LETTER OF INDEMNITY

7 April 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 as a monetary policy tool at its meeting on 22 March 2020, in reliance on such an indemnity provided by the Crown on 21 March 2020. The Reserve Bank began purchasing domestic government bonds under that approval on 25 March 2020.

Over recent weeks, the Reserve Bank has observed signs of significant dislocation in other New Zealand debt markets. There is particular concern about the dislocation and lack of liquidity in the market for New Zealand Local Government Funding Agency (**LGFA**) debt. Accordingly, I note the MPC and the Reserve Bank are also considering purchasing bonds issued by the LGFA from time to time (**LGFA Bonds**) as a monetary policy tool (the **LGFA Programme**).

In accordance with the MoU, the Reserve Bank has written to me as the Minister asking me, on behalf of the Crown, to give a letter of indemnity under section 65ZD of the Public Finance Act 1989 in respect of losses that might arise from the LGFA Programme.

In order to enable the Reserve Bank to undertake the LGFA Programme, the Crown has agreed to provide this letter of indemnity to cover losses which the Reserve Bank may incur as a result of operating the LGFA Programme for the next 18 months. This letter of indemnity is intended to apply only to losses resulting from large-scale asset purchases of LGFA Bonds acquired by the Reserve Bank at the direction of the MPC as part of the exercise of alternative monetary policy tools. The Crown acknowledges that the speed and scale of asset purchases is a matter for the MPC and the Reserve Bank to decide.

Indemnity

With effect from Tuesday, 7 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 LGFA Bonds.

The Crown may terminate the indemnity under this letter of indemnity at any time after 30 September 2021 (**Termination Date**) by giving one day's notice to the Reserve Bank. Otherwise, obligations under this letter of indemnity may be terminated by agreement between the Crown and the Reserve Bank if they both believe the LGFA Programme is no longer needed as a monetary policy tool.

Termination of this indemnity will not release the Crown from any liability in respect of Losses occurring after the Termination Date in respect of the Indemnified LGFA Bonds.

For the purposes of this section:

- **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 Cap.
- **Cap** means $3 billion or such other amount agreed between the Minister and the Reserve Bank from time to time as the maximum amount of Indemnified LGFA Bonds that can be held by the Reserve Bank in respect of which the Crown will indemnify the Reserve Bank for Losses.
- **LGFA Interest Risk Losses** means the amount by which any of the interest expense incurred on funding the amount invested in Indemnified LGFA Bonds, exceeds the interest income earned on the Indemnified LGFA Bonds during a calendar month; and the amount of realised losses less any realised gains on disposal of any Indemnified LGFA Bonds during that month - as calculated for each calendar month in accordance with generally accepted accounting practice.
- **LGFA Credit 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 LGFA Interest Risk Losses and LGFA Credit Losses.

Claims under the indemnity

The Reserve Bank may claim under this indemnity within 10 days of the end of each month for LGFA Interest Risk Losses incurred in that 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 LGFA Interest Risk Losses to the Reserve Bank within one business day of having received the Notice.

If the Reserve Bank make a gain on any Indemnified LGFA Bond in any month (calculated using the same principles and accounting practice as is used to calculate Losses), it must notify the Crown within 10 days of the end of the month and pay an amount equal to that gain to the Crown within one business day.

If the Reserve Bank realises any LGFA Credit 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 Losses to the Reserve Bank within one month of having received the Credit Loss Notice.

Exclusions from the Indemnity

This indemnity only applies to interest rate risk and credit risk on Indemnified LGFA Bonds. It does not apply to consequential risks such as operational risks in purchasing or holding Indemnified LGFA Bonds.

This indemnity does not apply to other aspects of alternative monetary policy such as large-scale purchases of private sector assets, large-scale purchases of foreign currency assets, interest rate swaps or term lending, nor does it apply to large scale purchases of domestic New Zealand government bonds which are covered under a separate letter of indemnity dated 21 March 2020.

Crown expectations of the LGFA Programme

The Reserve Bank should endeavour to ensure that the LGFA Programme is designed to minimise distortions in the market for LGFA Bonds. To help achieve this, the Reserve Bank must cooperate with the Treasury's Capital Markets unit when designing the LGFA 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 alternative 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 LGFA Programme and which sets out how the Reserve Bank will manage the potential risks covered by this letter of indemnity. The Reserve Bank recognises the importance of the risk control framework and will work to finalise an updated risk control framework to the reasonable satisfaction of the Treasury in the next 7 days.

Monitoring of potential Losses

As part of the risk control framework, the Reserve Bank will provide the Crown with an initial estimate of potential Losses and any other fiscal risks associated with the LGFA Programme.

The Reserve Bank will notify the Crown if the fiscal risks associated with the LGFA Programme differ materially from the initial estimate and, in particular, will update the Crown on significant market events and on any concerns about the possibility of default on Indemnified LGFA Bonds that could trigger payment for LGFA Credit Losses.

Accountability and transparency expectations

The Reserve Bank must closely monitor the impact of the LGFA Programme on financial markets more broadly and on risks to the financial system.

The Reserve Bank must run the LGFA Programme in a transparent manner and is accountable for its operation. The MPC will be accountable for decisions in respect of the LGFA 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 develop and publish frequent public reports on the transactions under the LGFA Programme, provided that such publication does not compromise the efficacy of the LGFA 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 LGFA 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 LGFA 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 under Indemnified LGFA Bonds.

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