



**RESERVE
BANK**

O F N E W Z E A L A N D

Review of the Reserve Bank of New Zealand's
Liquidity Management Operations
A consultation paper

March 2006

Review of the Reserve Bank of New Zealand's Liquidity Management Operations

Contents

I	Introduction	3
II	The rationale for a review of the liquidity management regime	4
III	Preferred features of a liquidity management regime	9
IV	Key design features and options	11
V	The Bank's preferred regime	13
VI	Questions, answers and next steps	15

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I Introduction

1. In the 2004-2005 *Annual Report*, the Reserve Bank announced that one of the Governor's priorities for the 2005-2006 financial year was for the Bank to work to ensure that adequate liquidity was being provided to the banking system, with collateral requirements and risks being balanced appropriately between the Reserve Bank and the New Zealand banking sector.¹
2. The method the Bank uses to provide liquidity to holders of accounts in the Exchange Settlement Account System (ESAS) has not been comprehensively reviewed for a number of years. Recent years have seen the Bank make a number of incremental changes to the methods it uses to provide liquidity to the system mainly in response to problems it has encountered, and as a result of other regime changes such as the implementation of the Real Time Gross Settlement (RTGS) system, Official Cash Rate (OCR) and the New Zealand dollar's entry into Continuous Linked Settlement (CLS).
3. The Reserve Bank currently uses the following methods to supply liquidity to the banking system:²
 - Open Market Operations (OMOs) – The Bank uses the daily OMO to offset the Crown's flows to and from the banking system in an attempt to maintain a broadly stable quantity of cash in the banking system overnight. The instruments used for these overnight and longer-term operations are repurchase and reverse repurchase of government securities. Terms are typically between 1 and 14 days.
 - Foreign exchange (FX) swaps – The Bank also uses FX swaps to offset Crown flows, by transacting directly in the market. FX swaps typically have a maturity between overnight and 3 months.
 - Overnight reverse repurchase facility – The Bank provides this overnight liquidity on demand. A potentially unlimited amount of liquidity can be accessed using government securities as collateral, at a margin of 25 basis points over the OCR.
 - Autorepo facility – The Bank also provides liquidity intra-day to ESAS "acountholders". Acountholders can access this liquidity during the day via intra-day reverse repurchase transactions of government securities and a limited amount of bank and corporate securities. This liquidity may be borrowed at no cost and is expected to be repaid to the Bank before the end of day (EOD). ESAS acountholders can roll their intra-day loans overnight at a margin of 30 basis points over the OCR although it is generally expected that this should occur infrequently.
4. This document describes the Reserve Bank's review of liquidity management. It sets out the rationale for this review, the desirable features of a liquidity regime and the key design issues. A range of possible options are discussed and the Bank's preferred regime is described.
5. The last section of the consultation document provides answers to a number of questions to clarify some of the main issues associated with this review. There is also a timetable, setting out the key dates and milestones associated with this consultation process. The Reserve Bank is keen to receive feedback on its preferred regime and will hold discussions with ESAS acountholders and regular participants in the Bank's liquidity management operations. However, the Bank welcomes views from other interested parties.

¹ Available on the RBNZ's website at <http://www.rbnz.govt.nz/about/whatwedo/0094054.html> - p40.

² We propose that the existing bond repurchase operations (e.g., the bond lending facility) remain unchanged at present. These facilities are not strictly part of the liquidity management regime and as a result do not form part of this review.

II The rationale for a review of the liquidity management regime

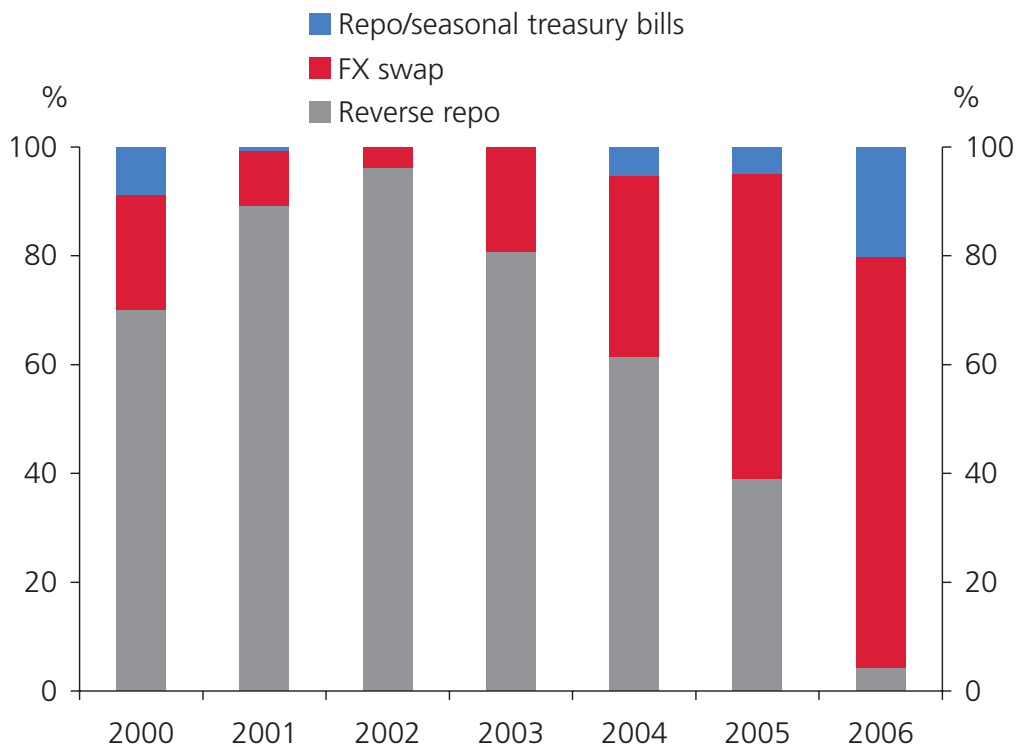
6. In recent years, there has been growing pressure for a review of the Reserve Bank's liquidity management regime. Our existing regime is, in many respects, an adaptation from the previous quantity-based monetary policy implementation regime. In that system, the Bank used the total amount of cash in the banks' accounts at the Reserve Bank (settlement cash) as a key operating lever to implement monetary policy. In the 1980's, the quantity of settlement cash had relevance as the Bank's view was that settlement cash, and other securities that could be converted readily into settlement cash, played an important role in determining the level of monetary conditions and thus inflation. As time went on, the Bank moved increasingly towards targeting the level of interest rates in implementing monetary policy and became less concerned about the quantity of settlement cash.
7. When the RTGS system was being designed in the mid 1990's to help reduce settlement risk, the Bank faced a problem in determining how it could provide the significantly increased amount of liquidity required for banks to settle their normal daily transactions on a gross basis as opposed to the traditional netting system. In a net settlement system, relatively little liquidity is needed; payments out are offset by payments in before any payments are made. A gross settlement system requires banks to raise liquidity to make payments out resulting in substantially higher liquidity requirements.³
8. The Bank solved this problem by creating intra-day liquidity via the Autorepo facility – a system in which banks can borrow cash within the day if they provide collateral to the Bank. This effectively gave banks access to enough liquidity to make payments without affecting the overnight and longer-term maturity markets. This is because intra-day liquidity was expected to be returned to the Bank before the end of day. This type of system was similar to that implemented elsewhere in the world and was a useful evolution from the previous system (i.e., it managed intra-day settlement risk without causing too much change elsewhere, for example in terms of monetary policy implementation).
9. The Autorepo system rigidly segregates intra-day cash for RTGS needs from overnight and beyond cash. However, it was not the case that such a structure would necessarily always stay in place. When the Bank shifted to the OCR regime, the Bank intended to review arrangements with a view to eventually moving to a more heavily cash-based system with a reduced reliance on bank bills as collateral in particular, and on Autorepo in general.⁴ Such a review was expected to be conducted once the existing RTGS/OCR systems had been well bedded down, making it easier to assess the medium term implications of the operation of these systems. The expectation was that the review would be better informed by the identification of the problems that emerged in time.
10. As time has gone on, the Reserve Bank has gained a better sense of how these new payment and settlement systems operate and how ESAS accountholders are affected by them. Problems have emerged over recent years which have prompted the Bank to make a number of incremental changes to the way in which it provides liquidity to the markets. Such changes have included:

³ See, for example, the discussion in the article in the *RBNZ Bulletin* 58(4): 259-263, 'Monetary policy and liquidity management after the introduction of Real Time Gross Settlement'.

⁴ See, for example, the discussion in the article in the *RBNZ Bulletin* 62(1):46-50, in particular 'Daily liquidity management operations'.

- Changes in the amount of bank paper accepted by the Bank as collateral for intra-day Autorepo loans (both up and down).
- Changes in the terms under which the Bank's Open Market Operations (OMOs) have been conducted, in particular the introduction of reservation rates⁵ on liquidity management instruments used in OMO auctions, and changes in the structure of OMOs (varying the use and maturity of reverse repurchase and repurchase instruments). The Bank introduced reservation rates in 1999 as a result of ongoing discussions with OMO counterparties over the appropriate rate for transacting in OMOs. This move provided transparency for the market, but did not alleviate the problems and arguably the number of OMOs that were underbid increased. This regime has required constant maintenance and is reviewed regularly, with adjustments being made to the regime in June 2000, September 2002, and more recently in December 2004.
- Forced changes in the types of instruments used to inject liquidity to offset Crown flows. In particular, the Bank's use of FX swaps has expanded significantly. From being an instrument used only exceptionally, to complement the use of reverse repurchase of government securities, FX swaps have become the predominant liquidity management tool. Figure (1) depicts the instruments the Bank has used in its OMOs over the last seven years and highlights the increasing use of FX swaps to inject liquidity, while the use of reverse repurchase has declined as government collateral has become more difficult to obtain.

Figure 1
Average OMO instrument utilisation as a percentage of total OMO transactions
 (year ending June)



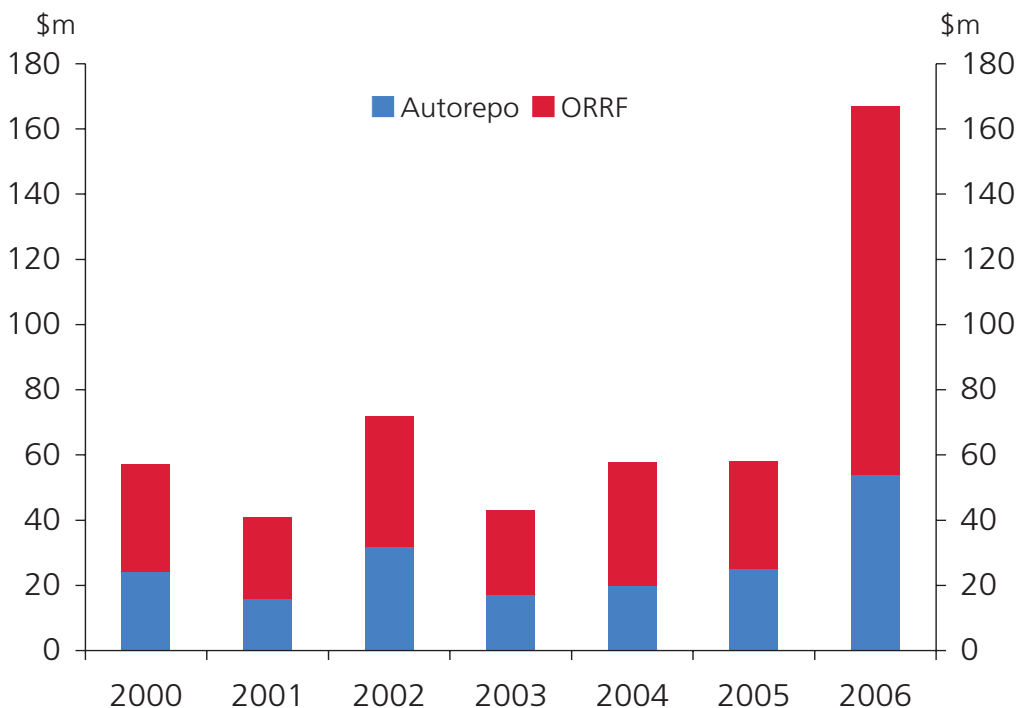
⁵ Reservation rates are minimum and maximum rates the Bank pre-publishes for its operations.

11. Most of these changes have been driven by the emergence of symptoms of stress either in the money markets or in OMOs. These symptoms have suggested that insufficient liquidity has at times been available to the banking system or that the liquidity that has been provided has been injected in an inefficient manner.

Some examples of these symptoms have been:

- delayed and “just-in-time” payments between market participants;
- failed payments (albeit rare);
- an increased and unsatisfactory level of underbid OMOs;
- the rise in the use of the Bank’s standing facilities at the end of the day, namely the Overnight Reverse Repurchase Facility⁶ and Autorepo Rollover.⁷ The use of these facilities has increased over time as a result of the underbid OMOs noted above and inefficiencies within the inter-bank cash market. Figure 2 below shows the use of these facilities increasing especially within the last financial year;
- the rate at which overnight cash trades in different markets. Figure 3 below highlights the rate at which overnight cash has traded in the foreign exchange swap market relative to the OCR. The cost of overnight funding through the FX swap market is typically above the OCR and at times by a significant margin;

Figure 2
Average volume of Rolled Autorepo and Overnight Reverse Repurchase Outstanding (ORRF)
 (year ending June)

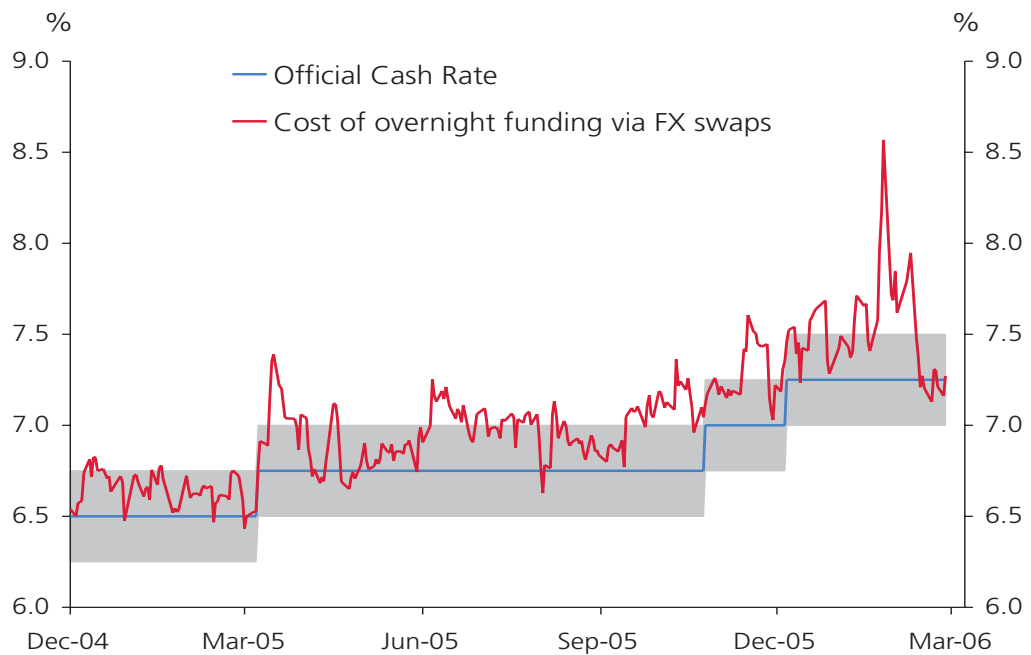


⁶ This facility allows the Bank’s counterparties, who have signed an inter-day Master Repurchase Agreement, to borrow cash overnight using government securities as collateral. This facility is transacted at 25 basis points above the OCR.

⁷ Autorepo rollover is a facility where users of the Bank’s intra-day cash facility can roll a transaction overnight using government security and limited amounts of bank and corporate paper as collateral. This facility is transacted at 30 basis points above the OCR.

Figure 3

The Cost of Funding via Overnight FX Swaps and the OCR.

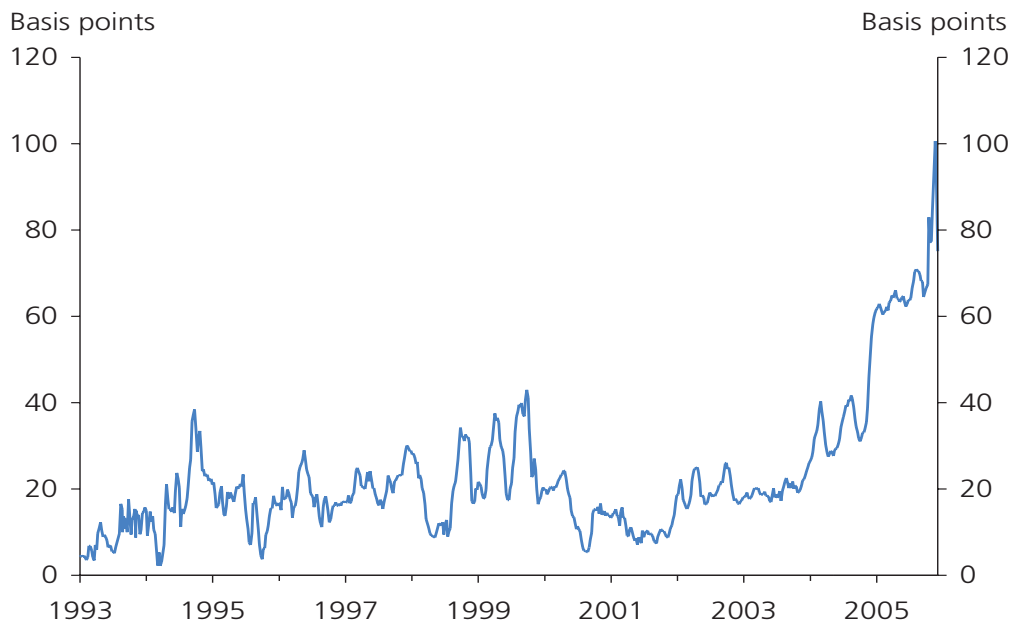


- a revealed demand for an increase in intra-day liquidity when the Bank temporarily allowed banks to pledge more bank paper as collateral for intra-day loans to ease the introduction of CLS and an associated decline in settlement and payment system problems during that period;
- evidence of uncooperative behaviour in ESAS, for example hoarding collateral and utilising non-government paper limits when the liquidity may not be immediately required, which have acted against the system working to its full potential;
- significantly increased demand for government securities (in particular Treasury bills) for use as collateral in ESAS and for obtaining overnight or longer liquidity from the Bank. The resultant increase in demand, combined with a stable level of supply of government securities and a lack of alternative sources of collateral has resulted in the prices of government securities increasing to historically high levels relative to their long term average. Figure (4) shows the 4 week moving average of the 3 month bank bill/Treasury bill spread since 1993 and highlights the increased cost of holding Treasury bills since December 2004; and

Figure 4

Three-month Treasury bill spread under bank bill

(Four week moving average)



- increased calls from market participants to review the liquidity management regime and in particular for the Bank to accept more bank paper as collateral in ESAS. These calls have reflected participants' discomfort at the increasing costs of holding liquid assets to pledge as security to raise intra-day liquidity in Autorepo.

III Preferred features of a liquidity management regime

12. Our experience of the current system suggests that our preferred liquidity management regime would ideally have the following characteristics:

- **Scalability**

The regime should be scalable (i.e., it should readily cope with changes in the level of demand for liquidity either over the cycle or in the long run as the payment systems grow and as the number of market participants changes);
- **Liquidity supplied at fair prices in a useful form**

Banks should be able to access sufficient liquidity from the Reserve Bank using collateral that is fairly valued, readily available, and naturally held by payment system participants (i.e., the system should not in itself distort participants' asset allocation decisions);
- **Supply of liquidity not unduly affected by exogenous factors**

The supply of acceptable collateral to payment system participants should be flexible and responsive to demand, and not dependent upon exogenous factors such as changes in the Crown fiscal position. The Reserve Bank should have the ability to respond to changing liquidity needs quickly;
- **Reserve Bank should be able to control supply of liquidity**

The supply of collateral should ideally be within control of the Reserve Bank so that the Bank is in a position to adjust the supply of liquidity in response to changes in the demand for liquidity. This would allow the Bank to respond effectively to changes in the requirement for liquidity, although the Bank expects such changes would be infrequent;
- **Reserve Bank not subject to undue risk/conflict of interest**

In providing liquidity to banks, the Reserve Bank should not need to routinely take an undue amount of credit risk to banks that the Bank might otherwise supervise or manage in a failure situation. Having a financial exposure to the domestic banks becomes a potential conflict of interest for the Bank, as a prudential regulator, during times of financial stress;
- **Reserve Bank to operate in liquid markets at market prices**

The Reserve Bank's liquidity management operations should be in liquid markets and instruments. As previously noted, the Bank has often faced difficulties in its OMOs, especially when injecting cash via reverse repurchase at what it considered market rates. Operating in more liquid markets will make market rates more easily discoverable;

- **Commercial banks should deal with each other first**

Incentives should be in place to foster an environment where the commercial banks get liquidity from each other and deal with the Reserve Bank only when liquidity is not otherwise available in the market. The Bank's main role is to transact its own business and provide liquidity when it is not otherwise available through other sources (i.e., other ESAS accountholders); and

- **The Reserve Bank should get information from its operations that is useful for its regulatory and policy roles.**

The Reserve Bank's operations should yield information and encourage the development of skills that will add to the Bank's role in promoting a stable and vibrant financial system. If the Bank is able to transact in more liquid money market instruments than it has in the past then this will routinely provide a richer source of information on the operation of those markets and assist the Bank in carrying out its payment system oversight duties.

IV Key design features and options

13. There are two key issues of relevance to this review:
- the level of cash routinely left in the payment system each day; and
 - the availability of acceptable security that banks can use to obtain liquidity from the Bank – either within the day or overnight.
14. These two issues are inter-related. Payment system participants have a routine demand for liquidity to conduct their normal operations during the day. The Reserve Bank's existing liquidity management regime segregates the supply and demand for intra-day liquidity from the supply and demand for liquidity for overnight and longer. However, as noted earlier, this separation is a legacy from the Bank's pre-OCR monetary policy implementation system which no longer has any monetary policy relevance. Prima facie, banks' liquidity needs could be satisfied by expanding the supply of liquidity permanently available and integrating the two markets. However, the extent to which cash is permanently provided also determines banks' need for collateral to raise cash to meet their payment obligations. The balance to be struck is in designing a regime that provides banks with sufficient liquidity, in the most convenient way, at a reasonable risk-adjusted cost (to banks as well as the Bank and the Crown).
15. There are potentially three ways forward towards a new liquidity management regime:
- making minor adjustments to the system as it stands;
 - implementing an "on-demand" liquidity facility; or
 - integrating the intra-day and overnight cash markets and significantly increasing the amount of settlement cash left routinely in the system.

Maintaining the status quo

16. Continuing with the status quo implies making marginal changes to the existing system by increasing the supply of acceptable securities available to banks when raising liquidity from the Reserve Bank. This could be achieved by one or more of the following means:
- increasing the supply of government securities;
 - loosening the Bank's credit tolerances; and
 - widening the definition of acceptable securities (domestic and foreign).
17. Each of the above options has problems that mean that maintenance of the status quo does not meet the criteria of an ideal system identified earlier.
18. The magnitude of the change required in the supply of government securities would be large relative to the existing Crown debt programme causing debt management problems and an expansion of the Crown balance sheet. Further, as the demand for liquidity and government securities fluctuates widely over the economic cycle, an increase in the use of government securities as collateral for liquidity management purposes would imply an undesirable fluctuation in the Crown debt programme over the cycle. Finally, the debt programme would need to be directed, or at least heavily influenced, by the Bank which is not optimal from a public policy perspective.
19. The second option of loosening the Reserve Bank's credit tolerances – either by expanding existing bank paper limits in Autorepo, or by taking bank paper as security for overnight or longer maturity reverse repurchase transactions in the OMOs – is also inconsistent with the earlier design criteria. Taking on a greater level of credit risk to the domestic banks is not an option the Bank has historically been prepared to accept in the

normal course of business. Having a financial exposure to the domestic banks becomes a significant issue during times of financial stress.

20. The third option of accepting alternative securities (domestic and foreign) has been investigated but found to be inadequate as a solution given the scale of the issue. Problems affecting the various forms of alternative collateral are that they:
- are not substantially naturally held by ESAS participants;
 - in some cases, exist in relatively small quantities; and
 - are typically not held in Austraclear and therefore not available for Autorepo.
- In many cases, there are also time delays in settlement due to time-zone differences, which therefore introduce a greater risk of settlement failure.
21. The only real source of alternative collateral would be for the Bank to accept foreign cash balances as collateral – essentially by expanding FX swap activities – an activity already undertaken by the Bank. Intra-day FX swaps cannot easily be implemented and would give rise to significantly increased Herstatt⁸ risk on counterparties.
22. Finally, all of the above options suffer the drawback of not being easily scalable (at least without a significant change in the absolute level of credit risk accruing to the Bank) and would probably require frequent changes in the future as market conditions change.

Introducing an on-demand standing facility

23. Depending on the method of implementation, an on-demand standing facility could reduce (or even eliminate) the requirement for the Bank to manage fluctuations in net Crown cash flows. It is likely that such a facility would reduce the need for daily OMOs and would leave the banks free to determine their liquidity requirements.
24. Injections or withdrawals would, in principle, occur at any time during the day. Transactions would be through any of the Bank's existing channels. Such a facility could require the banks to continue to hold acceptable government collateral for reverse repurchase transactions with the Bank, but injection of NZD FX swaps would be on-demand unlike at present.
25. Although intrinsically appealing, there are drawbacks to a pure on-demand system. In particular, the Bank assumes that commercial banks need certainty regarding both access to cash and the level of cash in the payment system before they would be comfortable to reduce existing liquid asset holdings (and thus lower the costs associated with managing liquid asset portfolios). The real benefits of an on-demand facility would really only be delivered if the Bank offered on-demand FX swaps intra-day, with the resultant Herstatt risk implications and implementation issues. Finally, if the Bank offered liquidity on-demand, the incentives for the market to transact with each other in the cash market would be significantly reduced.
26. Given the relatively unsatisfactory properties of the above options, we have concluded that the Bank's preferred way forward is to move to a fully cashed up liquidity management regime. This approach and the associated benefits are discussed in the next section.

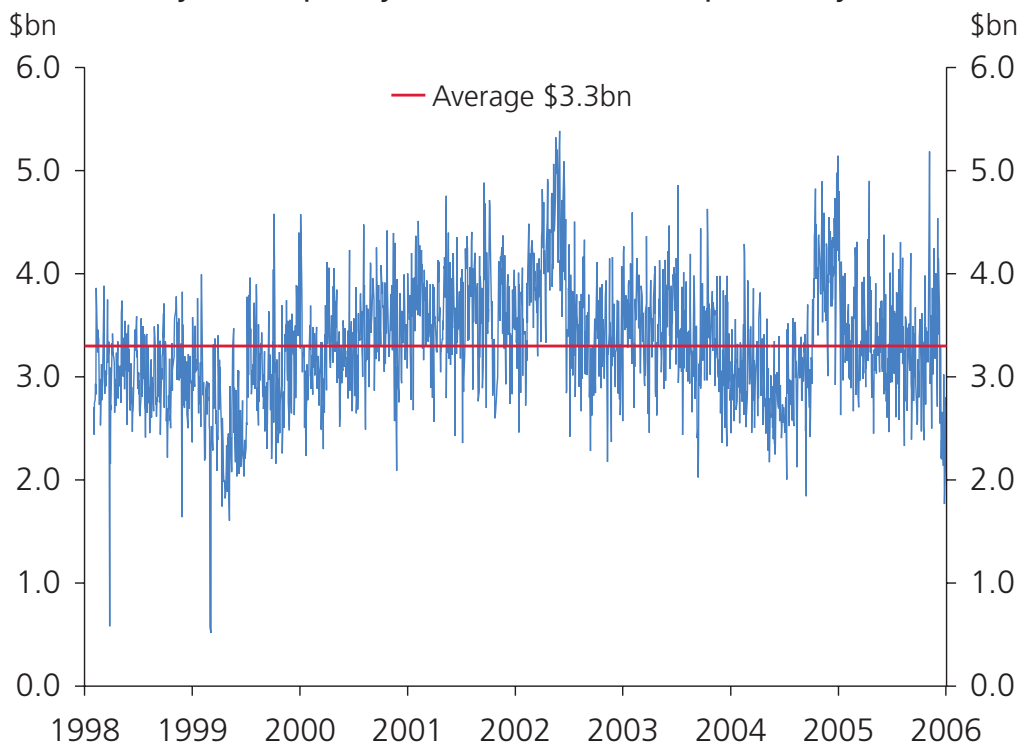
⁸ Herstatt risk is the risk associated with the settlement of two currencies in an FX transaction in different time zones. In the Bank's case this refers to the FX swap transactions. In these transactions the Bank pays away the NZ dollars on spot value date NZ time, but does not receive the US dollars until value date US time (the situation is reversed at maturity). This exposes the Bank to the risk that its counterparty may fail between the NZ dollar leg settling and the US dollar leg settling. This risk is present in our FX transactions as they are not settled DVP (delivery versus payment), the same way our securities transactions are.

V The Reserve Bank's preferred regime

27. We propose moving to a fully cashed up payment system. In such a system, the settlement cash level would be set by the Reserve Bank from time to time, although we expect that changes in the volume would be relatively infrequent to provide ESAS participants with some certainty over the supply of liquidity. The Bank's work indicates that a level of around \$7 billion may be appropriate. In particular, an examination of the current size of liquid asset holdings by banks and the sum of peak intra-day liquidity demands across all ESAS banks (i.e., the sum of peak Autorepo demand for each ESAS participant on any given day) both point to a requirement for around \$7 billion of settlement cash. However, the Bank wants to discuss the level of settlement cash proposed in greater detail with ESAS participants to gain a better understanding of the level of cash required to be "fully cashed up". Figure (5) below shows that on average just over \$3.3 billion of Autorepo is triggered each day, with a peak of \$5.4 billion.

Figure 5

Peak ESAS system liquidity raised in the Autorepo facility



28. In outline, the preferred regime would have the following characteristics:

- A higher level of settlement cash, possibly as high as \$7 billion;
- With the cash level set at this amount, the day-to-day balancing of Crown flows would be managed perhaps within a +/- \$500m corridor around the target level;
- Changes in the target level of settlement cash balances would be considered by the Bank periodically, but probably infrequently. Changes in this level would be informed by a number of indicators of the observed demand of banks for liquidity including the efficient conduct of payments in ESAS, the level of usage of the Bank's standing facilities, the level and shape of the yield curve for maturities up to around a month, and the relative prices of money market instruments. In general though, the Bank would aim to maintain a broadly stable level of liquidity in the system;

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- The Bank would offer an overnight deposit facility as at present. The rate on this facility would form the Bank's key policy rate (i.e., the OCR);
 - There would continue to be an overnight reverse repurchase facility (using government securities as collateral) with a price 50 points higher than the rate paid on overnight deposits (i.e., the OCR);
 - Intra-day Autorepo would be discontinued, thus removing the distinction between intra-day and overnight cash markets; and
 - The acceptance of bank bills and corporate paper as collateral as part of the Bank's normal domestic market operations would also be discontinued.

Benefits of the preferred regime

Benefits

29. The proposed scheme is scalable and flexible. The supply of settlement account balances would be easily changed and would be under the control of the Bank. Further, the demand for settlement account balances is not likely to be as affected by other exogenous factors (e.g., offshore demand for government securities or changes in the government's fiscal position).
30. Settlement account balances could also become a natural part of payment system participants' balance sheets assuming that banks could hold these balances as part of their liquidity and prudential holdings.
31. The price of Reserve Bank liquidity would also be fairly valued given that the Bank would pay its official rate (i.e., the OCR) on settlement account balances and that rate would in itself provide a benchmark against which alternative money market instruments, such as overnight FX swaps, would be priced. This would allow the banks more choice in the liquidity instruments they hold on their balance sheets, which in turn could allow banks to reduce the costs paid to generate liquidity.
32. The increased base level of settlement account balances in the system should better foster the development of an inter-bank cash market. In the presence of significant market liquidity, market participants should transact cash with each other at the end of day in preference to using the Bank's standing facilities. Development of the inter-bank market is desirable to improve the distribution of cash between ESAS participants, leaving the Bank to concentrate on the liquidity to the system as a whole. This market, if developed, would also provide another source of information for the Bank on any inefficiencies in the market.
33. Finally, to support the above system the Bank would probably routinely operate with reference to more liquid money market instruments than it has in the past. FX swap rates would likely provide the benchmark for liquidity management operations with maturities of more than a day as the FX swaps market is deep and liquid in comparison to the repurchase and reverse repurchase markets currently used in the OMO. Operating more routinely in liquid markets would provide a richer source of information to the Bank in its financial stability role.

VI Questions, answers and next steps

34. The Bank has listed below a number of questions with regard to the proposed regime, along with the answers to those questions. This list is by no means exhaustive and we look forward to discussing this proposal with interested parties in due course.

i) Where does the settlement cash level of \$7 billion come from?

An examination of the current size of liquid asset holdings by banks and the sum of peak intra-day liquidity demands across all ESAS banks (i.e., the sum of peak Autorepo demand for each ESAS participant on any given day) both point to a requirement for around \$7 billion of settlement cash. However, the Bank wants to discuss the level of settlement cash proposed in greater detail with ESAS participants to gain a better understanding of the level of cash required to be “fully cashed up”.

ii) What factors may influence this level?

Changes in the target level of settlement cash balances would be considered by the Bank periodically, but probably infrequently. Changes in this level would be informed by a number of indicators of the observed demand of banks for liquidity including the efficient conduct of payments in ESAS, the level of usage of the Bank's standing facilities, the level and shape of the yield curve for maturities up to around a month, and the relative prices of money market instruments.

iii) How will the new regime be implemented?

The Bank has not finalised the implementation plan, but expects that if this proposal is accepted it will be phased in over a period of time. The Bank will be talking to all interested parties regarding this timing issue.

iv) How does the proposed regime impact on the structure of ESAS banks' liquid assets?

ESAS banks would still ultimately choose the structure of their liquid assets. However, we assume that cash held at the Reserve Bank would meet the criteria to be one of these liquid assets.

v) What happens to Treasury bills?

Treasury bills would remain as an acceptable security, along with other government securities, for banks wishing to borrow cash from the Bank through the overnight reverse repurchase facility. However, the issuance of Treasury bills is the responsibility of the New Zealand Debt Management Office (NZDMO). The Bank is consulting with both the Treasury and NZDMO on this issue and the full proposal.

vi) How would the Reserve Bank conduct its operations going forward?

OMOs would be held less frequently due to the larger settlement cash level and the accepted variance we propose around that level (+/- \$500 million). OMOs would be conducted as and when required to return the settlement cash level to its target (e.g., \$7 billion), although the FX swap market would also be used to maintain settlement cash at the desired level. Standing facilities (e.g., deposit, overnight reverse repurchase and bond lending facility) would continue to operate in a similar manner to what they do now.

vii) What interest rates would apply to the standing facilities?

The deposit rate would be the OCR and the overnight reverse repurchase rate would be OCR plus 50 basis points (using only New Zealand government collateral).

viii) Why would the overnight reverse repurchase facility be 50 basis points over the OCR?

The Reserve Bank expects the use of this facility would be minimal given the level of cash in the banking system and the possible development of an inter-bank cash market. However, if this proved not to be the case, the Bank could review this margin.

ix) What would happen to the intra-day Autorepo facility?

Intra-day Autorepo would be phased out during the transition to the new Settlement Cash Level. This would include the removal of bank and corporate paper as an acceptable security for Reserve Bank liquidity early in the implementation of the new system.

x) Would the new regime impose further costs on banks or savings?

It is anticipated that the new regime would reduce the costs that the banks currently pay. In the longer term, it is not expected that the new system would cost payment system participants significantly more or less than has been observed historically. Settlement cash would provide an additional source of liquid assets for the banks' balance sheets at rates referenced to the OCR.

xi) Why not issue Reserve Bank (RB) bills?

Cash at the Reserve Bank is a short term form of RB bill. The Bank does not see the RB bill as an asset that banks would naturally hold on their balance sheets and it is unlikely that a secondary market would develop. Also, RB bills are only useful if there is a way to convert them into cash (i.e., if Autorepo continues or if a discount window was opened). The Bank's view is that payment system needs would be better satisfied by providing cash directly rather than indirectly.

xii) Where would the cash trade?

The Reserve Bank would pay the OCR on ESAS balances. Inter-bank cash would trade at the OCR or a margin above the OCR at a level determined by market participants.

xiii) What are the benefits expected from an inter-bank cash market?

Development of the inter-bank market is desirable to improve the distribution of cash and risks between ESAS participants, leaving the Reserve Bank to concentrate on the provision of liquidity to the system as a whole. This market, if developed, would also provide another source of information for the Bank on market conditions.

xiv) How would the increase in the settlement cash level impact on the yield curve?

The Reserve Bank expects that the change in the settlement cash level would eliminate distortions in the yield curve that have previously been due to liquidity pressures.

xv) Does this change impact on the Reserve Bank's implementation of Monetary Policy?

This change would not have any impact on the Reserve Bank's ability to implement Monetary Policy.

xvi) Why doesn't the Reserve Bank accept unlimited amounts of bank paper as security for Autorepo like the Reserve Bank of Australia?

Taking on a greater level of credit risk to the domestic banks is not an option the Reserve Bank has historically been prepared to accept in the normal course of business. Having a financial exposure to the domestic banks becomes a significant issue during times of financial stress. In the event of distress or failure of a domestic bank there are considerable conflicts of interest if the Bank is financially exposed to the distressed bank. The Bank's position on this matter runs counter to the preferred position of the domestic (predominantly Australian owned) banks and counter to the position of the RBA. In Australia, the RBA has taken the position of accepting bank paper in its OMOs and in unlimited amounts in Autorepo (albeit with a small charge for credit risk).

xvii) Does the Reserve Bank expect to receive applications for ESAS accounts as a result of this change to the regime?

It is likely that the proposed regime will increase the interest in being an ESAS accountholder. The Bank is currently reviewing its stance on this matter.

35. The timetable for the consultation process is as follows:

- Consultation document delivered to ESAS participants and posted on the Reserve Bank's website for other interested parties – 17 March 2006;
- Reserve Bank general presentations in Auckland and Wellington to ESAS participants – Auckland 22 March 2006 and Wellington 23 March 2006;
- Reserve Bank visits ESAS participants individually – 3 April to 12 April 2006;
- Deadline for responses to consultation document – 20 April 2006.

36. Comments are invited and should be sent to the Manager of Market Operations, Financial Stability Department, Reserve Bank of New Zealand, PO Box 2498, Wellington, or by email to Liquidity.Review@rbnz.govt.nz, by 20 April 2006.

37. The Bank would be pleased to discuss this proposal with interested parties. If you wish to discuss it further or have any questions, please contact one of the following:

- Simon Tyler, Manager Market Operations (04) 471 3874, simon.tyler@rbnz.govt.nz
- John Groom, Manager Liquidity Management (04) 471 3784, john.groom@rbnz.govt.nz
- Ian Nield, Special Adviser Financial Stability Department (04) 471 3968, ian.nield@rbnz.govt.nz

38. In the light of comments received, the Bank will finalise its proposal for the reform of its operational framework. A paper will be issued in due course setting out the changes the Bank intends to make and will consult as necessary, on questions of detail and implementation. We anticipate that this document will be released by end June 2006.

For further information please contact:
Simon Tyler, Manager Market Operations
John Groom, Manager Liquidity Management
Ian Nield, Special Adviser Financial Stability Department

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