RESERVE BANK
OF NEW ZEALAND
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Aide-memoire for Minister of Finance on Macro-Prudential Policy: Consultation Results

INTRODUCTION

1. During March and April, the Reserve Bank undertook a public consultation on its proposed framework for macro-prudential policy. The consultation document solicited views on the proposed objectives, instruments and decision-making framework and the potential costs of using macro-prudential policy instruments. It was intended that, following the consultation and any subsequent revisions to the framework, I would sign a memorandum of understanding with the Bank giving effect to the framework.

2. The Reserve Bank has informed me that the consultation has provided useful feedback that will help inform the detailed technical design of its macro-prudential instruments over the coming weeks. However, the Bank does not believe major modifications to the proposed framework or scope of monitoring are required in light of the consultation. Accordingly, I expect to be able to sign the memorandum of understanding with the Reserve Bank prior to the Budget.

3. This note briefly summarises the feedback from the consultation process and the Reserve Bank's responses on some of the points that have been raised. The Bank will. publish a summary of submissions over the coming weeks that will consider these issues in further detail. The presentation slides attached to this note cover the main points raised in the note.

4. The contents of this paper will form the basis of a paper for Cabinet on 6 May.

THE PROPOSED MACRO-PRUDENTIAL FRAMEWORK

5. On 4 March, Cabinet considered a background paper on the macro-prudential policy framework and a draft Memorandum of Understanding. A short summary of the main points made in those documents is as follows.

6. Macro-prudential policy would aim to promote financial stability by:

- Increasing the resilience of the financial system during periods of rapid credit growth and rising leverage or abundant liquidity; and

- Dampening excessive growth in credit and asset prices.

7. The Reserve Bank proposed a suite of four tools for the conduct of macro-prudential policy in New Zealand, which include:

- Adjustments to the Core Funding Ratio (CFR);

- The Counter-Cyclical Capital Buffer (CCB);

- Adjustments to sectoral capital requirements (SCR);

- Quantitative restrictions on the share of high loan-to-value ratio loans to the residential property sector (LVR restrictions). These could be either outright prohibitions, or "speed limits" on the share of lending e.g. only 5% of new housing lending can be for LVR greater than 90%.

8. The benefits of macro-prudential policy instruments come from reducing the risks to the financial system that can arise from unsustainable credit and asset price growth and rising household or business sector leverage. As many countries have experienced in recent years, boom-bust cycles in credit and asset prices can be extremely destabilising for banking systems and can create large economic costs. They can also pose a significant fiscal risk for the government balance sheet. While New Zealand was fortunate not to have experienced the major upheaval in its financial system seen in some countries, macro-prudential policy represents an important step in reducing the financial system's vulnerability to any such instability in the future.

9. The Reserve Bank has noted that one or more of the above tools could be temporarily applied to banks in response to extremes in credit and asset price cycles. While each tool offers benefits in terms of the objectives set out above, there are costs and risks attached to them. These include:

   - Risks of avoidance and the administrative costs associated with implementing and enforcing the instruments;

   - Efficiency costs and other unintended consequences associated with regulation or restrictions;

   - Possible financial sector disintermediation whereby lending shifts to non-bank lenders not subject to the instrument;

   - Distributional considerations (for example the tools might impact more heavily on different socio-economic segments of the population).

10. Under the proposed framework, the Reserve Bank would consult with the Minister of Finance ahead of making macro-prudential policy decisions and keep the Minister regularly informed of any conditions that might warrant a future macro-prudential policy response. However, final policy decisions would rest with the Governor of the Reserve Bank. The Bank would account publicly for its assessments and decisions, primarily in its regular six-monthly Financial Stability Reports.

11. The Memorandum of Understanding between the Reserve Bank and myself would:

- Set out the objectives of macro-prudential policy and list the macro-prudential instruments;

- Outline the Reserve Bank's powers and governance and accountability mechanisms for the conduct of macro-prudential policy; and

- Require amendment should the Reserve Bank contemplate changes to the proposed framework e.g. by adding new policy instruments.

A SUMMARY OF SUBMISSIONS TO THE MACRO-PRUDENTIAL CONSULTATION

Objectives

12. Submissions were generally supportive of the proposed objectives of macro-prudential policy. However, a few submitters questioned whether additional prudential regulation is needed, particularly given the increase in bank capital and liquidity requirements over recent times. The main rationale is that existing 'micro-prudential' regulation may still not be sufficient to contain a build-up in financial system risk during extremes in the credit cycle, particularly where it involves substantial increases in asset prices or rising household or business sector leverage. It is not envisaged that macro-prudential tools would be used continuously.

13. Some submitters asked whether macro-prudential tools could more actively assist monetary policy goals, exchange rate management or housing affordability. The Reserve Bank believes such tools will generally support monetary policy but are unlikely to be as powerful as the Official Cash Rate. The tools are not well suited for directly pursuing other economic policy goals and, under its Act, such tools must be used for financial stability purposes. However, to the extent that macro-prudential tools are successful at dampening excessive housing credit and house price cycles they may contribute indirectly to broader policy goals, by keeping future house price growth more in line with economic fundamentals such as income growth.

Loan to Value Restrictions

14. Much of the focus in the submissions was on the use of LVR restrictions. Key concerns were around the potential adverse effects of LVR restrictions on first home buyers, small businesses (some of which borrow using housing as security) and the rebuilding of Christchurch. Some submitters suggested exemptions for such borrowers, or targeting LVR restrictions at regions where high LVR lending is more prevalent.

15. The Reserve Bank's aim would be to apply the restrictions only at times when high LVR lending was judged to be posing a significant risk to financial system stability, and for a limited period. The Reserve Bank advises that while some

exemptions are likely to be required to avoid conflict with other Government policy objectives (such as for borrowers under the Welcome Home Loans scheme) or trapping borrowers with their existing lenders, setting broad exemptions could significantly dilute the effectiveness of the instrument. Targeting LVR restrictions to particular regions is potentially feasible but would entail significant practical difficulties and could create other distortions. Broad-based LVR restrictions are still likely to bite more in regions where credit and house price growth is strongest and house prices particularly elevated.

16. One variant of the LVR restriction proposed in the Reserve Bank's consultation paper would be to set a limit on the share of high LVR lending that banks can undertake in a given period. This would enable banks to continue providing some high LVR loans to creditworthy borrowers. There was support for this approach among the major banks in preference to an outright prohibition.

Avoidance/disintermediation risks

17. Submitters raised avoidance risks around LVR restrictions, including the potential for borrowers to use unsecured lending to top up their deposit, or 'gaming' through reclassification of lending away from housing or manipulation of loan valuations. Although borrowers could turn to unsecured lending, banks typically charge higher interest rates on such lending and have tighter credit processes, so there would still likely be some dampening effect on credit growth. The Reserve Bank will be tightening its policies around loan valuations and definitions to mitigate gaming risks.

18. It was suggested that the use of macro-prudential tools could displace lending away from banks towards lenders not subject to the instrument. For example, some lending could be picked up by finance companies funded through wholesale markets. The Reserve Bank acknowledges that some degree of disintermediation is likely when the tools are used. The Bank believes that the risks of disintermediation will be mitigated partly by its intention to use the instruments in a temporary and occasional fashion; also that disintermediation does not matter for the objective of increasing financial system resilience provided the lenders are not part of the core New Zealand financial system (e.g. if they are offshore). The Reserve Bank would monitor for signs of disintermediation, and intends to consider whether to extend the framework to non-banks once the core framework has been put in place.

Instrument effectiveness

19. Comments about effectiveness focused more on the objective of dampening the credit cycle than on the objective of increasing financial system resilience. Some submitters thought that LVR restrictions would be more effective at dampening the credit cycle and asset prices than instruments such as the counter-cyclical capital buffer or sectoral capital requirements. Faced with an additional capital requirement, some banks might make their buffer over the regulatory requirement smaller, so that actual capital may be largely unchanged. This would result in little impact on funding costs or interest rates for new lending. Moreover submitters

suggested that the impact of additional capital or core funding requirements on lending rates would depend on a range of factors, including banks' internal policies and models, the state of equity and debt markets, competitive conditions in lending markets and general economic conditions.

20. These points are largely in line with the Reserve Bank's views. There are a range of factors that the Bank will need to assess – which may vary according to context – when choosing whether and when to deploy macro-prudential instruments, and when selecting an appropriate instrument. Capital and funding based tools may be more effective in building additional resilience into the financial system than directly dampening credit supply or demand, consistent with IMF findings on this topic.

Macro-prudential policy indicators

21. The Bank intends to publish guidance on the on the indicators and judgements that underlie its macro-prudential policy decisions in its regular Financial Stability Reports. Given the broad range of factors shaping financial system risk, the Bank does not believe it will be able to publish simple thresholds or trigger points for decisions in the manner sought by some submitters.

NEXT STEPS ON MACRO-PRUDENTIAL FRAMEWORK

22. Over the next two months, the Reserve Bank intends to continue the detailed technical design of its macro-prudential instruments and will incorporate these into its Banking Supervision Handbook and banks' Conditions of Registration, which will set out the operational details of its various prudential requirements. Further consultation with the banks would occur as part of this process. The Reserve Bank has informed me that it does not consider that major modifications to the proposed macro-prudential policy framework are required in light of the submissions received.

23. Accordingly, I intend to sign the Memorandum of Understanding on Macro-Prudential Policy with the Governor of the Reserve Bank and announce the signing as part of the Budget.

CURRENT PERSPECTIVE ON HOUSING

24. As covered in the attached slides, the Reserve Bank believes there are significant risks in the housing market, with house prices rising strongly led by Auckland and Christchurch, and household sector leverage elevated. The Bank believes measures to increase housing supply, such as freeing up land for subdivision,

reducing the time and cost of housing developments and improving building sector productivity, will be key to alleviating pressures in the housing sector. Potential Reserve Bank policy measures to manage the financial stability risks in the nearer term include increasing capital requirements for high loan-to-value ratio lending, and the temporary use of one or more macro-prudential tools to dampen demand for housing finance. A tightening of monetary policy would be more likely if there were signs that rising house prices were beginning to boost consumption and inflation pressures.

RECOMMENDATIONS

25. It is recommended that you:

(i) **Note** that the Reserve Bank has completed its public consultation on the macro-prudential policy framework.

(ii) **Note** that the consultation has resulted in some useful feedback that the Reserve Bank expects will help inform its detailed technical design and implementation of macro-prudential instruments.

(iii) **Note** that the Reserve Bank does not consider that major modifications to the macro-prudential framework are required in light of feedback received from the consultation.

(iv) **Note** the Reserve Bank's intention to publish a more detailed summary and analysis of submissions.

(v) **Note** my intention to sign the Memorandum of Understanding with the Reserve Bank prior to the Budget.

(vi) **Note** our perspectives on the current state of the housing market.