The Treasury

Foreign Reserves Framework Information Release

August 2023

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Where this is the case, the relevant sections of the Act that would apply have been identified.

Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

[29] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment

[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

Where information has been withheld, a numbered reference to the applicable section of the Act has been made, as listed above. For example, a [29] appearing where information has been withheld in a release document refers to section 9(2)(d).

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Foreign Reserves - Details and Cabinet process

Date:	27 October 2022	**Report No:**	T2022/2157
		File Number:	MC-1-0

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Agree** to your proposed role during with regard to a financial stability intervention with the foreign reserves. **Agree** to the recommendations for the financial arrangements for the foreign reserves.	Wednesday, 2 November 2022

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Jack Starrett Wright	Senior Analyst, Macroeconomic and Fiscal Policy	[39]	[35]	✓
Renee Philip	Manager, Macroeconomic and Fiscal Policy			

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Foreign Reserves - Details and Cabinet process

Executive Summary

You must agree the Foreign Reserves Management and Coordination Framework (the Framework) with the Reserve Bank (the Bank) by the end of this year. You have asked the Treasury and the Bank to provide further advice and options for additional financial backing for the Bank, as well as on consultation and transparency options to be included in the Framework. Alongside this report, the Bank has provided you with its own advice on the form and approach to financial backing.

Under the 1989 RBNZ Act, the Bank would only be expected to intervene for financial stability purposes under a direction from the Minister of Finance. Under the 2021 RBNZ Act, the Bank has clearer independence to deal in foreign exchange for the purpose of its objectives. The Framework is a mechanism for you and the Bank to agree your role in future financial stability interventions. You should have a formal role, but not as decision maker.

Such interventions would likely occur during broader crises, could have significant fiscal impacts, and could relate to broader Government decision making. The Treasury recommends that the Minister of Finance should be informed of potential interventions and have the opportunity to share information with the Bank, for example related to the government's policy response, that may be relevant to their decision. This would ensure the intervention is fully informed and more likely to be successful.

You have agreed the Framework would increase the level of the foreign reserves – to [29], [37] for intervention purposes and [29], [37] for liquidity management purposes. [29], [37] This higher level would require additional financial backing from the Crown. The Bank currently holds [29], [37] against the current foreign reserves. [29], [37] The Bank recommends this be provided entirely in the form of capital. Treasury recommends instead providing $500m in capital, and [29], [37] an indemnity: this would provide transparency and clearly link the financial resources to the balance sheet risk it is provided for.

[33]

Because agreeing the Framework is a significant policy decision, and because it will require additional financial resources for the Bank that may require a capital appropriation, you may wish to take it to Cabinet ahead of signing the agreement. To support this, we will provide a draft Cabinet paper for your comment. We would like to discuss the approach with you at the Weekly Agency Meeting on 31 October. Subject to your agreement and any revisions, the paper could be submitted for DEV on 16 November and Cabinet on 21 November.

Recommended Action

We recommend that you:

Content of Framework

a **Agree** that the Framework will require the Bank to engage you prior to an intervention for financial stability purposes and provide you an opportunity to comment or share information, as is practical in the circumstances.

Agree/disagree

b **Agree** that the Framework Agreement will include requirements for the Reserve Bank to provide reporting to the Treasury. For example on the state and use of the reserves and the potential costs and benefits of an intervention.

Agree/disagree.

Financial resources

c **Agree** that, subject to further advice from the Treasury and consideration under section 65ZD of the Public Finance Act, you intend to indemnify the Bank for gains or losses due to intervening with hedged reserves [29], [37]

Agree/disagree

d **Agree** to ask Cabinet to provide the Bank [29], [37] capital to operationalise the Framework, noting that you may indemnify the Bank [29], [37] under the PFA subject to your decision in (c).

Agree/disagree

e [33]

Agree/disagree

f [33]

Agree/disagree

g **Note** that the Bank will provide you further advice as part of its broader review of its financial resources in Q1 2023. This may be an appropriate point to revisit the Bank's financial settings.

Noted

h **Note** that the Bank would not be able to fully operationalise the Framework until the financial arrangements are in place. In particular, without the full financial backing it may be limited in its ability to intervene without an urgent capital injection, indemnity, or direction.

Noted

Next steps

i **Note** that Treasury will provide your office with a draft Cabinet paper, reflecting your decisions following this report and the advice of the Reserve Bank.

Noted

j **Agree** that subject to your comments, necessary revisions, and ministerial consultation, the Cabinet paper will be lodged for the 16 November DEV meeting on 11 November, for Cabinet on 21 November. This is likely to result in less than the full 10 days for ministerial consultation.

Agree/disagree

Renee Philip
Manager

Grant Robertson
Minister of Finance

_____/_____/_______

Treasury Report: Foreign Reserves - Further details and Cabinet paper

Purpose of Report

1. You must agree a Foreign Reserves Management and Coordination Framework (the Framework) with the Reserve Bank (the Bank) by the end of this year. Treasury and the Bank have previously provided advice on the key policy issues [T2022/947 refers].

2. You agreed to the increased level and the composition of the reserves, and that you did not have any other objectives for which the reserves should be held. You also asked for further advice on the approach to financially backing the reserves, and the role you, as Minister of Finance, should have in an intervention for financial stability purposes [T2022/1497 refers]. This report provides you with further advice and options on these matters. Alongside this Treasury report, the Reserve Bank has provided you with its own advice on financial backing options.

3. As the Framework is a significant policy decision you are making under legislation you may wish to inform your Cabinet colleagues. Cabinet will also need to agree to provide any additional financial backing through capital. We will provide a draft Cabinet paper for your comment. To meet the legislative timelines, you will need to take this to Cabinet by mid-November.

Content of the Framework

The Minister of Finance should have a formal role, but not as decision maker

4. As Minister of Finance you are responsible for the Crown's balance sheet, and the fiscal risks and costs to the Crown. More generally, the Government is interested in New Zealand's economic resilience and wellbeing – which can be supported by the Bank holding and using the foreign reserves. As financial stability interventions are likely to occur during a broader crisis, such as a pandemic or an earthquake, other Government information or decisions are likely to be relevant to the Bank's response. Treasury is of the view that clearly establishing the Minister's role in the process supports public transparency and ensures the Bank can act independently.

5. Treasury recommends the Framework require that the Bank brief you, as Minister of Finance, before using the reserves to intervene for financial stability purposes. This briefing would be subject to what is practical in the circumstances, and be clear the Bank remains independent in its decision making. This engagement would provide you with an opportunity to share any relevant information you hold to ensure that the Bank's actions are fully informed, and thus more likely to be successful. The Bank would be comfortable with these requirements.

Reporting and transparency requirement

6. To support the Bank's transparent approach, and in light of the new legislation which includes a range of transparency and reporting requirements – including the Framework itself – we think it is important that the Framework includes requirements for the Bank to provide the Treasury with, and report on certain information relating to the reserves. Some of this may be provided through the Bank's other reporting and monitoring channels, but we believe there is value in explicitly linking this reporting to the foreign reserves. For instance, we would recommend that the Framework includes reporting on the implications of particular foreign reserves intervention. This would

support Government understanding of the impacts of the Bank's interventions. Treasury and the Bank will work through exact wording as we draft the Framework.

The level and composition of the Reserves is agreed, but may vary

7. As previously agreed, the Framework would require the Bank to maintain [29], [37] for financial stability and monetary policy intervention, and [29], [37] for liquidity management. The level and composition of foreign reserves is expected to fluctuate during normal times, as the exchange rate fluctuates. [29], [37]

The Bank can hedge reserves by swapping the NZD liability for a USD liability, this matches its USD asset and removes exchange rate risk. However, if the Bank sells the USD asset, it may have to meet the USD liability for a higher price if the exchange rate has moved.

8. [29], [37]

In the event of a foreign exchange intervention, or during the initial building of reserves, the level and composition of the portfolio will diverge from the expected average level and composition during normal times.

Providing financial backing and the independence of the Reserve Bank

9. You have previously asked us what your role should be in providing financial backing, such as an indemnity, to the Bank and how this interacts with their operational independence. For example, does your role in agreeing, or not, to indemnify the Reserve Bank's losses undermine their operational independence, and how much flexibility do you have in practice to exercise any decision rights?

10. We think the answer varies depending on which of the Bank's functions and tools it applies to. The Treasury consider that, as set out in the Act, the Bank should have a high degree of operational independence to use foreign reserves in pursuit of its objectives. To enable this, we would recommend that financial backing be prepositioned to allow the Bank to intervene freely without needing to seek financial backing at the time of an intervention. This will help ensure that there is market confidence that the Bank will be able to intervene to provide stability when needed.

11. [33]

12.

13. [33]

14. The need to balance Ministerial control over the Crown Balance sheet and operational independence was recognised in the MoU on alternative monetary policy tools "While the Bank has the capacity to use AMP tools …, the Minister and the Bank recognise that the use of some of these tools results in a significant increase in financial exposure for the Crown. The Bank recognises that this needs to be balanced against its operational independence."[1]

15. The Reserve Bank are undertaking a review of its financial resources. [33] Underpinning this will be a view as to what tools it is appropriate for the Bank to have operational independence to use, and therefore how much financial backing they need to support that. We understand they will report to you in Q1 2023. We intend to provide you with fuller advice at that time.

Financial backing for the foreign reserves

The Bank requires financial backing to hold, manage, and use the reserves

16. The Bank currently has a target capital position of [29], [37] of which [29], [37] is allocated for the risk due to the current level of foreign reserves. Increasing the level of reserves requires greater financial backing for the Bank – which could be provided through capital, an indemnity, or a tolerance for negative equity. We recommend Cabinet commit to providing the necessary positive financial resources before the Framework is signed. These financial resources can be provided through capital, indemnities or a combination of the two. We recommend you seek delegated authority from Cabinet to determine the final form of the financial backing, if required.

17. To a large extent, the fiscal risk created, and financial resource required, is set by the level and the composition of the reserves, and has been assessed through the Bank's loss modelling work [T2022/1497 refers]. This modelling, based on severe but plausible scenarios, indicates that holding and managing the proposed level of reserves would require an additional $500m in financial backing. This would cover exchange rate risk for the unhedged portion of the Reserves, as well as interest rate and counterparty risks. Treasury recommends covering this risk through additional capital of $500m, given that this risk will be present on the Bank's balance sheet from the time they build reserves to the new levels.

18. Providing the Bank additional capital can be done in two ways.[2] The Crown could "gift" the Bank additional non-market bonds or provide a cash grant. Both options have a neutral impact on net debt and the Crown balance sheet. "Gifting" non-market bonds does not impact the New Zealand Debt Management's (NZDM's) funding programme or change the Crown's aggregate interest rate exposures in the medium-term.[3] Providing a cash grant would increase NZDM's funding programme requirements and impact the Crown's aggregate interest rate exposures.

[1] as acknowledged by the Reserve Bank in the memorandum of understanding on the use of AMP tools in March 2020.
[2] It could also be done through withholding the dividend, although this could take some time.
[3] There may be an impact over time if RBNZ chooses not to roll its non-market bond holdings

19. The Treasury is comfortable with providing the Bank with $500 million of capital by way of non-market bonds. But for larger increases of capital, The Treasury thinks work should be done to confirm how market participants would perceive a large increase in non-market bond issuance and how it should be communicated, especially given the Bank may make further requests for financial backing next year.

The Treasury recommends risk caused by an intervention is covered by an indemnity

20. [29], [37]

We envision this would be triggered when the Bank enters a net negative open foreign exchange position – that is, when the Bank intervenes by selling more foreign currency than it holds, and then must meet those liabilities at a later date. Gains, or losses, would be paid to, and from, the Crown.

21. As the risk to the Bank's balance sheet would not be created until the Bank intervened, an indemnity would also clearly establish a transparent link between the financial resources and the balance sheet risk it is provided for, and avoid the market impacts of the larger capital provision.

22. Setting up the required indemnity would require legal and accounting work across the Reserve Bank and the Treasury. The Bank preference is for this risk to be covered by additional capital as this better meets the Bank's guiding principles of central bank independence, provides clarity of decision rights, is practical through the cycle, and ensures fiscal risks are adequately managed. The Bank is also concerned about the accounting complexities and potential communication challenges of an indemnity.

23. Treasury is of the view that an indemnity, issued on appropriate terms, would also meet the Bank's principles. Although we acknowledge possible practical complexities and challenges with indemnities, we do not consider them necessarily significant or decisive, and likely able to be resolved satisfactorily through further consideration during the design and implementation process. We note that such accounting and reporting has the ancillary benefit of providing transparency.

24. We recommend you decide whether you intend to pursue an indemnity approach now and seek further advice from Treasury on the drafting of the indemnity and the public interest test required by the Public Finance Act, and inform Cabinet of this intention. We envision the indemnity could be in place early next year. Alternatively, you could seek further advice before deciding whether this approach is desirable – although the Board of the Bank would likely seek reassurance that the financial backing will be adequate before agreeing the Framework.

[33]

25. [29], [37]

Should these losses be larger than the Bank's financial resources, the Reserve Bank would find itself in a negative equity position – i.e. its liabilities exceed its assets (which accrues through to the Crown as consolidated). The Bank is of the view that the financial accountability arrangements allow for this already, but is concerned that the Board may lack clarity, and that the ability of the Minister to issue a minimum capital level direction could generate some uncertainty.

26. [33]

[33]

27.

28.

Timing and process for the Framework and the financial arrangements

29. The Framework needs to be agreed by the end of this year. It will take some further work for Treasury and the Reserve Bank to work through the drafting of any direction, resolve accounting implications of any indemnity, and resolve any market issues surrounding the provision of additional capital. Treasury recommends you decide your preferred approach to financial backing, and [33] now and inform Cabinet of your intentions. Based on your decisions, we would provide further advice on the details and seek confirmation of your preferred approach, likely early next year.

30. The Bank would not be able to build the reserves to the agreed position until it has at least the $500m in capital to back it to hold and manage the reserves, and could not necessarily intervene to meet its objectives without the full quantum of financial backing. If the Reserve Bank needs to intervene before financial backing arrangements are clear, they would either need to take the risk of entering negative equity (with perhaps a lack of comfort), or you would need to issue an urgent indemnity or a direction.

31. The Reserve Bank is also planning to provide you further advice on its financial backing work in the first quarter of next year. As this will take a broader view of the approach to the Bank's capital, and may involve [33] indemnities, or additional capital, it may be expedient to decide these issues together. If so, you may need to test the Board's comfort in signing the framework in advance of finalising the financial backing options.

Next steps

32. Subject to your comments, we will prepare a draft Cabinet paper and provide that to your office for your feedback, targeting DEV on 16 November and Cabinet on 21 November. We recommend you provide decisions and feedback by 2 November, and discuss with officials on 31 October if necessary. This may require shortening the usual expectations of ministerial consultation to less than the full 10 days. If you prefer a

longer period for Ministerial consultation, this Cabinet process could be delayed by one week, although that would mean aiming for the last Cabinet meeting of the Calendar year.

33. We will also incorporate your views into the drafting of the Framework document. The Framework will be finalised and legally reviewed in November, before going to you and the Board of the Bank for agreement in mid-December.

34. Treasury and the Bank will also develop the details of the capital backing approach, prepare advice on an indemnity [33] as necessary in line with your decisions, and provide further advice as required. We would expect to report back to you with further advice early next year.