

MEMORANDUM FOR FSO Committee

FROM Macro Financial (Author: Mike Thornley)

MEETING DATE 7 November 2018

SUBJECT **Role of the countercyclical capital buffer in the capital framework**

The accompanying paper on the role of buffers in the capital framework recommends that the counter-cyclical buffer (CCyB) should be retained as part of the New Zealand capital framework (#7776522). We are therefore seeking in-principle decisions on how to operate the CCyB. We will use these decisions to calibrate the CCyB and to develop the detailed strategy for setting it.

The attached papers show the work we have done previously on the CCyB, including evidence on the effectiveness of the tool. These papers are for the very keen – ***it is not necessary to read the attached papers prior to the meeting.*** We will present the key insights from the papers, and circulate the slides prior to the meeting.

It is recommended that the Committee:

- **Note** that the purpose of the CCyB is to ensure banks can absorb larger losses when risks are high, and to support lending when banks are recovering from a crisis.
- **Note** that there are two broad approaches to setting the CCyB. A late strategy would raise capital buffers when risks are high. An early strategy would begin building the CCyB towards a prescribed neutral level, even if risks are not elevated. A neutral CCyB is effectively a part of the through-the-cycle (TTC) capital calibration that can be removed during a severe downturn.
- **Note** that there is some, but limited, evidence that using the CCyB could support lending in the period banks are recovering from a crisis (but not in the heat of a crisis). A large CCyB would be required to have a material impact on lending during the upswing.
- **Note** that the choice of neutral CCyB depends on our preference for the usability of capital buffers after a crisis. Less usable buffers provide more certainty that capital will be available to absorb losses after a crisis. More usable buffers may support bank lending, which could reduce the cost of crises.
- **Agree** to using the early strategy for setting the CCyB in order to increase the usability of TTC capital buffers.
- **Agree** that the neutral level of the CCyB will be calibrated based on our desired TTC settings, possibly drawing on the results of past stress tests.
- **Note** that a decision to use the early strategy would imply that banks would build up the neutral CCyB alongside any other increases to TTC capital.
- **Note** that MFD will develop a refreshed indicator set and guidance for the operation of the CCyB based on these decisions.