The Treasury

Additional Documents Related to Phase 2 of the Reserve Bank Act Review - December 2019 to April 2021 - Proactive Release

June 2021

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RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

TE TAI ŌHANGA
THE TREASURY

Joint Report: Scope of Lending Standards in the Deposit Takers Act

Date:	11 March 2021	Report No:	T2021/518
		File Number:	MC-1-7-3-1-20-1-20

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Agree** to the recommendations **Indicate** whether you wish to discuss this report further with officials **Refer** a copy of this report to the Associate Minister of Finance (Hon Parker)	16 March

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Enzo Cassino	Senior Advisor	[35] (wk)	N/A (mob)	✓
Tamiko Bayliss	Director, RBNZ Act Review	[35] (wk)	N/A (mob)	

Minister's Office actions (if required)

Refer a copy of this report to the Associate Minister of Finance (Hon Parker)

Return the signed report to Treasury.

Enclosure: No

Joint Report: Scope of Lending Standards in the Deposit Takers Act

Executive Summary

1. The recent Joint Report on draft Cabinet recommendations for the Deposit Takers Act (DTA) [T2020/313 refers] noted the DTA will explicitly provide for the Reserve Bank to set standards for property lending, but that regulations would delineate the permitted scope of lending standards and that officials would provide further advice on this delineation. The scope of standards refers to three aspects of macro-prudential policy:
    - The types of lending (e.g. residential, commercial or rural property)
    - The types of borrower (e.g. owner occupier, first home buyers, investors)
    - The type of instrument (e.g. Loan-to-Value Ratio (LVR), Debt-To-Income ratios (DTI), debt servicing restrictions).
2. These aspects of macro-prudential policy need to be either delegated to the Reserve Bank through empowering provisions in the DTA or prescribed through regulation and implemented through an Order in Council on the recommendation of the Minister of Finance. Changes to the calibration of macro-prudential policy instruments within the existing scope of standards would not require additional regulations but the Minister would be kept informed.

3. You agreed [T2021/313 refers] that there will be a statutory requirement for the Reserve Bank to *inform* the Minister of Finance of key financial policy changes. We understand that you would like to know what this statutory provision would mean in practice. It is envisaged that the informing process under the DTA will follow broadly similar steps to the current non-statutory process followed by the Reserve Bank when engaging you and your Office on changes to financial policy.

Recommended Action

We recommend that you:

a **agree** that the types of lending that lending standards may apply to will be prescribed by regulation, leaving the types of borrowers and the types of macro-prudential instruments used to be set by the standards (Reserve Bank recommendation)

Agree/disagree

OR

b **agree** that the types of lending and the types of borrowers that lending standards may apply to and the types of macro-prudential instruments that may be included in lending standards will be prescribed by regulation (Treasury recommendation)

Agree/disagree

c **agree** that the Minister of Finance can make regulations defining or changing the scope of lending standards *only in accordance with a recommendation* of the Reserve Bank (Reserve Bank recommendation)

Agree/disagree

OR

d **agree** that the Minister of Finance can make regulations defining or changing the scope of lending standards *after consultation with* the Reserve Bank (Treasury recommendation)

Agree/disagree

e **note** the Reserve Bank's process for informing the Minister of Finance of key financial policy decisions, as required in the DTA, will be broadly similar to the status quo, i.e., that the Minister will be notified when the Reserve Bank is actively considering a new standard and before the Reserve Bank makes its final decision.

f **indicate** whether you wish to discuss this report further with officials

g **refer** a copy of this report to the Associate Minister of Finance (Hon Parker)

Refer/do not refer

Tamiko Bayliss
Director, RBNZ Act Review

Hon Grant Robertson
Minister of Finance

Joint Report: Scope of Lending Standards in the Deposit Takers Act

Purpose of Report

1. This briefing provides you with further advice on the scope of lending standards in the Deposit Takers Act (DTA). The recent Joint Report on draft Cabinet recommendations for the Deposit Takers Act [T2021/313 refers] noted that the DTA will explicitly provide for the Reserve Bank to set standards for property lending, but that regulations would delineate the permitted scope of lending standards. The Joint Report noted officials would provide further advice on the scope of lending standards.

2. This report also provides further information on the process for the Reserve Bank informing you of changes to financial policy. You agreed [T2021/313 refers] there will be a statutory requirement for the Reserve Bank to inform the Minister of Finance of key policy changes. You requested further information about the process this informing requirement will follow.

Background

3. Macro-prudential policy is designed to mitigate the build-up of systemic risk in the financial system. Systemic risks arise from individual banks not fully taking account of the impact of their internal risk management policies on the overall financial system or the economy. The current framework for macroprudential policy is based on conditions of registration imposed by the Reserve Bank on banks, and the non-statutory Memorandum of Understanding (MoU) between the Minister of Finance and the Reserve Bank signed in 2013. The MoU lists four macro-prudential instruments considered useful in a New Zealand context for addressing systemic risks of financial instability. These instruments are: loan-to-value restrictions (LVRs), countercyclical capital buffers, sectoral capital requirements and adjustments to the core funding ratio. Under the MoU, the Reserve Bank has agreed to 'consult with the Minister and the Treasury' when the Reserve Bank is actively considering changes to macro-prudential policy and to 'inform the Minister and the Treasury' prior to making a decision on policy changes.

4. The MoU is largely a self-imposed constraint on the Reserve Bank in the performance of what, at the time, was a new policy area – both here in New Zealand and internationally in the wake of the global financial crisis (GFC). At the time there was also a lack of clarity about the Reserve Bank's ability to introduce and implement macro-prudential tools. While the framework gives the Reserve Bank decision-rights on the deployment and calibration of macro-prudential instruments, this is limited to the four instruments identified in the MoU. Should the Reserve Bank wish to use additional instruments, it would have to agree with you that they be included under the MoU. In effect, this means the Reserve Bank does not have full 'instrument independence' – i.e. the ability to choose the appropriate macro-prudential instrument to address emerging risks in the financial system (e.g. the ability to use debt servicing instruments). Typically, instrument independence would be considered an integral part of a prudential supervisor's 'operational independence'.

5. Notwithstanding the MoU, there is nothing in the current legislative framework that prevents the Reserve Bank undertaking macro-prudential policy or that circumscribes the choice of prudential instrument. That said, the statutory provision providing for the Reserve Bank's ability to set prudential lending requirements, such as LVRs, is tied to

a provision in the current Act that permits the imposition of conditions of registration relating to 'risk management systems and policies'.

6. The IMF Financial Sector Assessment Programme (FSAP) of New Zealand in 2017 recommended changes to New Zealand's macroprudential policy framework. It recommended that limits on debt-to-income (DTI) ratios should become part of Reserve Bank's macroprudential policy tool kit. The IMF argued DTI restrictions would complement LVR restrictions by addressing remaining financial stability risks and more directly targeting risks arising from high household indebtedness. DTI limits can increase the resilience of the financial system by reducing the probability of defaults and can contribute to the stability of the financial system by reducing demand for loans.

7. The IMF also recommended increasing the transparency around the process for adjustments to the macro-prudential framework and that any accountability arrangements do not jeopardise the "integrity and independence of the macroprudential decision-making process" [p.8, New Zealand: Financial System Stability Assessment, 2017].

8. The framework for macro-prudential policy has been a key focus in Phase 2 of the Reserve Bank Review. In December 2019, Cabinet agreed in principle [DEV-19-MIN-0346 refers] that standards would become the primary tool for imposing regulatory requirements on deposit takers. Cabinet also noted that you expected that powers to regulate lending standards would be explicitly provided for in the DTA and in broadly the same way as other prudential requirements, but that you had asked for further consultation on these powers.

9. The third consultation of the Reserve Bank Review proposed that macro-prudential powers should be subject to the same general framework as other standard-setting powers, and that this framework should empower lending standard tools in relation to property lending (e.g. LVRs and DTIs). Additional tools for other types of non-property lending could be introduced via regulations. The proposal consulted on whether the Reserve Bank should be allowed to set lending standards in relation to any sort of property mortgage, although it noted that an alternative would be to limit the scope of these standards to residential mortgages. For example, under the proposal, the Reserve Bank would be able to impose LVR restrictions on commercial and rural property as well. The alternative option would limit the Reserve Bank's ability to impose LVR restrictions to residential mortgages only, which would be the same as the status quo. The majority of submitters supported the proposal that the Reserve Bank should have the power to set lending standards in relation to residential mortgages. Some bank submitters were cautious about problems with expanding lending standards to commercial or rural property loans.

10. In December 2020, the Reserve Bank Review Steering Committee agreed to recommend to you that the DTA empower the Reserve Bank to set macro-prudential lending standards. The scope of the types of lending covered would be set through regulation. Lending standards were seen as different from other prudential standards as they directly impact the volume of lending rather than affecting the pricing of loans.

Scope of Standards

11. As noted above, the recent Joint Report on the DTA [T2020/313] recommended that the DTA will explicitly provide for the Reserve Bank to set standards for property lending, but that regulations would delineate the permitted scope of lending standards. The scope of standards refers to three aspects of macro-prudential policy:
    - The types of lending (e.g. residential, commercial or rural property)

- The types of borrower (e.g. owner occupier, first home buyers, investors)
- The type of instrument (e.g. LVR, DTI, debt servicing restrictions).

12. These aspects of macro-prudential policy need to be either delegated to the Reserve Bank through empowering provisions in the DTA or prescribed through regulation and implemented through an Order in Council on the recommendation of the Minister of Finance.

13. A clear specification of the scope of lending standards is consistent with the IMF FSAP recommendation for greater transparency around the macroprudential policy framework. The scope of lending standards should be specified in a way that ensures that the Reserve Bank's operational independence is maintained while recognising there may be differences between lending standards and all other prudential tools. The scope of lending standards could be limited by regulation to certain types of lending (e.g. residential property, commercial or rural property) or regulations could also limit lending standards to particular types of borrowers and the use of particular policy instruments (e.g. LVRs and DTIs). However, if instrument independence is constrained by regulation then the policy response to new and emerging risks may be delayed, with systemic risks unaddressed while the necessary regulations expanding the scope of lending standards are put in place.

14. A lending standard-making power that gives the Reserve Bank instrument independence would provide greater operational flexibility for the Reserve Bank to address emerging risks in a timely and effective manner. This circumscribes the Minister's ability to directly influence the use of macro-prudential *instruments*. However, the Minister would be able to manage broader societal preferences and the distributional consequences of macro-prudential policy, as lending standards could not be imposed by the Reserve Bank without regulations specifying the types of lending that such standards could apply to.

The Reserve Bank's view on the scope of lending standards

15. The Reserve Bank prefers that the DTA should empower the Reserve Bank to set the appropriate macro-prudential instruments (e.g. LVRs and DTIs) on different types of borrowers, with the types of lending that instruments may be applied to set in regulation. Empowering the Reserve Bank with instrument independence is consistent with the new financial stability objective the Reserve Bank has been delegated under the new Reserve Bank Bill, and would give it autonomy to choose the optimal policy instrument to achieve its financial stability objective.

16. The Reserve Bank's operational independence and its ability to implement macro-prudential policy would depend on the regulations defining the scope of lending. The Reserve Bank prefers that regulations defining the scope should only be made in accordance with a recommendation of the Bank to the Minister of Finance. This formulation reflects the Bank's designation as the specialist agency, and subject-matter expert, for prudentially regulating the financial sector, acting in accordance with its financial stability mandate. The Minister is not bound to accept a recommendation from the Bank and could freely express their views on a recommendation, including by asking the Bank to re-consider its approach. If the Minister is able to act independently (either contrary to a recommendation of the Bank or on their own initiative) it would raise questions about the basis for the Minister's action. In addition, it could undermine the Reserve Bank's status as the specialist agency and its operational independence to deploy macro-prudential instruments in an optimal manner to address financial stability risks. While regulation making powers under the Financial Markets Conduct Act only require Ministerial consultation with the Financial Markets Authority (FMA) this is likely a reflection of the fact that the FMA is not a policy-making agency.

17. The Reserve Bank is concerned that giving the choice of instrument to the Minister, allowing the Minister to override or reverse instruments that the Bank is deploying (as suggested in the example Treasury gives at paragraph 24 of the paper), not only seriously undermines the Reserve Bank's operational independence, it also exposes the Minister to political pressures. Operational independence is crucial in the deployment of macro-prudential tools as their implementation can often be unpopular (e.g. constraining credit at the upward stage of the business and credit cycle). Providing for the Minister to act on a recommendation from the Bank, thereby relying on the specialist technical expertise of the Reserve Bank, will help insulate the Minister from undue political pressures.

18. The Reserve Bank's preferred framework is consistent with the conclusions by IMF staff conducting the current Article IV review of New Zealand that the Reserve Bank Review is "an opportunity to ensure that the RBNZ has adequate operational autonomy and a sufficient degree of flexibility to respond to financial stability risks by having the full macro-prudential toolkit at its disposal".

19. As an illustration of the policy process under the Reserve Bank's view on the scope of lending standards, we can consider a hypothetical scenario in which the Reserve Bank identifies financial stability risks arising from growth in residential property prices driven primarily by investor demand. The Reserve Bank would recommend to the Minister of Finance that a regulation is required to empower the Reserve Bank to impose lending standards on residential property lending. After the regulation comes into force, the Reserve Bank would apply the policy instruments on the types of borrowers it considers appropriate to address the financial stability risk (e.g. loan-to-value restrictions on property investors). The Reserve Bank would inform the Minister of its decision to apply debt to income restrictions, but there would be no requirement for consultation or approval from the Minister.

The Treasury's view on the scope of lending standards

20. The Treasury prefers that the DTA should empower the Reserve Bank to set lending standards (e.g. LVRs and DTIs) but that any types of macro-prudential policy instruments (e.g. DTIs), types of borrowers and types of lending that may be covered in lending standards needing to be authorised by regulations.

21. It also considers that elected representatives do have a legitimate interest in the appropriate scope of financial stability tools, and the use and continued use of these tools. The Minister should have the ability to make a decision that is different from the Reserve Bank's recommendation, but he or she would need to set out the reasons for the decision and make this publicly available. For example, if the Reserve Bank were considering new lending standards for interest-only mortgages, the Minister could recommend that a tool to ban interest-only mortgages be added to the Reserve Bank's toolkit via regulations, which may differ from the Reserve Bank advice. However, it would still be up to the Reserve Bank to determine whether or not it would be appropriate to deploy this tool.

22. The Treasury considers that given the potential distributional effects of macroprudential instruments and their potential conflicts with wider government objectives, Ministerial approval via regulation should include the types of instrument that may be used by the Reserve Bank. This framework would be similar to the process in the current MoU, in which the development of additional policy instruments beyond the ones prescribed in the MoU requires your agreement to amending the MoU.

23. In the example noted above of financial stability risks in the residential property market, under the Treasury's view on lending standards, the Reserve Bank would consult the Minister of Finance on regulations to empower the Reserve Bank to:
    (i) impose lending standards on residential property lending,
    (ii) impose lending standards on property investors,
    (iii) utilise loan-to-value restrictions.

24. Another example of a different practical outcome under the Treasury and Reserve Bank views would occur if the Reserve Bank were already permitted to set DTIs that restricted lending to both investors and owner-occupiers, and a future Minister wanted to remove the ability for the Reserve Bank to restrict lending on a DTI basis for owner-occupiers. Under the Reserve Bank's proposal, a Minister would be unable to amend the scope of the lending restriction via regulations unless the Reserve Bank recommended the Minister to do so. Under the Treasury view, a Minister could amend the scope in this way, and would only be required to consult with the Reserve Bank prior to doing so and would not require a Reserve Bank recommendation to do so.

Summary of Options for the Changes to the Scope of Lending Standards

	Reserve Bank View	**Treasury View**
Type of lending (e.g. residential property)	Prescribed by regulation	Prescribed by regulation
Type of borrower (e.g. property investors)	Set by standards	Prescribed by regulation
Instrument (e.g. Loan-to-Value restrictions)	Set by standards	Prescribed by regulation

25. Under both the Reserve Bank and the Treasury views on lending standards a decision to adjust the calibration or settings of macro-prudential policy instruments within the *existing* scope of standards (e.g. increasing the level of LVR restrictions on residential property lending) would be made by the Reserve Bank and would not require additional regulations. This is in line with its delegated operational independence to achieve its financial stability objective. The Minister of Finance would be informed of changes to lending standards in line with the new statutory requirement to keep the Minister informed of key financial policy changes. This is elaborated further in the next section.

Process to inform the Minister of Finance on changes to standards

26. You agreed [T2021/313 refers] there will be a statutory requirement for the Reserve Bank to inform the Minister of Finance of key financial policy changes. You requested further information about the process this informing requirement will follow. The DTA is unlikely to be prescriptive about the process for informing the Minister. However, it is envisaged that the process will follow broadly similar steps to the current non-statutory process followed by the Reserve Bank to inform you on changes to financial policy, that is, the Minister is notified (but not consulted, as is required under the current MOU) when the Reserve Bank is actively considering the introduction of a new standard, and before its final decision.

27. The Reserve Bank's Statement of Policy-Making Approach sets out the Reserve Bank's process for setting prudential regulation policy. This includes its approach to interaction with the Government. The Reserve Bank aims to keep the Government informed of its regulatory policy agenda via its regular engagement with the Minister of Finance, sharing consultation papers with the Minister of Finance's office prior to their release, and through its preparation of accountability documents such as the annual

Statement of Intent. The Reserve Bank has a process of sharing consultation papers with the Minister at least two weeks ahead of planned release. This gives the Minister an opportunity to better understand the implications of new policy (but this would not amount to consultation, i.e. there is no formal requirement for the Reserve Bank to seek or consider feedback from the Minister on policy proposals).