The Treasury

Macro-prudential Policy Memorandum of Understanding Information Release

June 2013

Release Document

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Office of the Minister of Finance

Chair
Cabinet

BACKGROUND PAPER ON MACRO-PRUDENTIAL POLICY FOR NEW ZEALAND

Proposal

1. This paper provides you with background information in advance of the proposed public consultation on macro-prudential policy by the Reserve Bank of New Zealand.

Executive Summary

2. The Global Financial Crisis has highlighted the large economic costs of instability in the financial system. The costs of distress and resulting economic fallout have fallen heavily on households and businesses, and have placed considerable pressure on government balance sheets.

3. The development of macro-prudential policy is one way that countries have responded to the lessons from the crisis. Macro-prudential policy aims to (i) increase the resilience of the financial system and (ii) dampen excessive growth in credit and asset prices to promote financial system stability.

4. The Reserve Bank of New Zealand has proposed 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; and

   d. quantitative restrictions on the share of high loan-to-value ratio loans to the residential property sector.

5. The Reserve Bank and Treasury have developed a governance and accountability framework for the use of these tools. This framework would be made operational through a Memorandum of Understanding signed by the Minister of Finance and the Governor of the Reserve Bank.

6. The Memorandum of Understanding:

   a. affirms the Reserve Bank's role 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; and

   d. details the accountability arrangements that govern the Reserve Bank's management of this policy.

7. The Reserve Bank intends to undertake a public consultation on macro-prudential policy over the next several weeks.

Background

8. The Global Financial Crisis (GFC) has highlighted the significant economic costs that can arise through instability in the financial system. A combination of a sustained period of rapid credit growth, a marked rise in asset prices (particularly for housing), and complex market linkages sowed the seeds for widespread financial sector distress in many countries. Following the failure of the US sub-prime mortgage market, financial systems came under significant pressure, causing major economic disruption. The costs of financial distress and the resulting economic fallout have fallen heavily on households and businesses and have placed considerable pressure on governments' fiscal resources.

9. Recognition of the limitations of the existing approach to financial sector regulation in preventing financial system distress has prompted a fundamental reconsideration of regulatory frameworks. This is leading to widespread changes such as the implementation of new regulatory standards for bank capital and liquidity known as 'Basel III', a reshape of global accounting rules, enhanced disclosure and resolution regimes, better risk management practices and new legislation such as Dodd-Frank in the US.

10. Most countries are also enhancing their existing regulatory frameworks to include a class of policy known as 'macro-prudential' policy. This involves the use of various prudential instruments in the face of rapid credit growth, rising leverage or abundant liquidity – factors that were prevalent in the lead up to the global financial crisis. These instruments are intended to help increase the resilience of the financial system and to dampen excessive growth in credit and asset prices in order to promote financial system stability.

11. Macro-prudential regulation is not intended to replace existing (micro)-prudential regulation. In the New Zealand context, micro-prudential regulation aims to promote the stability of the financial system largely by helping to ensure the prudential soundness of individual financial institutions. For example, bank capital and liquidity requirements take into account the risks banks can be expected to face over an economic cycle, as well as in response to extreme events that could give rise to large losses. In the normal course of events, this framework should be sufficient to promote financial system stability.

12. However, as the GFC illustrated, the financial cycle can be associated with increasing optimism on the part of lenders, borrowers and financial market participants, which leads to an underpricing of risk, an excess of risk taking, and increasingly leveraged household, business and financial sector balance sheets. Macro-prudential policy provides a means of responding to these cyclical pressures in a time-varying manner. This is in contrast traditional to micro-prudential regulations which are not typically varied across the cycle even when the latter becomes extreme. The need for a more dynamic approach may be particularly important when there is an abrupt change of sentiment as the financial cycle turns. This can see lenders and borrowers becoming overly cautious, choking off the flow of credit to the economy, and exacerbating the economic downturn. Macro-prudential policy involves taking specific actions (such as enabling banks to draw on their counter-cyclical buffers) to help ensure credit remains available to creditworthy borrowers in a downturn.

13. Macro-prudential policy aims to address the limitations of the existing approach to regulation in the financial sector. Rather than replacing traditional micro-prudential policy, it adds to and complements it. The macro-prudential authority deploys many of the same prudential instruments, but it explicitly and specifically targets *systemic* risks that *build up over time*.

Comment

Objectives and Tools

14. The proposed objectives for macro-prudential policy outlined in the Reserve Bank's draft consultation paper for macro-prudential policy are:

> "to promote greater financial system stability through:
>
> - building additional resilience in the financial system during periods of rapid credit growth and rising leverage or abundant liquidity; and
> - dampening excessive growth in credit and asset prices".

15. The consultation paper sets out the proposed objectives, instruments and decision-making framework of macro-prudential policy, along with some considerations relating to costs and efficiency. The proposed instrument set includes:

- adjustments to the Core Funding Ratio changing the minimum core funding to vary the proportion of lending that 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;
- the 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, and 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;

- adjustments to sectoral capital requirements – an additional capital requirement that may be applied to a specific sector in which excessive private sector credit growth is judged to be leading to a build-up of system-wide risk; and

- quantitative restrictions on the share of high LVR loans to the residential property sector, that could be applied either as outright limits on loans above a given LVR threshold, or as restrictions on the share of high-LVR lending that banks may undertake.

16. During a boom in credit, macro-prudential tools such as counter-cyclical capital buffers or additional capital requirements on lending to particular sectors would require the banking system to accumulate extra capital at a time when it should be relatively easy to do so. The extra capital buffers would be made available to banks to draw upon during the subsequent downturn, providing them with additional scope to absorb losses. These extra cushions would thus be expected to promote the flow of credit. Similarly, a tightening of core funding requirements would require banks to source a greater share of funding from stable sources such as deposits or long-term debt, with this additional core funding then being available to act as a buffer against funding shocks.

17. Restrictions to high loan-to-value ratio (LVR) lending would increase the amount of collateral held against housing lending, thus enhancing the quality of the banks' lending. The use of such an instrument would of course only be considered during times when an increase in high LVR lending was considered to pose a risk to the stability of the banking system. Its use would be expected to enhance banking system resilience by helping to ensure that borrowers were better able to withstand income and asset price shocks that could force them into default by increasing required borrower equity in the house.

18. Each of these instruments may also act to reduce the build-up of systemic risk to the extent they succeed in slowing down the credit or asset price cycle. Dampening excessive credit or asset price growth would reduce the leverage of both borrowers and lenders, and could help short-circuit any self-propelling feedback between credit growth and asset price growth.

19. Outright LVR restrictions are likely to have the strongest impact on the credit cycle; the impact of tools such as tighter capital or funding requirements is likely to be more indirect. These would primarily work by influencing the cost of funding and hence lending, with higher lending costs likely to reduce the demand for credit.[1] LVR restrictions are also easier to "switch on", shortening the time between policy announcement and implementation.

20. On the downswing of the financial cycle, when credit growth and asset prices slow (or in more extreme circumstances decline markedly), macro-prudential requirements would be eased. Banks would be able to draw down funding or capital buffers, to mitigate the impact of loan losses, or funding and credit market shocks.

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[1] See also forthcoming background paper to the Reserve Bank Consultation on Macro-prudential Policy "Unpacking the toolkit: the transmission channels of macro-prudential policy in New Zealand".

21. For example, if the core funding ratio had been in place prior to the GFC, New Zealand banks would have been better placed to withstand the disruptions to wholesale funding markets that threatened their ability to keep lending. In turn, this would have reduced the need for central bank support in the form of liquidity facilities such as the Reserve Bank's Term Auction Facility.[2]

22. It is important to emphasise that macro-prudential policy is not a 'silver bullet.' The objectives of macro-prudential policy and the use of macro-prudential tools for these purposes is new, and there remains uncertainty around the extent to which macro-prudential tools can deliver. Despite these uncertainties, countries are increasingly adding macro-prudential tools to their financial stability frameworks and developing arrangements under which they would use them.

23. Nearly all G20 countries, including Australia, are in the process of implementing countercyclical capital buffer (CCB) frameworks as part of their Basel III reforms. New Zealand will implement such a framework from 1 January 2014. In addition, many countries are adopting other macro-prudential tools. The most common sectoral tool is LVR limits, but a number of countries are also introducing sectoral capital requirements.[3]

24. It should be noted that macro-prudential policy and monetary policy play quite distinct roles in the Reserve Bank's policy framework, with each having its own goal: the pursuit of financial system soundness and efficiency for the former, and the pursuit of price stability for the latter. Macro-prudential policy tools will be deployed for financial stability reasons and are not intended to be deployed for price stability purposes. However, it is expected that, in most circumstances, measures undertaken to meet macro-prudential objectives will provide support for monetary policy.

25. For example, macro-prudential instruments that help to dampen excessive credit and asset price growth are likely to be of assistance in containing inflation pressures. In the case where macro-prudential and monetary policy requirements are not well aligned, the respective policy areas will coordinate on the appropriate policy mix.

The Reserve Bank as Macro-prudential Authority

26. Internationally, there is no one model for the conduct of macro-prudential policy. In some instances, central banks are being charged with implementing such policy, while in others the authority rests with a separate prudential authority or a combination of the two. For example, the UK is moving to a model where macro-prudential and micro-prudential responsibilities both sit within the Bank of England, while in Sweden,

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[2] For an overview of the TAF refer "New Zealand's emergency measures during the global financial crisis", *RBNZ Bulletin*, June 2011, available at: http://www.rbnz.govt.nz/research/bulletin/2007_2011/2011jun74_2cassinoyao.pdf

[3] Switzerland recently became the first country to deploy a sectoral countercyclical capital buffers, with the announcement that banks will be required to hold extra capital equivalent to 1 per cent of residential mortgage risk-weighted assets. The measure is a response to strong growth in both bank credit and real estate prices, which is judged to have resulted in imbalances on the residential mortgage and real estate markets that pose a risk to the stability of the Swiss banking sector. See SNB Press Release 13 February 2013, available at: http://www.snb.ch/en/mmr/reference/pre_20130213/source/pre_20130213.en.pdf.

the Riksbank has a financial stability responsibility that sees it make macro-prudential recommendations, while regulatory powers remain with Finansinspektionen (the Swedish regulatory authority).

27. The increased focus on macro-prudential policy has brought with it a growing body of research into the optimal governance arrangements, particularly by the international financial institutions such as the IMF (International Monetary Fund) and the BIS (Bank for International Settlements).[4] Drawing on this work, the Reserve Bank and The Treasury have identified some key features of good governance arrangements.

28. One feature that stands out is the case for an independent macro-prudential authority (be it the central bank or another agency). Decisions to use macro-prudential tools designed to dampen the financial cycle are likely to prove unpopular in the short-term in a similar fashion to changes in monetary policy . The costs of macro-prudential policy often fall on discrete sectors (the financial sector, first home buyers in the case of LVR restrictions), which can make macro-prudential policy especially politically sensitive and subject to lobbying by special interest groups. Given the general unpopularity of these measures, there is always a risk that these tools will be used too infrequently or that decisions will be delayed until too late in the cycle. Policy actions need to be sufficiently early to build buffers and gain traction in leaning against the credit cycle; too late an intervention could risk precipitating a disorderly unwinding of imbalances. Another challenge is that the costs of using such tools tend to be highly visible and immediate, while the benefits (the absence of a systemic financial crisis) are often long-term and difficult to measure or demonstrate.

29. These considerations point to the delegation of macro-prudential decision making to an independent authority free of short-term political pressures and incentives. The case for macro-prudential independence is based on many of the same considerations as is the case for an independent monetary policy authority. Monetary policy independence has proven helpful in insulating decisions on monetary policy decisions from short-term political pressures and maintaining price stability. However, as with monetary policy, the case for independence also rest on there being strong accountability measures in place to help ensure responsible and transparent decision-making.

30. Table 1 sets out the features for effective macro-prudential policy governance, and assesses the Reserve Bank against each feature.

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[4] Refer BIS report on "Central bank governance and financial stability", June 2011, available at: www.bis.org/publ/othp14.pdf;; IMF Staff Discussion Note on "Institutional Models for Macro-prudential Policy", November 2011, available at:www.imf.org/external/pubs/ft/sdn/2011/sdn1118.pdf.

Table 1: Key features of effective macro-prudential policy governance arrangements

Feature	Description	Assessment
1. Mandate and powers	Establishment of a precise mandate is necessary to define accountability of the macro-prudential authority. It also prevents 'gaps', where it is unclear which authority has the responsibility for pursuing macro-prudential financial stability objectives.	• The Reserve Bank Act (the 'Act') already establishes a statutory responsibility for "promoting the maintenance of a sound and efficient financial system". It also provides the Reserve Bank with prudential powers that it can exercise in pursuit of this goal.
2. Policy autonomy	Macro-prudential policies offer long-term benefits (the absence of a financial crisis) but "success" is not easy to demonstrate. However, the costs are often highly visible and immediate. Macro-prudential tools are likely to be unpopular, similar to interest rate tightening in monetary policy. Operational independence allows policymakers to implement unpopular policy. It also improves the credibility and effectiveness of the policy framework.	• The Reserve Bank is already responsible for the independent operation of monetary policy, and for the prudential supervision of financial institutions. Given its existing mandate and technical expertise, it is best placed to independently operate macro-prudential policy. • Given challenges of measuring policy "success", the proposed framework will contain governance arrangements specific to macro-prudential policy. • The Reserve Bank will consult with the Minister and The Treasury on framework design issues, including any new macro-prudential tools, which will need to be agreed by both parties prior to their inclusion in the toolkit. • When considering the use of macro-prudential tools, the Reserve Bank will consult with the Minister and the Treasury, but the final decision will rest with the Reserve Bank.
3. Timely and effective use of macro-prudential tools	Tools need to be deployed sufficiently early to build buffers and head off a boom. It is easiest to do this when the risk assessment and decision-making functions are combined in the same agency.	• The Reserve Bank already combines risk-assessment capacity and the exercise of prudential supervision powers. Maintaining the macro-prudential function within the Reserve Bank will maximise the prospect of timely policy interventions.

Feature	Description	Assessment
4. Accountability	The case for political autonomy should be balanced against certain risks. For example, macro-prudential policy will affect credit allocation decisions. The economic costs arising from its use is likely to fall disproportionately on certain sectors. There may also be large fiscal costs in the event of financial crises. These risks require clear accountability measures.	• The key accountability mechanisms will be (i) transparent reporting through the semi-annual Financial Stability Report (FSR); and (ii) scrutiny by the Reserve Bank Board. • The FSR 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 Reserve Bank Board will review the appropriateness and effectiveness of policy decisions on a regular basis. In addition, the Reserve Bank remains fully accountable to the Board, Minister and Parliament for its advice and actions in implementing macro-prudential policy, as detailed in the Reserve Bank Act. • Regulatory Impact Assessments will be provided and are likely to be delivered via the FSR, as provided for in the Act. A review of the overall framework will be undertaken in five years' time.
5. Effective and efficient risk assessments	The macro-prudential authority needs to be able to monitor the emergence of systemic risks in a timely fashion, requiring access to a range of data and the ability to interpret it, as well as expertise in making judgements around macro-economic risks.	• The Reserve Bank combines expertise in both micro-prudential supervision and systemic risk analysis, and participates in international fora where macro-prudential policy thinking is developing. It is also experienced in monitoring financial market developments, such as trends in wholesale funding conditions, and actively deals in financial markets on a daily basis.
6. Efficient use of a mix of tools	This refers to the ability of the decision-making authority to calibrate the tool mix (monetary, micro-prudential, macro-prudential) to the conditions.	• As a "full-service" central bank, the Reserve Bank would be responsible for the operation of monetary policy, prudential policy and macro-prudential policy functions. This means that major policy trade-offs can be handled under one roof. • Given that these policies can interact with and have an influence on each other, there will be expectations for the Reserve Bank to be transparent about these trade-offs when communicating decisions.

31. Overall, the Reserve Bank is best placed to be the macro-prudential authority in New Zealand, reflecting its existing prudential role, its statutory mandate for financial system soundness and efficiency, and its technical expertise. On the other hand, assigning macro-prudential responsibilities would concentrate more power in the hands of the Reserve Bank, in areas where there may be large economic costs. Governance and accountability measures have been strengthened in consideration of this,

32. The proposed governance and accountability arrangements are set out in the Memorandum of Understanding that we would expect to be signed by the Minister of Finance and the Governor of the Reserve Bank. The memorandum makes it clear that the Minister would need to agree to all instruments that the Bank will be able to deploy as part of its macro-prudential policy. It also sets out the process for consultation and decision-making when macro-prudential intervention is being considered by the Reserve Bank. As such, the memorandum aims to ensure that there is appropriate consultation with the Government at the framework design stage – reflecting the broad economic and fiscal implications of macro-prudential tools – but that instrument deployment is insulated from short-term political pressures.

33. The accountability measures set out in the memorandum are based on the existing mechanisms set out in the Reserve Bank Act. Scrutiny by the Reserve Bank Board and reporting requirements through the semi-annual Financial Stability Report will play key roles. In addition, the framework will be reviewed in five years, given that macro-prudential policy is a new field and international practice is likely to evolve over time.

34. In sum, assigning the macro-prudential policy function to the Reserve Bank leverages the Bank's core skills, and would enable the macro-prudential policymaker to draw on the existing data and the analytical and decision-making expertise of the Bank.

35. In formulating policy, the Bank would be able to explore the full range of options with regard to monetary policy, micro-prudential and macro-prudential policy so as to arrive at the optimal policy mix. It would be well placed to do this in a timely manner.

36. Recognising the potential costs of financial system failure to the wider economy and to the Crown's balance sheet, the case for independence is matched by a case for stronger accountability, transparency, and governance.

Frequency of Macro-prudential Intervention

37. Macro-prudential policy aims to mitigate excesses in the financial cycle during periods in which credit and asset price growth are judged to have become disconnected from economic and financial system fundamentals. The 'through-the-cycle' calibration of micro-prudential policy means that the prudential requirements around banks' capital and liquidity positions already factor in the normal ups and downs of the economic cycle.

38. Macro-prudential policy is thus not aimed at managing the risks associated with normal business cycles, but at mitigating the risks that arise when credit cycles become extreme. Accordingly, macro-prudential instruments are not expected to be employed continuously through time but would be switched on in exceptional conditions.

39. It is difficult to be definitive regarding the likely frequency of use of macro-prudential instruments. However, looking back over the past twenty years, the evidence suggests a significant build-up of financial system risk occurred between 2003 and 2006. During this period, asset price gains significantly outstripped income growth, with house prices rising sharply relative to income, and farm prices rising sharply relative to farm product returns. Aggregate private credit growth accelerated from 2005, reflecting buoyant house price growth and easy credit conditions.

40. As the Reserve Bank has outlined in its regular Financial Stability Reports, these developments created significant vulnerabilities for the financial system. While credit and asset markets in New Zealand did not experience the disorder seen in many countries following the GFC, the rise in leverage at that time (particularly among households and farms) still remains a source of vulnerability today.

41. Therefore, had a macro-prudential policy framework been in place at that time, it is very likely that the Reserve Bank would have been actively investigating the case for macro-prudential intervention.

42. A key determinant of the frequency of macro-prudential intervention will be the financial cycle. International studies find that financial cycles have a much lower frequency than the traditional business cycle, which is also generally the case in New Zealand.[5] The financial cycle is a necessary phenomenon and macro-prudential intervention would not try to prevent its normal ups and downs; it would be targeted at periods of excessive growth in credit and asset prices, or when there is a serious disjuncture between the New Zealand cycle and the international cycle.

Conclusion

43. The Reserve Bank has been developing a framework for macro-prudential policy drawing on lessons learned from the Global Financial Crisis. The GFC showed the potential for significant economic damage following extremes in credit and asset price cycles.

44. Proposed governance arrangements for New Zealand would see responsibility for the use of macro-prudential instruments resting with the Reserve Bank, under terms and conditions agreed in a memorandum of understanding between the Bank and the Minister of Finance. The Bank's responsibility for macro-prudential policy would reflect its existing role and technical expertise, and the ability to coordinate the monetary, micro-prudential and macro-prudential policy functions.

45. Accountability measures would be in place to balance this additional power, including scrutiny by the Reserve Bank Board, and through regular reporting in the Bank's Financial Stability Reports. In addition, the framework would be reviewed in five years time. The Minister of Finance and Treasury would be consulted when policy instruments are likely to be used.

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[5] Claude Borio (2012), "The financial cycle and macroeconomics: what have we learnt?" BIS *Working Paper No 395*, December.

Consultation

46. The Department of Prime Minister and Cabinet was informed.

Financial implications

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

Human Rights

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

Legislative Implications

49. 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

50. 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 intends to 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 is likely to use the Reserve Bank's semi-annual Financial Stability Report as a vehicle for regular publication of these regulatory impact assessments.

Gender Implications

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

Disability Perspective

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

Publicity

53. On conclusion of the public consultation period and following any revisions to the Memorandum arising from the consultation, I propose to sign the Memorandum of Understanding with the Governor of the Reserve Bank and publicly announce the establishment of the framework.

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

Recommendations

55. I recommend that Cabinet:

1. **note** that the Reserve Bank will be publicly consulting on the proposed macro-prudential policy framework;

2. **note** the attached draft public consultation document and draft Memorandum of Understanding; and

3. **note** that the Minister of Finance will sign the Memorandum of Understanding on conclusion of the public consultation period and following any revisions arising from the consultation.

Hon. Bill English
Minister of Finance

Date:

Annex 1: Draft Consultation Paper

Macro-prudential policy instruments and framework for New Zealand

The Reserve Bank invites submissions on this Consultation Paper by 9 April 2013. Please ensure that responses are sent in before the closing date. Submissions received after this cannot be considered.

Submissions and enquiries about the consultation should be addressed to:

Attention: Bernard Hodgetts
Head of Macro-Financial Stability
Financial Markets Department
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

Email: macroprudential@rbnz.govt.nz

When responding, please state whether you are doing so as an individual or on behalf of an organisation.

Please note that a summary of submissions may be published. If you think any part of your submission should properly be withheld on the grounds of commercial sensitivity or for any other reason, you should indicate this clearly.

March 2013

1.0 BACKGROUND

1. Following the Global Financial Crisis (GFC), there has been considerable international focus on reducing risks to the financial system. These risks may be created by a build-up of leverage and rapid credit and asset price growth. They may also arise from the financial system's collective reliance on unstable sources of funding. If the risks to the financial system are not properly managed they have the potential to undermine the ability of the system to perform its financial intermediation role and cause significant damage to the broader economy (Ha and Hodgetts, 2011).

2. There has been a growing consensus that regulatory frameworks focusing on the stability of individual financial institutions might not be sufficient in managing risks to the financial system as a whole. This is leading to the development of a policy approach known as 'macro-prudential policy', which uses various prudential instruments to dynamically manage financial system risks.

3. In developing and implementing its own prudential policy framework, the Reserve Bank has always placed considerable weight on the requirement under its Act that it promote the maintenance of a sound and efficient financial system. However, the Reserve Bank has in recent years been considering a range of macro-prudential instruments that could further assist in promoting financial system stability. The 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.

4. The countercyclical capital buffer (CCB) is a macro-prudential instrument within the Basel III framework that is being widely adopted internationally (BCBS, 2010a). As part of the recent Basel III changes to the capital adequacy framework, the Reserve Bank has already consulted on a framework for the CCB (RBNZ, 2012a; RBNZ, 2012b). The Reserve Bank will be formally implementing the CCB framework as from 1 January 2014.

5. The Reserve Bank has also identified several other macro-prudential instruments that may have a role to play in the New Zealand context. These include adjustments to the minimum core funding ratio, sectoral capital requirements, and restrictions on high loan-to-value ratio (LVR) residential mortgage lending.

6. The purpose of this consultation document is to describe and seek preliminary feedback on the full package of macro-prudential instruments. The instrument discussion is for the most part high-level and principles-based, and will feed into a more detailed instrument design process that reflects the outcomes of this consultation. As the technical details of the new instruments are refined, further consultation may be undertaken where necessary.

7. In addition to outlining the proposed instruments, the paper outlines the objectives of macro-prudential policy and the proposed decision-making, governance and accountability framework for the conduct of macro-prudential policy.

8. The macro-prudential framework proposed in this paper relates to the banking system, which currently accounts for most financial intermediation in New Zealand. Capital-based instruments and adjustments to the minimum core funding ratio would directly apply to locally incorporated banks (around 90 percent of the total assets of the New Zealand banking system), while loan-to-value restrictions would apply to all registered banks. When the CCB is imposed, Basel III reciprocity arrangements would also see foreign bank branches required to hold extra capital against their New Zealand exposures.

9. It is recognised that in some circumstances it may be desirable to extend the perimeter of macro-prudential regulations to capture other financial institutions. Should an extension of macro-prudential regulations be contemplated in the future, the Reserve Bank would expect to undertake additional public consultation setting out its proposals. Consultation would also be undertaken should any additional macro-prudential instruments be identified.

2.0 OBJECTIVES

10. The objectives of macro-prudential policy are to promote greater financial system stability through:

    - building additional resilience in 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. Measures to dampen credit and asset price growth can promote financial stability by strengthening private sector balance sheets, reducing the impact of asset price falls on banks' balance sheets and helping to reduce incentives for speculative behaviour. Such behaviour has the potential to become self-propelling, contributing to destabilising boom-bust cycles in credit and asset prices.

12. In turn, boom-bust financial cycles risk setting off a destabilising feedback loop between the real economy and the financial system that can have significant and lasting economic costs (BCBS, 2010b). The GFC is a recent notable example: a crisis that originated in the banking system sent many countries into deep recession, with large-scale job losses and significant falls in household income and wealth. As such, macro-prudential interventions that reduce the frequency and severity of financial crises will have broader economic and welfare benefits.

13. It is expected that, in most circumstances, measures undertaken to meet macro-prudential objectives will provide support for monetary policy in its role of maintaining price stability. For example, macro-prudential instruments that help to dampen excessive credit and asset price growth are likely to be of assistance in containing inflation pressures. Monetary policy, for its part, is required to monitor asset prices and to have regard to the soundness and efficiency of the financial system in its pursuit of price stability.

14. 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.

15. 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.

3.0 INSTRUMENTS

16. Table 2 classifies the proposed macro-prudential instrument set according to the nature of the risk that each instrument is designed to address, and whether or not the instrument targets generalised risks to the financial system or specific ‘at-risk’ sectors.

Table 2: Macro-prudential instruments

Nature of risk	Generalised	Specific
Banking sector leverage	Countercyclical capital buffers Adjustments to core funding ratio	Sectoral capital requirements
Household sector leverage		Restrictions on high-LVR lending
Maturity transformation	Adjustments to core funding ratio	

17. Tools that target excessive leverage in the financial system include the countercyclical capital buffer and sectoral capital requirements. Both of these directly affect the gearing of lenders’ balance sheets, whereas restrictions on high-LVR lending improve the quality of lenders’ assets by requiring borrowers to provide a greater proportion of equity. At the same time they constrain the build-up of leverage on household balance sheets. Adjustments to the minimum core funding ratio reduce maturity transformation risk by requiring lenders to fund their balance sheets using a greater share of stable funding.

18. The remainder of this section discusses each of the instruments in detail, setting out the ways in which they can contribute to the Reserve Bank’s financial stability objectives, and some evidence around their effectiveness.[6]

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[6] See also forthcoming background paper to the consultation “Unpacking the toolkit: the transmission channels of macro-prudential policy in New Zealand”.

3.1 Countercyclical capital buffer[7]

19. The CCB framework aims, during the credit cycle upswing, to provide the banking system with an additional cushion against subsequent losses or sharp increases in risk-weighted assets that may be associated with periods of credit downturn. Release of the CCB during the downturn will help banks to meet regulatory capital requirements without having to cut back on lending to creditworthy borrowers.

20. When risks to the New Zealand financial system are judged to be low, the CCB rate will be set to zero. However, in times of excessive private sector credit growth, banks may be required to hold the CCB, which will provide the banking system with an extra layer of high quality capital (common equity). The CCB rate is typically expected to range up to 2.5 percent of risk-weighted assets; however, there is always the possibility that it may need to be higher.

21. There are three main ways in which banks can meet the CCB requirement:
    1. they can *raise capital*, through equity issues or higher retained earnings;
    2. they can *reduce risk-weighted assets*, by reducing exposures (including lending) or rebalancing away from higher risk-weighted assets;
    3. they can *reduce their voluntary capital buffers*, leaving overall capital ratios unchanged.

22. Where banks raise extra capital to support their lending, this may also increase their cost of funding, at least in the short term. Should banks opt to pass on part of the increased cost of funding to borrowers, this will weigh on the demand for credit, helping rein in excessive credit growth. Imposition of the CCB also sends a strong signal to banks and market participants around the riskiness of lending, and could result in expectations of credit growth and asset price growth being revised downwards, again weighing on demand. On the supply side, the CCB may result in a tightening in credit conditions, as banks reduce lending and tighten lending standards.

23. Cross-country research conducted by the Committee on the Global Financial System (CGFS) suggests that in the short run, banks will typically respond to an increase in target capital ratios by making about half to three quarters of the required change through an increase in capital. The remainder of the adjustment takes place through a reduction of risk-weighted assets of which, in turn, only half is in the form of reduced lending (CGFS, 2012).

3.2 Adjustments to the core funding ratio

[7] The Reserve Bank sought submissions on the CCB framework in March/April 2012 and final policy decisions on the framework have been announced. Details of the CCB framework are included in this consultation paper so as to provide an overview of the complete macro-prudential policy framework.

24. Since 1 January 2013, the minimum core funding ratio (CFR) has required banks to source at least 75 percent of their funding from retail deposits, long-term wholesale funding or capital. A greater use of 'stable' funding sources will make the banking system more resilient by increasing the 'stickiness' of funding during times of market pressure and reducing rollover risk on the stock of wholesale funding. A requirement to use a greater share of stable funding sources could also help lean against the credit cycle, given that banks can only sustain faster credit growth by raising core funding, which is typically more expensive than short-term wholesale funding.

25. However, when there is a significant deterioration in external funding market conditions, downward adjustments to the CFR might also be appropriate. An example could be the global easing in funding conditions leading up to the financial crisis, which fuelled an aggressive expansion in domestic credit. Had an existing CFR been in place, an increase in the minimum CFR could have been considered. Alternatively, when New Zealand banks were unable to access wholesale funding due to systemic stresses in global funding markets, an easing in the CFR requirement would have helped banks manage their way through the stress period without having to shrink their balance sheets.

26. An upward adjustment to the CFR can be met by banks in three main ways:
    i. they can *increase their share of core funding*, by using a greater proportion of retail deposits, term funding or capital;
    ii. they can *reduce their total funding requirement*, by reducing exposures (including lending);
    iii. they can *reduce their voluntary funding buffers*, leaving overall core funding ratios unchanged.

27. The effects of these responses will follow a similar path to the CCB. Any increases in the cost of funding that are passed on to borrowers will weigh on the demand for credit, while credit conditions will tighten should banks choose to reduce lending. Expectations of higher funding costs and consequently slower credit growth could also weigh on expectations of asset price growth. In addition we would expect to see banks tighten liquidity risk management practices in response to the signal of increased funding risk.

28. A downward adjustment to the CFR would work a little differently. In this case, the primary objective will be to provide a safety valve for the system, so that in times of prolonged funding market stress, the CFR requirement does not unduly constrain the flow of credit in the economy or force excessive adjustment to market conditions via bank deleveraging. Banks would be able to temporarily increase their use of short-term wholesale funding, allowing them to maintain the flow of lending.

29. The introduction of the minimum CFR requirement in New Zealand has seen the system CFR rise from a little under 70 percent in October 2008, when the Bank first consulted on the CFR policy, to 85 percent at end 2012. This has reflected both an increased volume of stable funding and relatively low rates of lending growth over the period.

3.3 Sectoral capital requirements

30. Adjustments to sectoral capital requirements (SCR) are conceptually similar to the CCB but target particular sectors of the financial system in which risk is accumulating and posing a threat to the stability of the overall financial system. As with the CCB, sectoral capital requirements work by providing a temporary additional cushion against potential loan losses in a particular sector.

31. Sectoral capital requirements would typically be applied through overlays to sectoral risk weights, say for housing lending or agricultural lending, but could also be applied through a capital add-on that is calibrated as a proportion of banks' risk-weighted exposures to the sector. When sectoral risks are judged to be acceptable, there will be no macro-prudential SCR in effect. Sectoral capital requirements applied via risk-weights would be part of the minimum regulatory capital requirement, whereas a capital add-on would be treated in the same way as the CCB.

32. As well as providing additional loss absorbency capacity, the imposition of additional sectoral capital requirements could alter the relative attractiveness of lending to the targeted sector. Banks might decide to reduce their exposures to the sector if faced with a higher cost of funding. Alternatively, should banks pass on any increased funding cost, a rise in borrowing costs would reduce demand for credit in the sector.

33. Requiring banks to hold extra capital against exposures to a particular sector also sends a strong message to banks and market participants about the riskiness of lending to that sector. It is expected that banks would review their credit practices and pricing policies in that sector, which could see some tightening in credit conditions. Again, expectations of slower credit growth may flow through to asset price expectations, helping mitigate speculative demand.

3.4 Restrictions on high-LVR housing lending

34. Restrictions on high-LVR housing lending provide a supplementary tool for addressing imbalances in the housing sector. They could take the form of an outright prohibition on mortgages that exceed a specified proportion of the property value (the loan-to-value ratio), or quantitative restrictions on the share of high-LVR lending, either as a proportion of the lender's housing loan book or of new housing lending.

35. Binding LVR restrictions would effectively reduce the pool of eligible borrowers, thereby reducing the demand for housing loans, helping to reduce pressure on real estate prices.

36. LVR restrictions would also increase the resilience of the banking system, by increasing the average amount of collateral held against housing loans (i.e. reducing borrower leverage). Lower borrower leverage means that a larger drop in house prices would be required to put a borrower in negative equity. This would translate into fewer loan losses on mortgages as more distressed borrowers would be able to sell or refinance their way out of trouble. The introduction of restrictions on high-LVR lending would require banks to substantially modify their lending practices, resulting in a significant tightening of credit conditions.

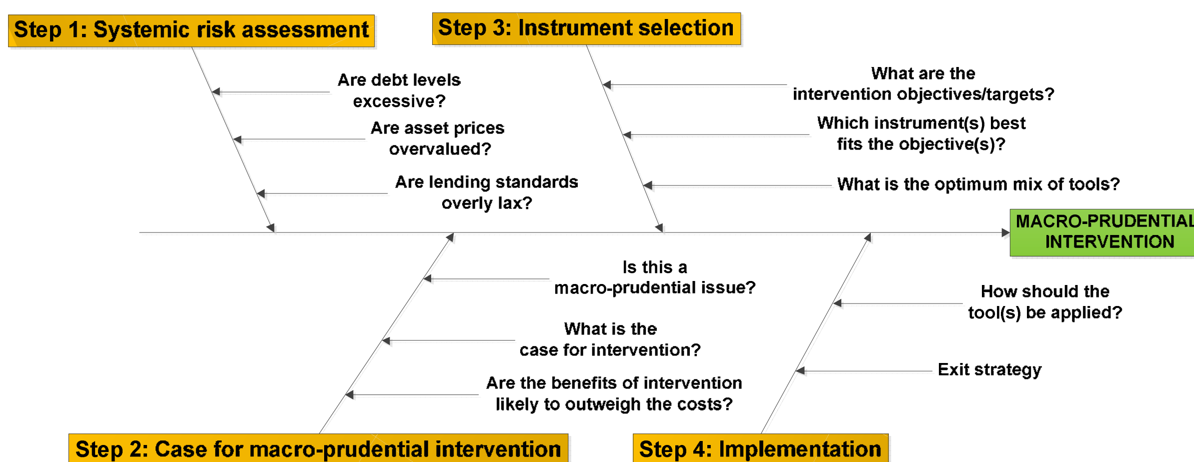
37. Loan-to-value ratios do not capture all forms of risk affecting housing loans. In particular, debt-servicing ability also has an important bearing on the default risk of mortgage lending and some countries have applied restrictions on debt servicing ratios as part of their macro-prudential frameworks. While the Reserve Bank is not contemplating such measures at this time, our regular assessments of financial conditions take into account trends in the household sector's debt servicing burden as well as bank standards applying in this area.

38. LVR restrictions have tended to be used in emerging market economies, although their use is becoming more widespread in OECD countries. Canada, Sweden, Norway and Israel have all implemented some form of LVR restriction in recent years. International evidence suggests that imposing LVR caps during booms slows down real credit growth and house price appreciation. LVR limits also appear to increase the resilience of banks by increasing the resilience of borrowers: several studies find that tighter LVR caps reduce the sensitivity of households to income and property price shocks (CGFS, 2012).

4.0 DECISION-MAKING FRAMEWORK

39. There would be four key steps to the macro-prudential policy process (Figure 11).

Figure 1: The macro-prudential decision framework



40. *Step One* involves a systemic risk assessment and focuses on whether debt levels and asset price imbalances are, or are likely to become, excessive and whether lending standards may be overly lax. A critical judgement will be whether these indicators are deteriorating or improving. In reaching judgements on these matters a range of quantitative (statistical) and qualitative information will be consulted. Table 32 lists some examples of the data that the Reserve Bank is currently monitoring, and the financial conditions that the indicators can help track.

Table 3: Examples of macro-prudential indicators

Type of indicator	Macro-prudential indicator	Purpose
Macroeconomic	Credit	Leverage and credit market conditions
	Household credit	Leverage and credit market conditions
	Business Credit	Leverage and credit market conditions
	Agricultural credit	Leverage and credit market conditions
	Government debt	Leverage
Banking sector	Capital adequacy (actual)	Balance sheet strength
	Non-performing loans	Asset quality
	Sectoral watchlist loans*	Asset quality
	High-LVR lending	Leverage and risk appetite
Market-based	House prices	Asset market condiitons
	Commercial property prices	Asset market condiitons
	Farm prices	Asset market condiitons
	Market funding spreads	Funding and credit market conditions
Qualitative	Bank lending standards	Risk appetite

* *Household, business and agriculture sectors*

41. The Basel Committee on Banking Supervision particularly favours use of the de-trended ratio of credit to GDP (also known as the 'credit gap') as a key guide to macro-prudential interventions (BCBS, 2010b). Historical analysis of New Zealand data suggests that the credit-to-GDP gap should be a useful indicator of excessive credit growth. However, since the crisis, 'credit gap' indicators appear to have become distorted and there is a risk that they might be late in signalling the need for intervention. The Reserve Bank will monitor a broad range of indicators, which is likely to vary over time, and will be supplemented by both market and supervisory intelligence, and stress tests of banking sector resilience. Judgement will be an important part of the decision-making process.

42. *Step Two* considers whether a macro-prudential intervention is warranted or whether other economic policy responses might be appropriate. The existence of imbalances might not be best addressed through a macro-prudential response if the imbalances reflect a mis-calibration of other policies. In addition, it is important to ensure that there has been adequate communication of the risks to banks and the public, as in some cases this may help to change behaviour without recourse to additional prudential measures. There would also need to be a broad assessment of the potential costs of macro-prudential intervention relative to the expected benefits, which would, *inter alia*, consider some of the issues raised in section 5.0.

43. *Step Three* involves selecting an appropriate macro-prudential instrument. In selecting the appropriate tool, it is important to consider the effectiveness of the various tools in meeting the policy objectives: building financial system buffers and reducing extremes in the credit cycle. The likely benefits of the instrument will need to be weighed against the costs of intervention, including any distortions to the financial system or potential leakages. For example, as noted in Section 5.0, LVR restrictions are likely to adversely affect efficiency, and there is a risk of leakage should there be an increase in new lending by the non-bank sector.

44. In some cases, the optimum response might involve using more than one instrument. For example, during a credit boom it might be appropriate to not

only constrain the build-up of leverage in the banking system with the countercyclical capital buffer but also to target high risk borrowing more directly (e.g. through the use of LVR restrictions). Timing will be an important consideration, with notice periods varying according to the macro-prudential instrument (TABLE 4).

Table 4: Notice periods for macro-prudential instruments

Instrument	Notice period
Countercyclical capital buffers	Up to twelve months
Sectoral capital requirements	Up to three months
Adjustments to core funding ratio	Up to six months
Restrictions on high-LVR housing lending	At least two weeks

45. *Step Four* is concerned with how individual tools should be applied. The Reserve Bank favours a discretionary and relatively simple approach to implementation. Macro-prudential instruments will not be applied in a formulaic manner; they will be applied in a forward looking manner; and they will not affect existing loan agreements.

46. In times of financial crisis, a priority will be to ensure that the flow of credit is not unduly constrained, subject to the banking system remaining adequately capitalised. For example, a countercyclical 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 may be technically difficult and may conflict with the natural tendency of lenders and financial markets to become more risk averse during a downturn. This could make macro-prudential tools asymmetric in their effect – it may be easier to lean against credit booms than it is to encourage lending during a downturn.

47. During this decision process and before any implementation decisions are taken, there will be consultation with the Minister of Finance and the Treasury. A *Memorandum of Understanding* (MoU) between the Minister and the Reserve Bank will provide a framework for this engagement, by setting out the agreed objectives, instruments and operating guidelines for macro-prudential policy.

48. In line with the Reserve Bank Act, the Bank's semi-annual Financial Stability Report (FSR) will be a key *accountability* document. The FSR reports on matters relating to the soundness and efficiency of the financial system including any build-up of systemic risk. The Reserve Bank will foreshadow the emergence of financial system imbalances in the FSR, along with the case (or not) for macro-prudential intervention. As part of this process, it is expected that the key macro-prudential indicators will be published and discussed.

49. The appropriateness and effectiveness of macro-prudential policy decisions will be reviewed regularly and reported in the FSR. This will include an assessment of the key judgements that led to macro-prudential decisions as well as a policy impact assessment. As the macro-prudential policy framework evolves, the Reserve Bank is planning to publish more detailed policy pieces outlining various aspects of the framework, either in the FSR or in other Reserve Bank publications.

5.0 COSTS AND BENEFITS

50. The instrument discussion illustrates the ways in which individual instruments, through creating additional capital and liquidity buffers, and mitigating extremes in the financial cycle, can contribute to the overall stability of the financial system. The main benefit of a more stable financial system is reduced risk of financial crisis and associated output losses. The GFC has demonstrated that failures in the financial system can result in significant economic disruption, placing households and business under severe stress, as well as placing considerable pressure on governments' fiscal resources.

51. These system-wide benefits will be weighed carefully against the potential costs associated with each of the instruments. Examples of costs and implementation issues, as well as associated mitigating measures, might include:

    a) The possibility of financial disintermediation – macro-prudential instruments that only apply to locally incorporated banks (i.e., the CFR, CCB and sectoral capital requirements) could displace credit growth to foreign bank branches or the non-bank lending sector (including possibly to lenders based offshore). In the case of the CCB, these risks would be partly mitigated by the reciprocity provisions of Basel III.[8] Similarly LVR restrictions would only apply to registered banks and could induce disintermediation towards the non-bank lending sector, Should there be a substantial risk of financial sector disintermediation, the Bank might need to investigate the possibility of extending the perimeter of macro-prudential regulation;

    b) External market conditions – instruments such as the core funding ratio or CCB may be less effective in leaning against credit growth if global funding spreads become compressed and bank funding is plentiful;

    c) The use of some macro-prudential instruments, such as restrictions on high loan-to-value lending, will likely require the compilation and collection of additional data on lending patterns. In addition these instruments will need to be vigorously enforced and monitored in order to reduce avoidance;

    d) Instruments such as loan-to-value restrictions will tend to directly impede some viable borrowers' access to home ownership and may have broader distributional and equity effects. LVR restrictions may particularly affect new home buyers with little equity;

    e) The possibility that banks might choose to reduce voluntary buffers (funding or capital) to meet the macro-prudential tightening, and on the downswing, that banks might be reluctant to eat into released buffers for fear of markets

[8] The Basel III global standard envisages reciprocity arrangements to help maintain a level playing field between banks that are regulated locally (including the subsidiaries of the Australian parent banks) and foreign banks that are not regulated by the local supervisor (such as the branches of foreign banks operating in New Zealand). Under reciprocity, the CCB that would apply to each bank at a consolidated level would reflect the geographic composition of its portfolio, i.e. a weighted average of buffers across the group's regional operations.

seeing this as a signal of weakness. The latter risk is expected to be partly mitigated by the fact that the release would be system-wide, and driven by systemic rather than idiosyncratic (bank-specific) events.

6.0 REQUEST FOR SUBMISSIONS

52. The Reserve Bank seeks your views on the proposed macro-prudential policy instruments and framework set out in this paper, including:

    a) The use of adjustments to the minimum core funding ratio, sectoral capital requirements and restrictions on high loan-to-value ratio (LVR) mortgage lending as macro-prudential policy instruments;

    b) How banks' lending, funding, pricing and balance sheet management are likely to adjust in response to changes in the minimum core funding ratio, or to changes in aggregate or sectoral capital requirements;

    c) Any operational considerations relating to the imposition of sectoral capital requirements via a risk weight overlay vs. a capital add-on;

    d) The likely impact of restrictions on high loan-to-value ratio mortgage lending, including operational considerations relating to the use of outright limits vs. quantitative restrictions on the flow of high-LVR lending;

    e) The proposed decision-making framework for macro-prudential policy;

    f) The proposed notice periods for the core funding ratio, sectoral capital requirements and restrictions on high-LVR residential mortgage lending;

    g) The likely costs and benefits of the proposed tools.

53. Note that the Reserve Bank is not seeking specific feedback on the operational arrangements for the countercyclical capital buffer as the CCB framework has already been finalised and announced following a consultation in March/April 2012.

54. This consultation will close on 9 April 2013.

GLOSSARY

BCBS – Basel Committee on Banking Supervision
CCB – countercyclical capital buffer
CFR – core funding ratio
CGFS – Committee on the Global Financial System.
FSR – Financial Stability Report
GDP – Gross Domestic Product
IMF – International Monetary Fund
LVR – loan-to-value ratio
OECD – Organisation for Economic Co-operation and Development
RBNZ – Reserve Bank of New Zealand

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ANNEX 2 – DRAFT MEMORANDUM OF UNDERSTANDING

CONFIDENTIAL 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 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;
–
– (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 2013