The Treasury

Reserve Bank Act Review Phase 2 Second Consultation Information Release

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Phase 2 of the review of the Reserve Bank of New Zealand Act:

Macroprudential Policy: introduction and review issues.

IEAP presentation
14 December 2018

Structure

A. Macroprudential Policy- introduction and conceptual issues.

B. The review: current policy framework and options for reform

A. What is “Macroprudential”?

Global view after crisis:
Regulation pre-GFC focused on individual institutions: failed to look enough at system-wide (macro) risks.
E.g. if bank A has trouble, can convince its borrowers to go elsewhere (deleveraging can ease risks). But if all banks in trouble, deleveraging is impossible.

“Macroprudential” policy responds to system-wide risk
Build resilience in key parts of system (e.g. extra capital for core banks)
Build resilience during cyclical periods of credit excess (e.g. temporary capital overlays or LVRs)

New Zealand: term “macroprudential” typically used for cyclical policy (only), as this was the post GFC innovation (RBNZ felt ‘system’ risks already part of framework).

Features of (NZ) Macroprudential Policy

Cyclical use of prudential regulation.

Put in extra buffers (bank capital, or borrower equity) during the upswing to increase bank and/or borrower resilience. Can remove the buffers during the downturn (to encourage continued lending)

More consumer facing than typical RBNZ approach.

LVRs and DTIs can affect individual borrowers more directly than most prudential policies. Potential for controversy:

- Is it overreaching to seek to make borrower balance sheets resilient (rather than simply keeping banks safe). How far should RBNZ's objectives go?
- Who should govern the decision?

Uses existing (1989 Reserve Bank Act) powers in new way – agreed in 2013 Memorandum of Understanding (MOU) to consult Minister/Treasury when implementing.

Macroprudential Tools

Tool	Short description
Countercyclical Capital Buffer (CCYB)	Additional capital banks must hold (or face dividend restrictions). Allows losses to be absorbed in a downturn, putting banks in better position to continue lending.
Sectoral Capital Overlay (cyclical)	Additional capital banks must hold in respect of lending to a particular sector (e.g. mortgages). Can be removed in a downturn.
Core funding ratio (cyclical adjustment)	Adjustment to limits on bank's short term wholesale funding. Can encourage prudent funding during boom and reduce 'rollover' problems for banks in downturn.
LVRs	Limits on proportion of mortgage loans to borrowers with small deposits (high LVR).
DTIs	Limits on proportion of mortgage loans that are large relative to borrower income (high DTI)

Macroprudential Tools

Tool	In MOU?	Used in NZ	International (developed market) use since GFC
Countercyclical Capital Buffer	Yes	No	Yes
Sectoral Capital Overlay (cyclical)	Yes	No	Rare
Core funding ratio (cyclical adjustment)	Yes	Yes*	Generally eased
LVRs	Yes	Yes	Yes
DTIs	No	No	Yes

*refers to 2011 delay to planned core funding ratio implementation due to global turmoil

Macroprudential common around world, particularly since 2014

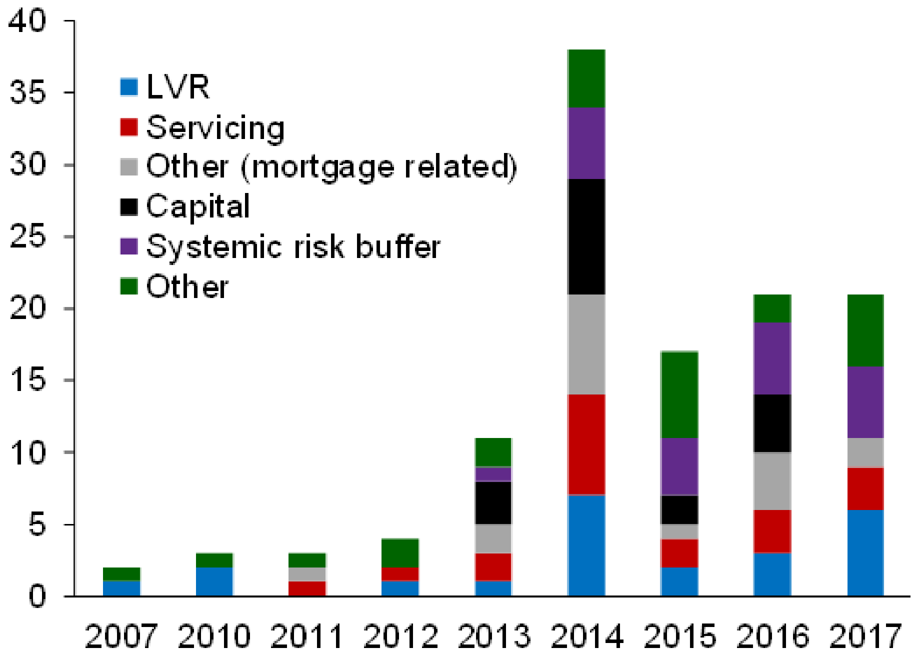


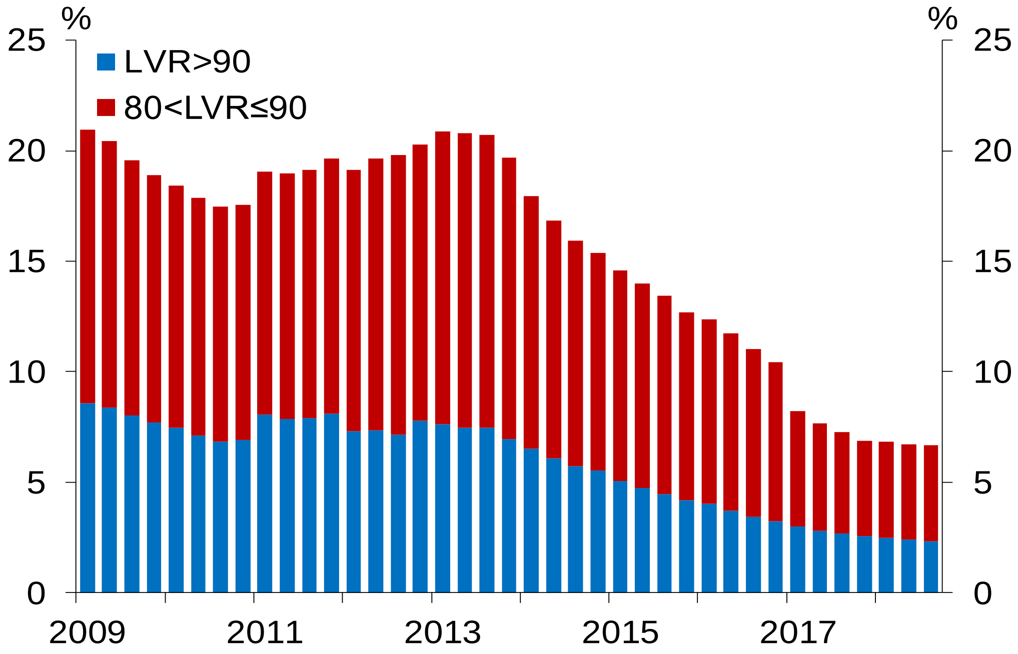
Chart shows number of European policy actions each year. Source: ESRB.

Key Reserve Bank Policy Actions

- LVRs were introduced in 2013, and tightened twice (with the biggest tightening in late 2016).
  - Restrictions implemented via ‘speed limits’ (which places a ceiling on the share of lending at LVRs above a given threshold).
  - 2013 policy reduced high LVR (>80%) lending from around 30% of new housing lending to below 10% of lending.
  - 2016 policy: key effect was to reduce LVRs on investment property to below 60% (2015: controls on Auckland investors only).
- 2017: Reserve Bank advocated limits on mortgage debt relative to borrower income as additional tool in toolkit – issue held for macroprudential review

Macroprudential can increase resilience, even in borrowers

Share of Bank Mortgages Outstanding with High LVRs



But impacts on the financial cycle (e.g. house prices) are more subtle

- As a part of boosting resilience, LVRs or DTIs may reduce house prices and credit growth slightly (2013 changes: perhaps 4% and 2% reductions respectively). Capital tool effects would be even smaller.

- These upswing effects are small relative to other factors driving those variables, so certainly shouldn’t seek to target particular levels (e.g. of credit).

- In downturn, more resilient balance sheets should reduce defaults and help support house prices.

Can Macroprudential help monetary policy?

- This has been considered in NZ at times when currency appears excessively high (eg 2004).
- Macroprudential tightening (especially LVR or DTI) may reduce need to raise OCR: take pressure off exchange rate while still controlling inflation.
- Current view: should be at most a secondary factor – tool also needs to be justifiable on stability grounds.

Who should decide? Conceptual issues

Case for Independent Central Bank	Case for tighter ministerial control
Independent institution may find it easier to take tough decisions (as with monetary policy)	Objectives are difficult to define precisely (compare to monetary policy)
Decision making is very technical and central bank has relevant expertise.	Intrusive nature of policy: should more properly be in hands of Minister*
	Policies are controversial – potential to cause bank reputational damage*

*Issues that apply most strongly to LVRs and DTIs

Who decides? International evidence

- If Central bank is the key bank regulator, they almost always handle CCYB
- Same story for LTV (if it exists) – though a few more exceptions (e.g. US, Netherlands)
- There aren't usually special statutory controls on macroprudential (exceptions – UK, Malaysia), though a statutory interagency council often has recommendation powers.
- Where MOF has explicit role, some tendency for policy to be delayed (CCYB) or quite gentle (e.g. USA and Netherlands max LVRs around 100%)

B. Dimensions of the macroprudential review:

Legislative Framework & Objectives: Currently treated similarly to other RBNZ regulatory decisions for banks. RBNZ act review provides opportunity to reconsider this: most importantly, who should decide, especially on LVRs/DTIs. Should reduce need for MOU (side-agreements).

Toolkit and effectiveness: MOU envisaged 4 potential tools. Most actual policy has related to LVRs. RBNZ has suggested DTIs would be worth adding. With RBNZ’s help, review will re-evaluate evidence on how well policy has worked.

Decision making approach within RBNZ&Accountability: Policy is new and involves more judgement than monetary policy. But review is an opportunity to look for greater systemisation of the policy approach (e.g. RBNZ planning ‘framework’ document).

Key issues relate to LVRs and DTIs

- Time varying capital or liquidity overlays don't seem to need extra governance (relative to permanent capital settings)
- With LVRs/DTIs, the first question is whether these powers should exist.
- If yes, there are a variety of enhanced governance options: e.g. could assign decision to a RBNZ body with external members, and/or could give Minister a veto.
- Can also boost accountability arrangements or provide more detailed objectives (delegated by Government to RBNZ).

The case for LVRs and DTIs

- Housing market downturns can have severe economic effects (Ireland and the US during the GFC for example)

- These effects partly relate to household balance sheet damage: ensuring banks remain solvent (via capital rules) isn’t enough to keep the economy going. LVR/DTIs increasingly common overseas.

- Mortgage credit availability has become more permissive over time, contributing to a rise in house prices relative to income and boosting risks
  - 1989 – NZ households could borrow around 2 times gross income, LVRs expected to be below 75%.
  - Today – some customers can borrow 6-7 times income, first home buyer LVRs often around 90%.

*For more details see the DTI consultation paper on RBNZ website.

Current policy framework

Dimension	Structural features	Explanation
Scope/Objectives	Part 5 Powers (banks) Soundness/Efficiency Broad (S78) mandate	Implemented using RBNZ part 5 powers to impose conditions on banks (only). Purpose given by part 5. RBNZ can impose conditions in general areas like "risk management systems" (incl LVR)
Governance	Reserve Bank decides MOU: consult Tsy, Mof	Policy decisions made by Reserve Bank But RBNZ committed under MOU to consult.
Implementation	Consult banks Cost-benefit analysis (CBA) New tool – seek MOU change	Must also consult banks/stakeholders. Must undertake CBA as part of consultation docs Expectation MOU will be re-agreed before new tools added
Evaluation	FSR (FEC examines) RBNZ Board, FSAP Consultation, cost-benefit analysis Tsy advice to MOF	RBNZ reports in FSR, Examined by FEC Also reviewed by board, and IMF FSAP RBNZ outlines reasoning, stakeholders comment Treasury advises MOF on RBNZ actions

Macroprudential using existing RBNZ Act powers: assessment.

Part 5 objectives: Agencies in other countries have very similar objectives and use them to conduct macroprudential policy.

Focus on banks: NZ non-bank lending sector is very small**.** There has been very limited evidence of non-banks providing a material channel for LVR avoidance (although Australia is future proofing their regime to account for this risk).

Specific areas that can be regulated: These are written in a broad way (e.g. "risk management systems"). A more precise list empowering types of instruments would be clearer. Could retain ability for MOF to extend list of areas via regulation.

Other workstreams will lead to enhanced macroprudential framework

- Define objectives better and define powers more precisely (Objectives and regulation review)
- Broaden decision making outside RBNZ e.g. require interagency consultation, or non-objection from MOF (Regulation review)
- More prudential options for directing bank lending practices e.g. ‘enforceable standards’ (Supervision review)
- Broaden decision making within RBNZ (Governance review)
- Extend beyond banks (Perimeter review)
- Make policy approach more transparent (describe principles in framework document)

Enhancements using current law and likely broader changes

Dimension	Status Quo	Options	Reason for change
Scope/ Objectives	Part 5 Powers (banks) Soundness/Efficiency Broad (S78) mandate	S68 Govt statements More specific objectives Tighter S78 powers Perimeter extensions	Reduce discretion: more guidance on macroprudential purposes, Define powers more specifically.
Governance	Reserve Bank decides MOU: consult Tsy, Mof	RBNZ Act: require RBNZ to consult MOF. Alter RBNZ decision making (e.g. Board/ FPC).	Broaden decision making. Eliminate need for MOU
Implementation	Consult banks Cost-benefit analysis New tool- seek MOU change	Framework document	RBNZ provides more guidance, based on new scope/objectives from Govt. Discretion reduced.
Evaluation	FSR (FEC examines) RBNZ Board, FSAP Consultation, cost-benefit analysis Tsy advice to MOF	Framework document allows more ex-ante evaluation	Transparency: Stakeholders incl. FEC/Treasury can examine RBNZ actions against framework.

RBNZ to publish framework document

- Will state intermediate objective(s) e.g. "Mitigate and prevent excessive credit growth and leverage"
- Identify relevant tools and develop indicators for choosing between tools, guiding implementation (though policy will remain judgmental)
- Each EU country has relevant framework documents along these lines – generally published by central bank.
- RBNZ currently has MOU, and articles explaining approach. Useful to consolidate into a single source.
- But should this be a voluntary RBNZ publication? Could be led by Minister (through remit and/or charter) or required by legislation.

More fundamental change options
(not recommendations at this point)

- Toolkit reduced (e.g. powers rewritten in a way that takes away LVR power)
- Explicit ministerial veto over use of macroprudential tools, or giving powers to interagency group (e.g. COFR)
- <u>Automatic</u> broad perimeter (e.g. new law that applies LVR and DTI to all lenders)

Steady-state LVR (or DTI) settings?

- NZ LVR restrictions were initially envisaged as temporary and infrequent, but this is unusual globally.
- Internationally, low interest rates have continued to drive asset price booms – LVRs used for longer in NZ, and adopted or strengthened in other countries.
- UK and Ireland are using LVR or DTI with 'speed limits' introduced at a non-binding level, an 'insurance' approach.
- Conclusion: Powers should not be explicitly temporary, but there should be obligation to regularly review, and explain strategy.

Extra slides

Similar financial stability objectives

Country	Key Objective
NZ	promoting the maintenance of a sound and efficient financial system
UK (Bank of England FPC)	protecting and enhancing the stability of the United Kingdom's financial system
Australia (APRA)	promote financial system stability in Australia
Hong Kong (HKMA)	promote stability and integrity of the financial system
Ireland (Bank of Ireland)	stability of the financial system overall

Balancing considerations in NZ

Status Quo: RBNZ seeks to select level of safety that balances (efficiency) costs and (soundness) benefits

Inherently judgemental – how much insurance to buy? But hard to define target (e.g. desired crisis frequency).

Reasoning is technical (i.e. It is difficult to measure how specific policies reduce risk and difficult to measure policy costs)

→ Case for Reserve Bank to prepare the arguments and make implementation decisions (Instrument Independence), but Minister and stakeholders should have some input on judgemental aspects (interpreting goals, measuring costs)

→ For new instruments not covered by S78, Minister has important role of extending powers via regulation (creating additional instruments)

Extending balancing considerations –guidance on macroprudential objectives

- Legislative goal could be qualified – e.g. wider list of ‘principles’ as in NBDT act to inform interpretation of soundness and efficiency
- Standing Government Policy Statement could advise on interpretation of goals (how risk averse to be)

Consultative obligations: Part 5 could require consultation with Minister (and thus Tsy) when using lending standard rules (e.g. LVR/DTI) – RBNZ to have regard for Minister’s view.

Decision Making

- Operational independence seems to make policy more pro-active (IMF advocates it, see NZ FSAP). Macroprudential has similar arguments for operational independence to monetary policy.
- Decisions could be taken by the FPC (if created) or the board (if no FPC, but board becomes governing body):
    - Once framework in place, we think Macroprudential decisions (e.g. tighten LVRs) are less complex than wider prudential framework decisions (e.g. outsourcing policy), though still more complex than monetary policy.
    - Decisions have broad impacts, and external involvement should help boost legitimacy.
- Having a well specified framework would help committee make and explain decisions – particularly useful if committee has external members.

Accountability/evaluation arrangements

- Status Quo: FSR (FEC), Board, FSAP, Consultations incorporating Regulatory Impact Assessments.
- By convention, Consultation docs provided to Minister, Treasury.
- Reserve Bank/Treasury regularly discuss stability developments, policy stance.
- Framework document would aid evaluation of RBNZ policy – can policy be justified on the basis of the pre-announced framework?