TE TAI ŌHANGA
THE TREASURY

13 May 2020

How the Reserve Bank's Large Scale Asset Purchases affect the Crown balance sheet

This document outlines how the Reserve Bank's Large Scale Asset Purchases (LSAPs) affect the Crown's overall balance sheet and net core Crown debt.

Background on LSAPs

LSAPs are an alternative monetary policy tool that the Reserve Bank can use, at the direction of the Monetary Policy Committee. LSAPs support the Monetary Policy Committee's economic objectives of achieving and maintaining stability in the general level of prices over the medium term, and supporting maximum sustainable employment. The LSAP programme is expected to provide support to the economy, build confidence, and reduce interest rates on government bonds.

In March 2020 the Reserve Bank announced that it would begin Large Scale Asset Purchases (LSAPs) of government bonds. In April 2020 the Reserve Bank expanded the scale and scope of its LSAP programme to include Local Government Funding Agency (LGFA) bonds. The Crown has indemnified the Reserve Bank for financial losses arising from LSAPs, to help manage the financial risks associated with the LSAP programme.[1] At the time of publication, the indemnity covers interest rate risk for both government and local government bond purchases and credit risk arising from local government bond purchases.

Effects of LSAPs on the Crown balance sheet

The effects of LSAPs on the Crown balance sheet differs between LSAPs of assets that are already a part of the Crown balance sheet (in particular, New Zealand government bonds) and assets that are not already part of the Crown balance sheet (such as LGFA bonds).

LSAPs of New Zealand government bonds[2]

When the Reserve Bank purchases government bonds through its LSAP programme it issues a liability in the form of settlement cash. Because the Reserve Bank is

---

1 Details of the Reserve Bank's LSAP programme and the indemnity documents can be found on the Reserve Bank's website.

2 This explanation supersedes advice that appeared in a press statement by the Minister of Finance (https://www.beehive.govt.nz/release/govt-backs-rbnz-move-support-economy-lower-interest-rates). At the time the LSAP programme was announced, the Treasury advised that LSAPs would not have an immediate impact on net debt, although total Crown liabilities would be more exposed to changes in interest rates. Following further review of

consolidated into the Crown balance sheet, this means that the consolidated Crown exchanges one liability (a government bond with a specified interest cost and term) for another liability with no set term and a floating interest rate (the Official Cash Rate). This has the following impacts on the Crown accounts:

1. **Increased exposure to interest rate changes:** Government bonds are usually long-dated fixed interest liabilities, whereas settlement cash pays a floating interest rate, so LSAPs increase the Crown's exposure to changes in interest rates.

2. **An initial increase in reported net debt that is expected to reverse over time.** Due to differences between the book value and the current market value of government bonds, reported net core Crown debt initially increases when LSAPs are undertaken. This increase is expected to unwind as lower interest expenses are paid over the lifetime of the bonds. As the impacts to net debt reverse, this effect does not impact the Government's long term fiscal position. The increase and unwind occurs because government bonds are reported in the Financial Statements of Government on an amortised cost basis determined from their value on the day on which they were issued, whereas during LSAPs they must be purchased for their current market value. Bond prices have increased recently as interest rates have fallen, so the Crown will record an initial loss when the bonds are purchased. This initial loss will be offset over time by expected savings on interest payments. The annex elaborates on this effect.

3. **Indirect support to the fiscal position.** Beyond the direct effects on the Crown accounts generated by the two items above, LSAPs of government bonds are expected to support the fiscal position more broadly over time. This is because LSAPs of government bonds lower the government's interest costs and support economic growth. Higher economic growth will increase tax revenue and reduce certain types of expenses (such as unemployment benefit payments).

LSAPs of other assets

When the Reserve Bank purchases an asset that is not already a part of the Crown accounts (such as LGFA bonds), the effects on the Crown accounts differ slightly. In this case the consolidated Crown's assets and liabilities increase equally when the purchases are made – the assets by the amount of the purchase, and the liabilities by the amount of the settlement cash issued. This has the following effects:

1. **Increased exposure to interest rate changes if the Reserve Bank purchases long-dated fixed interest assets.** If the Reserve Bank purchases long-dated fixed interest assets through LSAPs by issuing settlement cash, the

---

the accounting treatment, the Treasury now advises that the Reserve Bank's LSAPs will have an initial impact on net debt, although this will unwind over time, as outlined in point 2 of this section and in the annex.

Crown will be more exposed to changes in interest rates, similar to LSAPs of government bonds.

2. **There is no initial change to reported net debt, but bond values will be updated for market changes over time.** As the bonds were not liabilities of the Crown prior to the LSAP transaction, the initial repricing involved with purchases of government bonds does not occur with other assets. However, unlike government bonds, other assets such as LGFA bonds purchased in the LSAP programme will be repriced for changes in their market value over time and these assets will be reported at their market value in the Financial Statements of the Government.[3]

3. **Indirect support to the fiscal position.** LSAPs of government bonds are likely to affect government bond yields more directly than LSAPs of other assets, but LSAPs of other assets can still support the fiscal position over time. This is because LSAPs of other assets are also expected to support economic growth and help lower interest rates generally across the economy (including interest rates on government bonds). In addition, LSAPs of LGFA bonds will support the financial position of local authorities by reducing their interest expenses on new bond issues.

4. **Increased exposure to credit risk**. The Crown will be exposed to credit risk on the assets it purchases. The magnitude of this credit risk will depend on the specific assets purchased through the LSAP programme. At the time of publication, the only credit risk covered by the indemnities the Crown has given the Reserve Bank for its LSAP programme is credit risk on LGFA bonds. The credit risk for LGFA bonds is very small, and this is reflected in the LGFA's credit rating of AA+ (domestic long term) by international credit rating agencies S&P Global Ratings and Fitch Ratings.[4] If credit losses occur these will impact net core Crown debt when they are recognised.

The financial risks arising from the Reserve Bank's LSAP programme are managed through a risk control framework agreed between the Treasury and the Reserve Bank. Further information about alternative monetary policy can be found at the Reserve Bank's website: www.rbnz.govt.nz.

[3] This treatment has not yet been confirmed through an external audit process.

[4] The LGFA's most recent credit ratings can be found at https://www.lgfa.co.nz/

Annex: Changes to reported net debt arising from LSAPs of New Zealand Government Bonds

This annex elaborates on the increase and subsequent unwind of net core Crown debt that occurs during LSAPs of government bonds due to differences between the current market value of government bonds and their book value recorded in the Crown accounts.

The Reserve Bank's LSAPs of government Bonds will initially increase reported net core Crown debt…

The initial increase arises because:

- Government bonds are recorded as a core Crown liability at approximately the value on the day on which they were issued.
- Government bond prices are now higher than their initial value because interest rates have fallen. As the Reserve Bank is repurchasing from the market at a time when interest rates are low, it must pay a purchase price that is greater than the book value of the debt.
- During LSAPs the Reserve Bank purchases bonds at their current market price using settlement cash. The government bonds held by the Reserve Bank are eliminated when the Reserve Bank's balance sheet is consolidated with the rest of the Crown, which results in the liability for the bonds being derecognised and replaced by higher Reserve Bank settlement account liabilities.
- This difference is recorded as a net loss.

… although this will unwind over time.

This impact is expected to unwind over the life of the bonds as the Crown will be paying the official cash rate on those liabilities, which is expected to be lower than the coupon payments on the bonds.

These effects are recorded in the Financial Statements of Government…

The operating balance before gains and losses (OBEGAL) and net debt are affected in the following ways:

- The up-front loss is reported as a gain or loss on financial instruments, so does not impact OBEGAL but does impact the operating balance and net debt.
- Lower future interest costs are included in OBEGAL (and therefore also the operating balance). Lower interest costs impact net debt year by year (i.e. they are not capitalised up-front).

The up-front losses only appear on consolidation – not on the Reserve Bank's balance sheet – and are not covered by Crown indemnities for LSAPs.

The initial impact on net debt and subsequent unwind will depend on movements in bond prices and the timing and composition of the LSAP programme. At the time of publication, the Treasury expects recorded net debt to initially increase by an amount equal to approximately 10-20% of the value of government bonds purchased. This impact is expected to fully unwind over the life of the bonds. Approximately half of the impact is expected to unwind by the end of the forecast period, in 2024.

At each *Economic and Fiscal Update* the Treasury's fiscal forecasts will include estimated losses arising from the Bank's LSAP programme. The fiscal forecasts will not include any impacts arising from changes to the LSAP programme after the fiscal forecasts are finalised.

These changes in recorded net debt do not affect debt issuance requirements

As the impacts to net debt are largely owing to a timing impact, this accounting treatment of LSAPs does not affect the Government's debt issuance requirements, and does not reflect material fiscal risks associated with the LSAP programme.