Prudential policy and monetary policy

Monetary policy formulated and implemented to achieve price stability is entirely consistent with the Reserve Bank's obligation to promote the maintenance of a sound and efficient financial system. Our prudential supervision is based on disclosure and market discipline, self discipline by registered banks, and regulator discipline focused on compliance with a limited number of constraints. This is supportive of price stability.

On the other hand, the Bank believes the active use of prudential instruments to achieve price stability is rarely effective and usually involves some loss of efficiency in the allocation of resources. Further, by confusing the objectives of policy instruments, both price stability and the soundness and efficiency of the financial system may be undermined.

Introduction

1. Good central banking requires a thorough understanding of financial institutions, financial markets, and financial system infrastructure. For monetary policy purposes, understanding the role of financial institutions and markets in the transmission process from central bank decision-making to their ultimate economic effects, aids efficiency in policy implementation. It is also required for prudential purposes as, while it is institutions that fail, often financial markets and financial system infrastructures can be either the source of problems or transmit risk from one institution to another.

2. In New Zealand, the Reserve Bank not only carries out monetary policy operations but also supervises banks, manages foreign exchange reserves, and operates the core of the national payments system. The combination of these roles in the same institution helps the Reserve Bank keep fully informed about financial developments, issues and problems, and enables the Bank to identify solutions which best deal with causes rather than symptoms. We also find that information gained from multiple sources provides a richer perspective than would otherwise be possible.

3. Also there is considerable overlap amongst the skills required to meet the different requirements. The fact that we carry out these different roles makes it easier for us to maintain a pool of resources, including legal, accounting, financial engineering and risk management skills, which can be used for both prudential and monetary policy purposes.

Prudential supervision

4. Under Part V of the Reserve Bank Act, the Reserve Bank is required to register banks and undertake their prudential supervision to:

   - promote the maintenance of a sound and efficient financial system; and
   - avoid significant damage to the financial system that could result from the failure of a registered bank.

5. The clear emphasis in Part V of the Reserve Bank Act is on the promotion of "systemic" stability. Neither the Reserve Bank nor the government provides any assurance that banks will not fail or that depositors funds are safe, and nor is there any deposit insurance scheme.

6. The Reserve Bank seeks to implement its prudential policies by:

- encouraging self-discipline within the banks themselves, notably by requiring bank directors to attest that their bank has adequate risk management systems in place and that these are being properly applied;
- encouraging market discipline by requiring banks to make comprehensive quarterly public disclosures of both financial and qualitative information; and
- by applying some, albeit relatively few, rules to banks as to capital adequacy and connected exposures, and having a range of supervisory intervention powers to deal with significant problems if they arise.

The contribution of monetary policy to prudential objectives

7. Financial sector stability is best achieved – and arguably can only be achieved – in the context of a stable macroeconomic environment. Experience, both in New Zealand and elsewhere, is that abrupt changes in asset prices have often been the primary cause of serious damage to the financial system. This is both directly and also indirectly through adverse impacts on businesses borrowing from the banks. Thus, an approach to macroeconomic policy management which aims to keep the general level of prices stable, and which facilitates flexible adjustment of the economy and financial markets in the face of changes in business conditions or unexpected shocks, is fully consistent with prudential goals.

8. The current monetary policy framework thus not only delivers low inflation as a goal in its own right, but also establishes the best foundations available for financial sector stability and institutional soundness.

The contribution of prudential policy to monetary objectives

9. A strong and efficient financial system is a prerequisite for securing the best possible economic performance, this being the fundamental objective of monetary policy. A stable financial system also helps provide the economy with resilience in the face of adverse events. International experience shows that financial and banking distress has been inextricably linked to currency and macroeconomic crises. Our prudential policies are aimed at promoting financial system stability, which we see as being a pre-condition for macroeconomic stability.

10. However, it has been suggested that prudential powers can assist the conduct of monetary policy, for example by helping to dampen particular hot spots in the economy at certain times. We are reluctant to go down this path.

11. This is because our past experience applying selective controls on lending to particular sectors showed that these methods are crude and largely ineffective. This is because they involve trying to attack the symptoms of problems rather than the underlying causes, and they can also be easily circumvented. Selective measures are difficult to target accurately and difficult

to maintain in the face of changing market conditions. They inevitably lead to significant inefficiencies, and can cause unintended harm.

12. We believe that there would be potential dangers in extending the scope of existing prudential powers to pursue price stability, including a loss of clarity in the objectives.

13. Looking more specifically at the type of prudential measures that might be deployed, and analysing those, highlights the points made in paragraph 11. For instance, if there was a concern regarding heightened activity in the housing market, a prudential power might be exercised to increase the risk weight on bank lending for housing in the measurement of a bank's capital adequacy, the aim being to establish a disincentive to banks to lend to this sector. However, it is doubtful that increasing the risk weight would make a substantive difference to bank lending behaviour. However, if it did then this would raise competitive neutrality issues between branches and locally-incorporated banks. Furthermore, risk weights reflect the security provided for the loan and do not necessarily reflect the purpose for which the funds advanced will be used. Prudential measures aimed at monetary policy objectives would be not only relatively ineffective but also result in an adverse impact on efficiency in the allocation and use of resources. Moreover, such regulation is inconsistent with a regime which emphasises director and management discretion and accountability for funding and lending choices by registered banks.

Potential conflicts

14. It is possible to envisage situations of conflict between monetary policy objectives and prudential goals, which might arise particularly in conditions of serious economic or financial-system stress. Such a situation arises when inflationary pressures require interest rates to be raised sharply, and banks are potentially exposed to significant write-downs of their asset valuations or losses on foreign exchange positions as a result. While we have seen episodes like this in the past, we do not think that this conflict would now be very material. Banks no longer have large long-term fixed interest portfolios: both the asset and liability sides of the balance sheets are subject to much more frequent repricing than they used to be. And to the extent that banks face interest rate risk or foreign exchange risk, they now hedge their positions fairly comprehensively – as do many non-banks. The disclosures of market risks by banks in New Zealand show that none of them would be placed significantly at risk by even a sizeable change in interest rates.

15. However, a greater conflict could arise if it were thought that the value of some assets underpinning bank loans (including collateral) might fall below the amount of the loans as a result of interest rate increases. This would not automatically cause significant problems for banks, but it could become a prudential concern if:

- business or household borrowers were highly geared;
- the fall in asset values was substantial and sustained for a period; and
- the underlying cash flows of the businesses or households were also damaged to the extent that debts could not be serviced.

16. Another difficulty could arise if the Reserve Bank became deeply involved in managing some kind of a banking crisis. This has the potential to significantly distract the Bank from its monetary policy activities, and could also have the effect of damaging the Bank's reputation in a way which might not be helpful to the "credibility" required to operate a sound anti-

inflationary policy. These kinds of problems are probably unavoidable: it is certainly not self-evident that any kind of institutional reform would make them go away, and a central bank will always be closely involved in helping to deal with a financial system crisis, irrespective of its formal responsibilities. The best option is to ensure that we do not get into a banking crisis, and we believe that our policies are well directed in that respect. We also need to pre-think our approach to significant banking problems so that we can act promptly and professionally in the unlikely event that they do occur, and we have significant work underway in this respect at present.

So what does Section 10(a) mean?

17. Section 10(a) of the Reserve Bank Act requires the Bank, in formulating and implementing monetary policy, to "have regard to the efficiency and soundness of the financial system".

18. While efficiency is not defined, we interpret this as requiring the Reserve Bank to:

- avoid unnecessary instability or volatility in the general level of prices, asset prices, interest rates or exchange rates; and
- achieve desired monetary conditions at any time through techniques which impose the lowest (transaction and other) costs on the market.

Note that the Chief Manager of the Banking System Department is a member of the Monetary Policy Committee of the Reserve Bank.

Organisation of supervision

19. Some other regulators, mainly the Securities Commission and the Commerce Commission, also play a role in the financial sector. This appears to have worked reasonably well, as there are a small number of regulators, good communications amongst them, and no major inconsistency of objectives or techniques. The case for reforming the structure of supervision in New Zealand is thus considerably weaker than it has been in many other countries.

Supervisory framework