectoral capital overlays would be more suitable for targeting sectoral credit excesses.

During this stage we would need to carefully weigh the costs of using the instrument(s). We would also need to decide which institutions to apply them to. While there is a strong presumption that macro-prudential instruments will largely involve the banks, in some circumstances it might be appropriate to apply them more widely. We would need to give careful thought to the powers we had to do this and discuss with you.

Implementation

Having selected the instrument(s) the final stage would involve calibrating the instrument using our own internal modelling and simulations (analogous to what we do with monetary policy). We would expect to consult with you and the banks (or other financial institutions) before implementing the instrument in question.

5 Conclusion

Having identified a range of macro-prudential options, the Bank has been developing the internal processes for deciding when macro-prudential interventions might be desirable in the future and what form they should take. We are also keeping abreast of international developments in this area, bearing in mind that few countries have fully developed their own macro-prudential frameworks and that experience with the use of particular tools is limited. The Bank for International Settlements, Financial Stability Board and IMF have been undertaking work to establish best practice for macro-prudential policy frameworks and are expected to submit a joint progress report at the November G-20 summit, which we will examine closely.

Our work in this area is for future preparedness. Given current weak credit growth, it is important to note that we see little likelihood of the need to deploy macro-prudential instruments in the short to medium term.