# The Treasury

## Macro-prudential Policy Memorandum of Understanding Information Release

## June 2013

## Release Document

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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

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

THE TREASURY
Kaitohutohu Kaupapa Rawa

# Treasury Report: Final advice on Macroprudential Memorandum of Understanding

| **Date:** | 7 May 2013 | **Report No:** | T2013/1230 |
|---|---|---|---|

## Action Sought

| | Action Sought | Deadline |
|---|---|---|
| Minister of Finance (Hon Bill English) | **sign** the proposed Memorandum of Understanding with the Governor of the Reserve Bank on 13 May | 13 May 2013 |

## Contact for Telephone Discussion (if required)

| Name | Position | Telephone | | 1st Contact |
|---|---|---|---|---|
| Vinayak Nagaraj | Senior Analyst, Macroeconomic and Fiscal Policy | 04 917 6234 (wk) | [1] (mob) | ✓ |
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## Actions for the Minister's Office Staff (if required)

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|---|
| **Return** the signed report to the Treasury. |

**Enclosure**: No

# Treasury Report: Final advice on Macroprudential Memorandum of Understanding

## Executive Summary

This report provides you with our final advice on the contents of the Macroprudential Memorandum of Understanding that you intend to sign with the Governor of the Reserve Bank of New Zealand.

The Treasury has been involved in the preparation of the Memorandum and has undertaken a review of suitable governance arrangements and is comfortable with the proposed Memorandum of Understanding and considers it fit for purpose.

## Recommended Action

We recommend that you:

a **note** that the Reserve Bank and the Treasury have been working together to establish formal governance and accountability arrangements for the Reserve Bank's proposed macroprudential policy framework

b **note** that the Treasury evaluated a number of institutional models against four evaluation criteria, and reached a view that final arrangements should espouse the following objectives:

(i) the Reserve Bank should lead the implementation of macroprudential policies
(ii) the Reserve Bank should have operational independence with appropriate accountability and transparency measures in place, and
(iii) the ongoing involvement of the Treasury is desirable but should be at arm's length from any decision making to preserve operational independence.

c **note** that the contents of the proposed Memorandum of Understanding would be in the spirit of these objectives, and

d **sign** the Memorandum of Understanding with the Governor of the Reserve Bank on 13 May.

Joanne Hughes
**Manager, Financial Markets**

Hon Bill English
**Minister of Finance**

# Treasury Report: Final advice on Macroprudential Memorandum of Understanding

## Purpose of Report

1. This report provides you with our final advice on the contents of the Macroprudential Memorandum of Understanding that you intend to sign with the Governor of the Reserve Bank of New Zealand.

## Analysis

2. The Reserve Bank and the Treasury have been working together to establish formal governance and accountability arrangements for the Reserve Bank's proposed macroprudential policy framework.

3. The Reserve Bank, through its financial stability mandate, has led the technical development of the policy framework. The Treasury's involvement in this process arises from: (i) its responsibilities for the overall macroeconomic policy framework; (ii) its role as the ultimate bearer of Crown risk; and (iii) its obligation to ensure that institutional and governance arrangements appropriately reflect Ministers' views and interests where possible.

4. The Treasury has been monitoring the development of macroprudential policies for several years. Our initial work in this area concluded that Treasury should focus on establishing transparent and accountable institutional arrangements. Our recent internal work programme, therefore, has focussed on helping to shape and determine a consensus "Treasury view" on what optimal governance and accountability arrangements for the use of macroprudential policies would look like.

**Our approach**

5. We developed four evaluation criteria to assess possible institutional governance and accountability arrangements:

   a. supports high quality decision making
   b. allows for politically independent decision making
   c. creates an enduring framework, and
   d. encourages coordination with other policies.

6. Using these criteria, we evaluated a number of institutional models with varying levels of accountability and Treasury participation. In addition to these models, we also evaluated the costs and benefits of two additional measures:

   a. **The establishment of a Joint Economic Committee[1]** which would help cement existing relationships, and foster more frequent and comprehensive policy dialogue and coordination between the Reserve Bank and Treasury, and

   b. **The costs and benefits of amending the Reserve Bank Act** as part of the final governance and accountability arrangements.

[1] The aim of the committee would be to provide a platform for more policy dialogue between both institutions, while maintaining respect for each institution's operational independence. It would formalise some of the existing relationships that are shared between both institutions, and provide more context to the operational Memorandum of Understanding between the Treasury and the Reserve Bank.

### The Treasury's view

7. Our recommendation is that final governance and accountability arrangements should espouse the following objectives:

   a. The Reserve Bank should lead the implementation of macroprudential policies, but with appropriate institutional governance and accountability arrangements that are robust and adaptable to evolving best practices

   b. A high degree of operational independence for the Reserve Bank is important. At the same time, greater transparency and accountability will ensure higher quality decision making, and

   c. The ongoing involvement of the Treasury is desirable as: (i) the Crown faces large externalities arising from failure to mitigate systemic risk; and (ii) future tools may involve taxes and/or other fiscal/regulatory levers. The Treasury's role, however, should not compromise the operational independence of the Reserve Bank.

8. We believe that the proposed Memorandum of Understanding between the Governor and the Minister of Finance would be in the spirit of these objectives. It would ensure Ministerial buy-in, provide a line of accountability between the Governor and the Minister, and allow the Government to set the goals and objectives of the framework, while still preserving the Reserve Bank's operational independence.

9. This policy agreement defines:

   a. what macro-prudential policy is in the New Zealand context
   b. what the primary objectives of the policy are
   c. what the tools available for use under the policy are
   d. under what circumstances would the tools be considered for use
   e. whether there are secondary objectives aside that would warrant consideration under the policy framework
   f. how decisions would be made
   g. how decisions would be communicated
   h. what arrangements would be in place to govern the decision making process (e.g. Board reviews, regular reporting to the Finance and Expenditure Committee), and
   i. what role each party to the Memorandum of Understanding would play in the framework.

### Future work

10. In addition to the establishment of a Memorandum of Understanding, there are some additional questions that need further work and consideration in the near future:

    [2]

[2]

**c.** **Decision making process.** One of the accountability questions that we face is that “policy success” in the macroprudential context may be very difficult to measure. At the same time, deciding when to use (and withdraw) macroprudential tools is likely to be complex and involve a large degree of judgement. There may, therefore, be some merit in looking at whether the single decision making framework is most suitable in this context. Alternatively, if there is further joint work looking at international practice around decision making models for monetary policy, it may be worth looking at the macroprudential decision making process at that time.

11. In addition, under the Memorandum of Understanding, reviews of our macroprudential arrangements will be conducted every five years. This will enable us to incorporate lessons learned from our experiences as well as international best practice.

## Next Steps

12. You have signalled your intention to sign the Memorandum of Understanding on 13 May, and make an announcement at the Budget speech.

13. Based on our work, we believe that the proposed Memorandum of Understanding provides a suitable level of clarity regarding the governance arrangements for the Reserve Bank’s use of macroprudential policies.

14. We are comfortable with this timeline, and recommend that you sign the Memorandum with the Governor of the Reserve Bank.

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

**MACRO-PRUDENTIAL POLICY AND OPERATING GUIDELINES**

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

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

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

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

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

The Minister and the Governor agree as follows:

## 1. Objective of macro-prudential policy

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

## 2. Operating guidelines

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

### *2.1 List of macro-prudential instruments*

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

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

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

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

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

- Restrictions on the share of new high-LVR lending that banks may undertake;

- Outright limits on the proportion of the value of the residential property that can be borrowed to create a minimum equity buffer for the lender.

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

### *2.2 Operation of macro-prudential instruments*

The Bank will assess financial system developments, and monitor risks to the system. The Bank will publish information on its risk assessment framework, including the macro-prudential indicators that are used to guide its macro-prudential policy settings. Where significant risks are judged to be emerging, a case for macro-prudential intervention – in the form of deployment of a macro-prudential policy instrument or instruments – will be considered by the Bank. Macro-prudential instruments do not replace conventional prudential regulation but may be used from time to time to help manage the risks associated with the credit cycle. In most instances macro-prudential instruments will reinforce the stance of monetary policy.

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

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

### *2.3 Relevant legislation*

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

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

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

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

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

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

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

## 3. Consultation

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

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

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

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

## 4. Reporting and accountability

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

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

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

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