RESERVE BANK OF NEW ZEALAND
TE PŪTEA MATUA

Macroprudential Policy: Past, Present and Future

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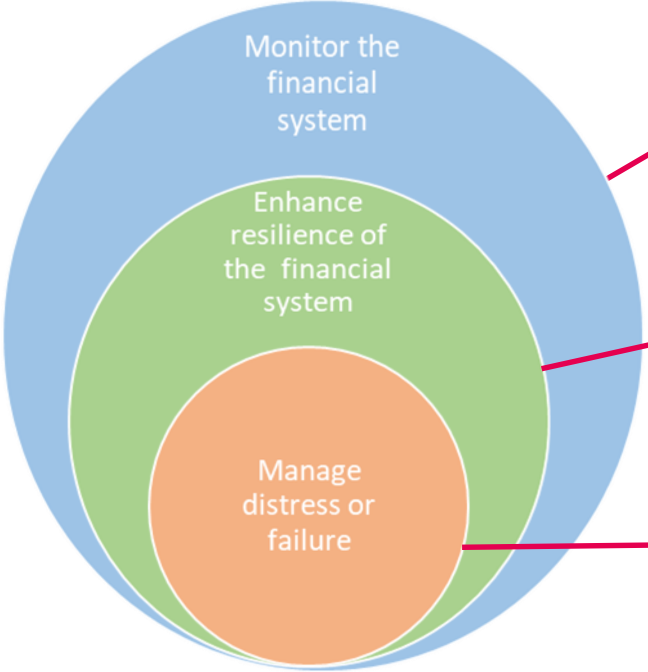
Outline

- Why are we bringing back direct lending restrictions?
- Financial stability is important for wellbeing.
- Macroprudential policy is part of how we safeguard financial stability.
- My talk will cover
  - How does macroprudential policy mitigate risks?
  - Has the Reserve Bank's macroprudential policy enhanced stability? Were there any side effects?
  - What is our strategy for governing and operating the tools?

Maintaining financial stability



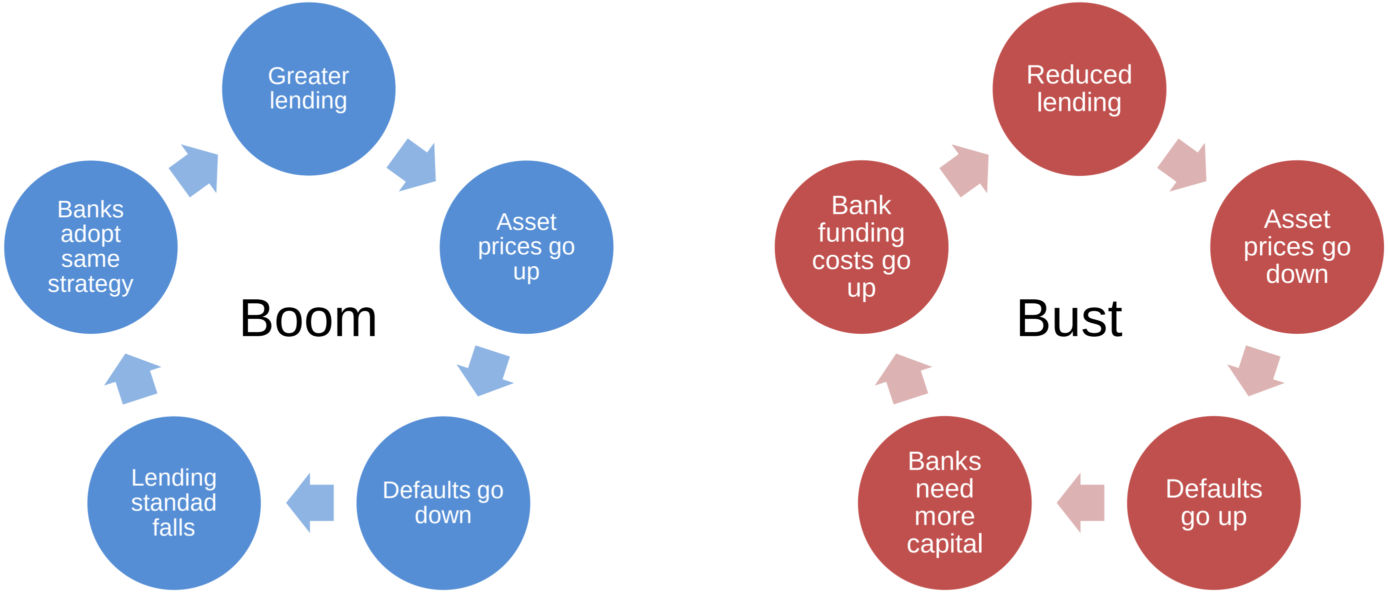
Identify and monitor risks; support effective self and market discipline

Establish rigorous baseline requirements, and adapt as necessary

Minimise the costs of institutional distress or failure

Pro-cyclicality of financial risks

Figure 1: Boom bust financial cycles

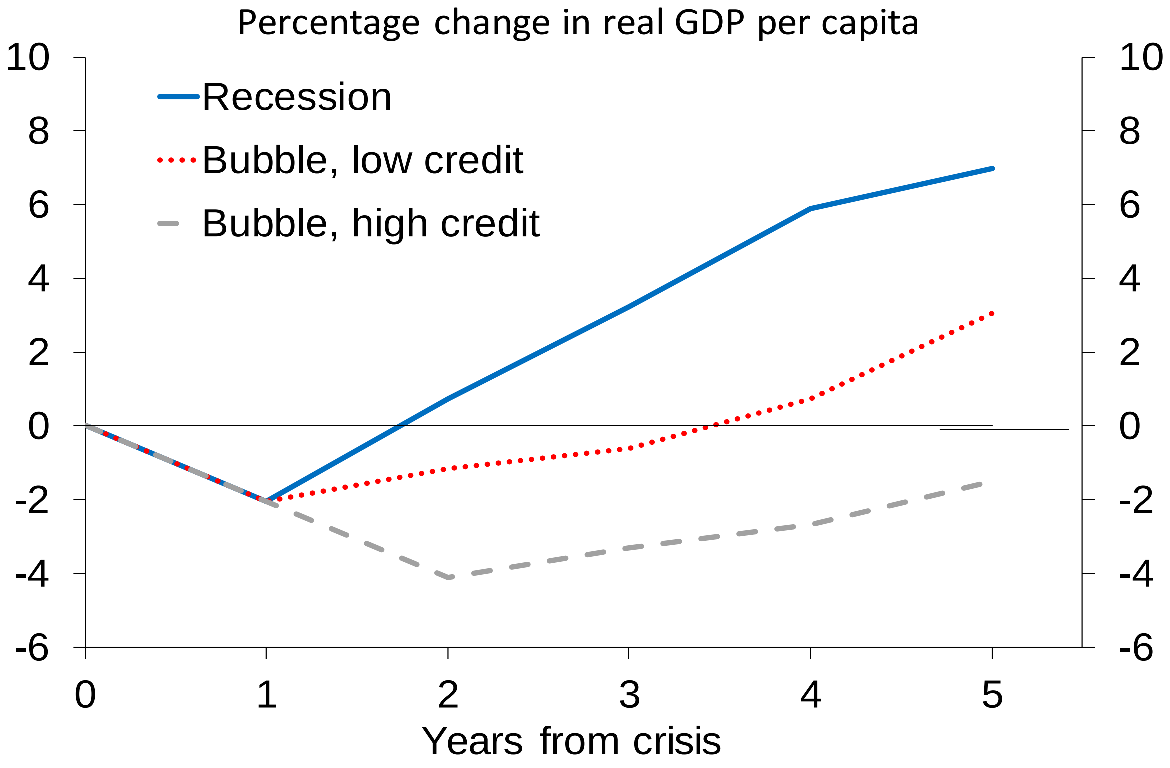


Credit & housing bubbles worsen recessions

Figure 2:

The role of housing bubbles and credit in recessions (1870-2013)

Source: Jorda *et al*.



Role of macroprudential policy

Macroprudential policy…

- …Is a part of our financial stability framework
- …Complements baseline prudential policy (e.g. capital)
- …Builds additional protection when risks are high
- …Interacts with monetary policy
  - Macroprudential and monetary polices tend to be complementary
- …as with all regulation, comes with costs.

Regulatory toolkit

	Purpose	Relevant tools	Impact on financial system resilience	Impact on wider economy
Crisis Prevention	*Macroprudential policy* Reduce risk that the financial system amplifies a severe economic downturn	Borrower restrictions (LVRs)	Reduced losses in a severe economic downturn	More resilient households and banks reduce potential severity of an economic downturn
		Capital and liquidity instruments (CCyB/SCR)		Lowers incentives on banks to deleverage in a downturn; supports higher credit supply and economic activity
	Prudential policy Maintain baseline resilience of the financial system	Capital buffers	Banks remain solvent through the economic cycle	Maintains market confidence and lowers risk of sudden increases in funding costs for households, businesses and the economy
		Liquidity policy		
		Governance and local incorporation		
Crisis Management	Manage and limit impact of distress or failure	Collateral standards	Banks remain functioning parts of financial system	Maintains availability of credit and banking services necessary for economic activity Mitigates costs for creditors and taxpayers
		Outsourcing		
		Open Bank Resolution		
		Minimum capital	Losses absorbed first by shareholders	

Supervision, oversight and disclosure

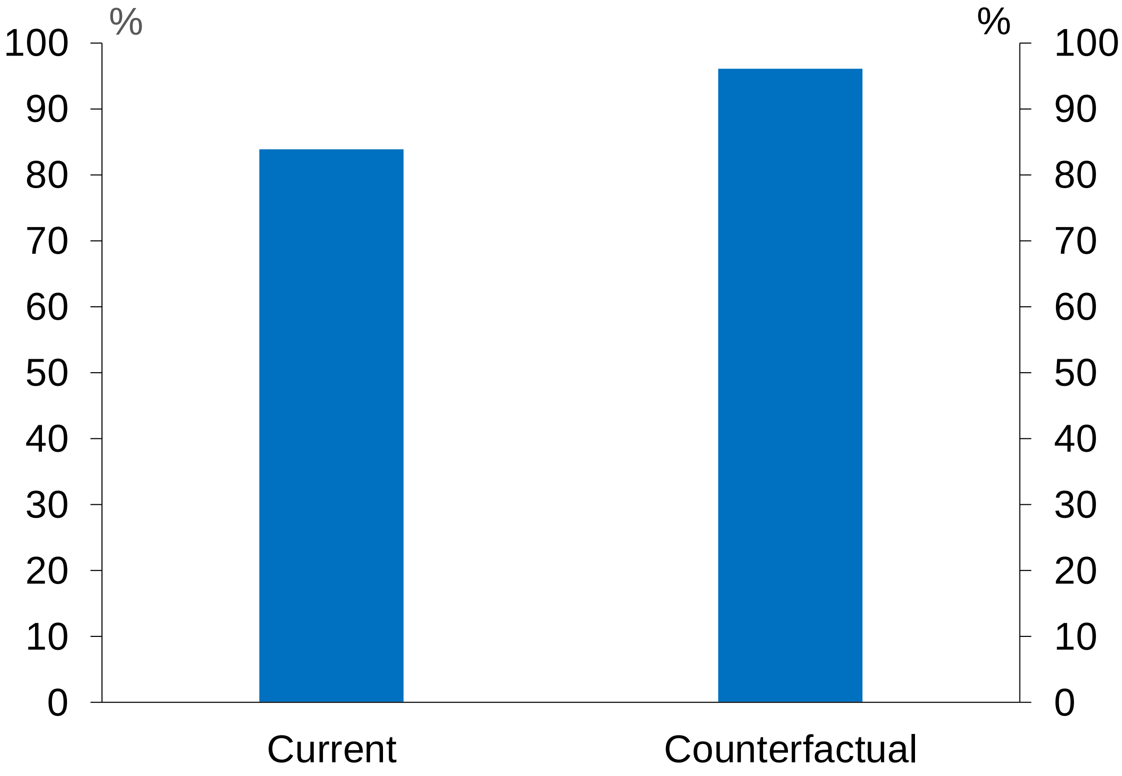
Use of LVR tool increased after GFC

- New Zealand among the leaders in macroprudential policy.
- The GFC has made the world more conscious of financial stability risks.
- Borrower restrictions have gained acceptance internationally.

Review: LVR policy increased bank resilience

Figure 3:

Estimated mortgage losses as share of housing capital requirement in a downturn.



Mitigation of economic downturns

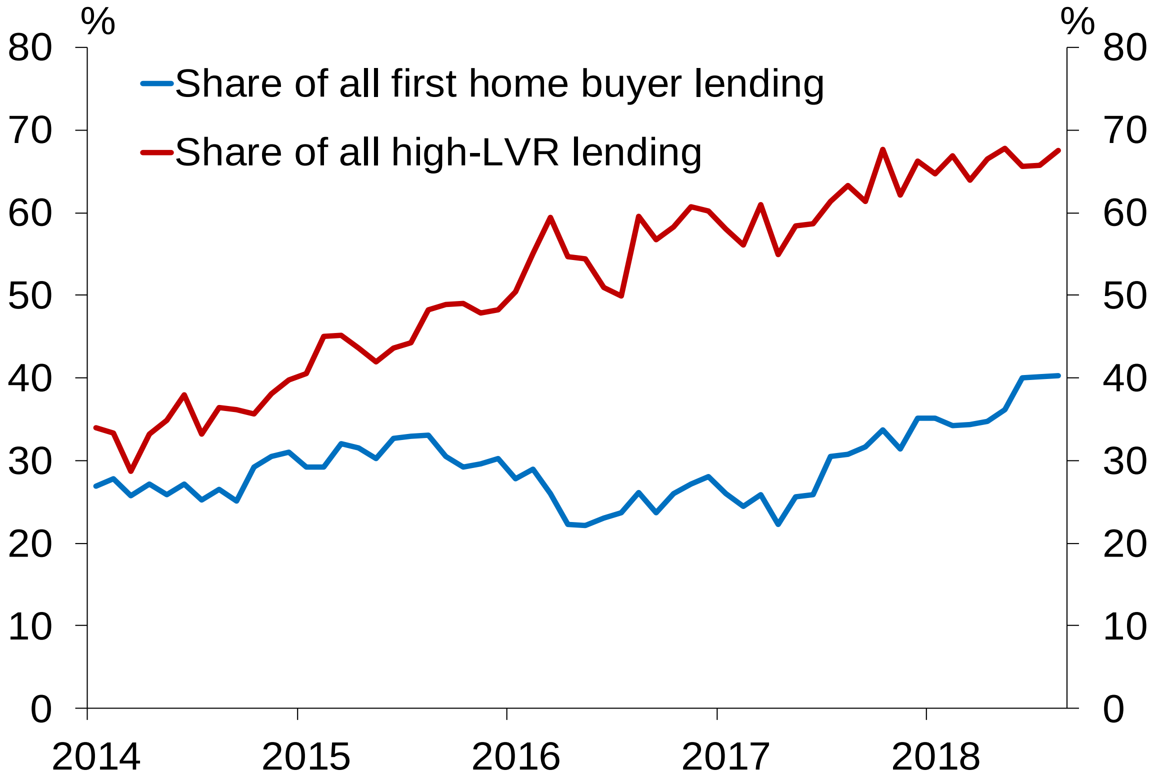
- Internationally, the GFC's effect on economic welfare was worsened by
  - High household debts
  - House price declines

- LVR restrictions will mitigate a downturn because they
  - Reduce households debts
  - Soften a potential house price fall

LVR policy design mitigated impact on FHBs

Figure 4:

Share of first home buyer high-LVR lending



Other policy tensions and limitations

- LVR exemptions mitigated tensions with other public policy areas.
- Regional LVR policy can produce unintended spill-overs.
- Low disintermediation of risky lending to non-bank lenders.

Lessons:

- Good LVR design can help to mitigate tensions with other public policy.
- Importance of consultation around related policies.
- Macroprudential policy is not a tool for social objectives.

Principles of governance

- Operational independence
  - Visible short-term costs vs. long-run, dispersed benefits
  - Independence particularly important for borrower tools

- Transparency is needed for accountability

- Governance board model
  - An alternative is interagency committee, but may undermine accountability.

Operational strategy

Systemic risk monitoring

- Risk of a correction in the credit cycle
- Bank resilience
- Feedback with economy

Policy choice

- Interaction with baseline policy
- Bank-based vs borrower-based tools.

Policy assessment

- Consultation
- Decision
- Ongoing assessment

LVR policy Outlook

- LVR restrictions unchanged in the May FSR
- Easing in the LVR policy over time if risks decline
- Full removal vs. neutral LVR setting?
- Interaction between capital review and LVR policy
  - Higher capital suggests **less active** use of LVRs
  - However, capital proposals and LVRs are complementary policies
  - Capital proposals include a **counter cyclical capital buffer** that could be released in recession

Conclusion

- Macroprudential policy helps to safeguard financial stability.
- Our strategy for macroprudential policy is shaped by
  - Our experience with the LVR tool
  - International evidence
- Our strategy is a starting point for the Government’s review of the macroprudential framework.