Dear Chief Executive,

As you will be aware, the Reserve Bank has been exploring a range of alternative monetary policy tools. In March, the Monetary Policy Committee (MPC) stated that it would hold the Official Cash Rate (OCR) at 0.25 percent for the next twelve months, but MPC members have reiterated that negative interest rates remain an option in the future. It is important that the New Zealand banking system understands the implications of low and negative interest rates and is prepared for scenarios where the OCR may become negative.

Based on responses to the Supervision Department’s letter of 29 January 2020, we are pleased to hear that many banks are already undertaking their own contingency planning to assess whether their systems and processes can handle negative interest rates, and addressing contractual and conduct risk issues.

The purpose of this letter is to outline that negative interest rate functionality in the New Zealand banking system remains a priority from an operational and risk management perspective. While the Reserve Bank has deprioritised a number of regulatory initiatives, we expect that banks continue to progress their work programmes to ensure that systems and processes are prepared to function in a scenario where the OCR is zero or negative.

Towards the end of 2020, we intend to assess banks’ capability to operate with zero or negative interest rates on:

a. the Reserve Bank’s standing facilities and ESAS balances (including above credit tiers should these be reintroduced);
b. a range of financial market securities (e.g. bank bills, bonds, interest rate swaps, and derivatives); and
c. all products relating to non-retail customers.

Based on international evidence, interest rates on retail products have tended to be bound by zero and we do not expect banks’ retail systems and documentation to be prepared for negative interest rates.

Over the next six months, we also expect that banks engage through relevant industry associations to clarify market conventions for trading and settling negative yielding financial securities and to discuss the purpose of zero interest rate floor clauses.
We are aware of the prevalence of zero interest rate floor clauses in some loan documentation and would like to understand why these floors are being applied. Given the mismatch risk that a zero interest rate floor clause can create for firms who hedge interest rate risk with interest rate swaps (which do not have such clauses), due consideration should be given to potential conduct risks these create. In addition, the clauses can limit the effective pass-through of monetary policy.

We are aware from discussions held with banks over the last few days that undertaking this work will, in some cases, require significant re-prioritisation. The timeframes outlined in this letter are longer than we had originally planned to allow the banking system to prepare for negative interest rates. Consistent with our previous decision to reduce the regulatory burden in 2020, we have extended the timeframe for negative interest rate capability and contained the scope so banks can balance this work programme alongside other priorities to manage their business and continue supporting customers through this period.

We would ask you to engage with the Reserve Bank on the implementation issues you identify, to ensure you can factor in the Reserve Bank’s position when you provide an initial status report and remediation plan. We expect to receive those by 30 June 2020. The remediation plan should outline how you propose to remediate all identified issues by 1 December 2020. We look forward to hearing of your progress and engaging with you as the year develops.

Ngā mihi

Geoff Bascand
Deputy Governor/General Manager Financial Stability