

LETTER OF INDEMNITY

Date: Sunday 10 May 2020

To

Adrian Orr
Governor
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

Dear Adrian

A memorandum of understanding between the Minister of Finance on behalf of the Crown (the **Minister**) and the Reserve Bank of New Zealand (**Reserve Bank**) dated 21 March 2020 (**MoU**) recognises that the Reserve Bank may from time to time need to use alternative monetary policy tools and that the use of such tools may require a Crown indemnity.

The Monetary Policy Committee of the Reserve Bank (**MPC**) approved a programme for large-scale asset purchases of New Zealand domestic government bonds (**NZGB**) as a monetary policy tool at its meeting on 22 March 2020 (**NZGB Programme**), in reliance on an indemnity provided by the Crown at the request of the Reserve Bank on 21 March 2020 (**NZGB Indemnity**). The Reserve Bank began purchasing NZGBs under the NZGB Programme on 25 March 2020.

The MPC has since approved an extension of the large-scale asset purchases programme to New Zealand Local Government Funding Agency Limited (**LGFA**) bonds at its meeting on 5 April 2020 (**LGFA Programme**), in reliance on an additional indemnity provided by the Crown at the request of the Reserve Bank on 7 April 2020 (**LGFA Indemnity**). The Reserve Bank began purchasing LGFA bonds on 16 April 2020.

In accordance with the MoU, the Reserve Bank has written to me as the Minister asking me, on behalf of the Crown, to amend the terms of the NZGB Indemnity and the LGFA Indemnity (**Existing Indemnities**) by changing the cap from a fixed dollar amount of the relevant bonds to a cap based on a percentage of the market size of various categories of bonds covered by the Existing Indemnities. The Crown has agreed to amend the Existing Indemnities and consolidate and restate them on the terms set out in this letter of indemnity which is given under section 65ZD of the Public Finance Act 1989.

This letter of indemnity is intended to apply only to losses resulting from the purchase of bonds under the NZGB Programme and the LGFA Programme (together, the **LSAP Programme**) prior to 30 September 2021 or prior to such later date as the Crown may choose to terminate this letter of indemnity. The Crown acknowledges that the speed and scale of asset purchases under the LSAP Programme is a matter for the MPC and the Reserve Bank to decide.

Indemnity

With effect from Tuesday, 12 May 2020 (**Effective Date**), the Existing Indemnities will be amended and restated on the terms of this letter so that the rights and obligations assumed by the parties shall, on and after the Effective Date, be governed by and construed in accordance with this letter of indemnity.

For the avoidance of doubt, rights and obligations that had accrued under the Existing Indemnities prior to the Effective Date are not affected by the amendment, consolidation and restatement of them in this letter of indemnity and, in particular:

- the payment due from the Reserve Bank to the Crown in accordance with the terms of the NZGB Indemnity in respect of gains realised in the month of March 2020; and
- any payment due in accordance with the Existing Indemnities in respect of losses incurred or gains realised by the Reserve Bank in the month of April 2020.

The Crown agrees to indemnify the Reserve Bank in respect of all Losses which the Reserve Bank incurs in respect of the Indemnified Bonds. The Crown may terminate its obligation to indemnify any new purchases of bonds under the LSAP Programme (**New Purchases**) under this letter of indemnity at any time after 30 September 2021 by giving one day's notice to the Reserve Bank (**Termination Notice**). Otherwise, obligations to indemnify New Purchases under this letter of indemnity may be terminated by agreement between the Crown and the Reserve Bank if they both believe the LSAP Programme is no longer needed as a monetary policy tool. Termination of this indemnity in respect of New Purchases will not release the Crown from any liability in respect of Losses occurring after the Termination Date in respect of the Indemnified Bonds nor will it release the Reserve Bank from its obligations under this letter of indemnity which will only terminate 20 Business Days after it ceases to hold any Indemnified Bonds.

For the purposes of this section:

- **Business Day** means every day other than a Saturday, Sunday, a public holiday (as defined in the Holidays Act 2003) in Wellington, New Zealand and any day in the period 25 December to 2 January (inclusive).
- **Indemnified Bonds** means Indemnified LGFA Bonds and Indemnified NZGBs.
- **Indemnified LGFA Bonds** means all bonds issued by the LGFA that are purchased by the Reserve Bank under the LGFA Programme prior to the Termination Date and any LGFA Bonds purchased as a reinvestment of those bonds up to the LGFA Cap.
- **Indemnified NZGBs** means all New Zealand domestic government bonds purchased by the Reserve Bank under the NZGB Programme prior to the Termination Date and any NZGBs purchased as reinvestments of those bonds up to the NZGB Cap.
- **NZGB Cap** means:
 - for nominal bonds, 50% of the face value of all New Zealand government nominal bonds on issue on the date of purchase; and

- for inflation-indexed bonds, 30% of the face value of all New Zealand government inflation-indexed bonds on issue on the date of purchase.
- **LGFA Cap** means 30% of the face value of all LGFA bonds on issue on the date of purchase of any LGFA bonds.
- **Termination Date** means the date specified in the Termination Notice or such other date as is agreed between the parties.
- **Interest Risk Losses** means the amount by which any of the interest expense incurred on funding the amount invested in Indemnified Bonds, exceeds the interest income earned on the Indemnified Bonds during a calendar month; and the amount of realised losses less any realised gains on disposal of any Indemnified Bonds during that month – as calculated for each calendar month in accordance with generally accepted accounting practice.
- **LGFA Credit Risk Losses** means the difference between all contractual cash flows that are due to the Reserve Bank from the LGFA in accordance with the terms of the Indemnified LGFA Bonds and all the cash flows that the Reserve Bank actually receives from the LGFA in respect of the LGFA Bonds.
- **Losses** means Interest Risk Losses and LGFA Credit Risk Losses.

Claims under the indemnity

The Reserve Bank may claim under this indemnity within 10 Business Days of the end of each calendar month for Interest Risk Losses incurred in that calendar month by giving a notice of the amount (**Notice**) accompanied by its monthly accounts.

The Crown will, in absence of manifest error by the Reserve Bank, pay the full amount of the claim for Interest Risk Losses to the Reserve Bank within one Business Day of having received the Notice.

If the Reserve Bank makes a gain on any Indemnified Bond in any calendar month (calculated using the same principles and accounting practice as is used to calculate Interest Risk Losses), it must notify the Crown within 10 Business Days of the end of the calendar month and pay an amount equal to that gain to the Crown within one Business Day.

If the Reserve Bank realises any LGFA Credit Risk Loss, it may claim under this indemnity at any time after that loss has been determined by giving notice (**Credit Loss Notice**) of the amount together with such evidence as the Crown may reasonably require to support that claim.

The Crown will, in the absence of manifest error by the Reserve Bank, pay the full amount of the claim for LGFA Credit Risk Losses to the Reserve Bank within 20 Business Days of having received the Credit Loss Notice.

Exclusions from the Indemnity

This indemnity only applies to Interest Risk Losses and LGFA Credit Risk Losses. It does not apply to consequential risks such as operational risks in purchasing or holding Indemnified Bonds.

This indemnity does not apply to other alternative monetary policy tools such as large-scale purchases of private sector assets, large-scale purchases of foreign currency assets, interest rate swaps or term lending.

The caps

For clarity, the NZGB Cap and the LGFA Cap apply only at the time bonds are purchased. If the face value of all of the relevant bonds on issue subsequently reduces (e.g. because bonds are repaid and new bonds not issued in their place) so that the Reserve Bank holds in excess of 50% of that face value in respect of nominal bonds or 30% of that face value in respect of inflation-indexed bonds or LGFA bonds, bonds that were purchased within the relevant cap at the time they were purchased are still Indemnified Bonds.

Crown expectations of the LSAP Programme

The Reserve Bank will endeavour to ensure that the LSAP Programme is designed to minimise distortions in the markets for Indemnified Bonds. To help achieve this, the Reserve Bank must cooperate with the Treasury's Capital Markets unit when designing the LSAP Programme.

Both parties agree to act in a co-ordinated manner and in a way that does not intentionally undermine the objectives of debt management, in the case of the Treasury, and monetary policy, in the case of the Reserve Bank.

The Reserve Bank must establish, and act in accordance with, a risk control framework, to be agreed with Treasury, which applies to operations conducted under the LSAP Programme and which sets out how the Reserve Bank will manage the potential risks covered by this letter of indemnity. The Reserve Bank has completed risk control frameworks for both the NZGB Programme and the LGFA Programme in accordance with the Existing Indemnities. The Reserve Bank recognises the importance of the risk control frameworks and will work to finalise an updated risk control framework which takes into account the amended terms of this indemnity to the reasonable satisfaction of the Treasury within 5 Business Days of the Effective Date.

Monitoring of potential Losses

As part of the existing risk control frameworks, the Reserve Bank has provided the Crown with an initial analysis of potential liabilities of the Crown under the Existing Indemnities and any other fiscal risks associated with the NZGB Programme and the LGFA Programme and has provided an updated analysis based on the change to the caps for Indemnified Bonds in this letter of indemnity (**Updated Analysis**).

The Reserve Bank will notify the Crown if the fiscal risks associated with the LSAP Programme differ materially from the Updated Analysis, and, in particular, will update the Crown:

- if the MPC announces a change in the scale of the LSAP Programme, within 5 Business Days of such announcement;
- on significant market events; and
- on any concerns about the possibility of default on Indemnified LGFA Bonds that could trigger liability for LGFA Credit Risk Losses.

Accountability and transparency expectations

The Reserve Bank must closely monitor the impact of the LSAP Programme on financial markets more broadly and on risks to New Zealand's financial system.

The Reserve Bank must run the LSAP Programme in a transparent manner and is accountable for its operation. The MPC will be accountable for decisions in respect of the LSAP Programme in the same way that it is for its decisions on the level of the OCR. It will still be required to explain its monetary policy decisions through the Monetary Policy Statement and provide its evidence to the Finance and Expenditure Committee.

The Reserve Bank must continue to publish frequent public reports on the transactions under the LSAP Programme. Aggregate information on the scale of operations, and the associated gains or losses, should be published in the Reserve Bank's annual report.

The Reserve Bank of New Zealand Act 1989 and Reserve Bank Board Charter require the directors of the Reserve Bank to prepare, for each financial year, a report setting out its assessment of the performance of the Reserve Bank, the Governor and Deputy Governor, the performance of the MPC, and the use of the Bank's resources (**Report**). The Report should cover the performance of the LSAP Programme. The Board will make itself available to meet with the Minister at least annually to brief the Minister on the Board's assessment as outlined in the Report.

Additional reporting

The Reserve Bank will report monthly to the Crown (through the Treasury) on transactions undertaken as part of the LSAP Programme.

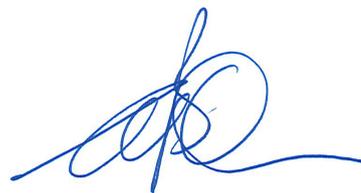
The Reserve Bank also agrees to provide to the Crown (through the Treasury) such information as it may reasonably require from time to time to understand its liability or potential liability for Losses under this letter of indemnity.

SIGNED by the Sovereign in Right
of New Zealand, acting by and
through the Minister of Finance



Hon Grant Robertson
Minister of Finance

AGREED by



Adrian Orr
Governor of the Reserve Bank of
New Zealand
