

Liquidity Management Review Consultation

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ahead of a panel discussion



Reserve Bank
of New Zealand
Te Pūtea Matua

Kia ora koutou, good afternoon, everybody.

Before we begin this panel discussion on liquidity, I wanted to take this opportunity to tell you about a consultation we have just launched this morning.

Now, I know some of you will be thinking that consultations from the RBNZ seem to come pretty thick and fast. But this consultation comes from the Financial Markets Department – so it is not a regulatory consultation – and it’s the first consultation from our department since 2006, when we consulted on the same topic: liquidity management.

Before I go any further, a quick disclaimer: In this presentation and potentially on the panel that follows I will talk about monetary policy implementation. That is the facilities and market operations the Reserve Bank uses to *give effect* to the stance of monetary policy. I won’t be talking *about* the stance of monetary policy – that is the level of the OCR and the outlook thereof – which is a matter for the Monetary Policy Committee. Please refer to the August Monetary Policy Statement for the latest on that.

When we talk about liquidity, what exactly do we mean? At this event two years ago, Assistant Governor Karen Silk gave a speech titled ‘Liquidity: One Word. Three Meanings’. As a quick refresher, these were the 3 types of liquidity we considered in that speech:

- (i) *Funding liquidity*, which speaks to how deposit takers are funded and the composition of their liquid assets
- (ii) *System Liquidity*, which is about the amount of settlement cash in the banking system; and
- (iii) *Market liquidity*, which is about how easy it is to buy and sell securities in the market

When we talk about Liquidity Management we are referring to the RBNZ’s management of system liquidity. Some central banks call this their Operating Framework, we call it our Liquidity Management Framework. But how system liquidity is managed has implications for both funding liquidity and market liquidity.

As you’re probably aware by now, during the COVID-19 pandemic the RBNZ greatly expanded its balance sheet as part of its monetary policy response. That means the settlement cash level rose from around \$6-8billion, which was a target the RBNZ maintained pre-COVID, to at its peak more than \$50b. It’s been declining in the past couple of years to currently around \$30b and it will continue to decline as the last of the pandemic era stimulus tools mature in the next year or so, but it will remain higher than its pre-pandemic level.

Last year we communicated that like many peer central banks we will be seeking to maintain what’s known as an “ample” level of settlement cash. That means comfortably enough to anchor short-term wholesale interest rates near the OCR, without very frequent fine-tuning operations, but not a lot more than this.

A key point that we want to convey in the consultation is that it’s more useful to think of an ample settlement cash level in terms of the conditions it creates in markets, rather than a specific dollar figure. So unlike in the pre-pandemic era, we don’t currently intend to explicitly target a narrow range for the SCL. Although we may find in time that it does settle in a range.

To borrow a phrase used by United States Federal Reserve Chair Jerome Powell to describe another nebulous central bank concept, the neutral interest rate, you will know the ample settlement cash level by its works.

How do we intend to maintain an ample settlement cash level?

Through our Business as Usual (BAU) operations, we can inject and withdraw system liquidity through either transacting in foreign exchange (FX) swaps, which we already do, to maintain FX swap implied NZ dollar interest rates close to the OCR. We can also carry out open market operations – both repo and reverse repo – which we used to do, and we envisage doing more frequently again in the future.

Beyond our BAU operations we also have standing facilities like the Overnight Reverse Repo Facility (or “ORRF”) and from 2028 we will have a Committed Liquidity Facility (more on that later).

I’ll skip the crisis tools for now, but these are the “break-glass” tools and facilities we can deploy if a crisis threatens financial stability.

The consultation we have launched today seeks input on our design of Open Market Operations (OMO) and the Committed Liquidity Facility (CLF)

Firstly, let’s talk about OMOs:

We want to design our OMO with our objectives for a liquidity management framework in mind, these are:

- *Effective monetary policy implementation*: it must ensure that short-term wholesale interest rates are anchored near the policy rate. This is mandated by the RBNZ Board to achieve our economic (price stability) objective
- It should also be designed in a way that *supports financial stability*, being the RBNZ’s other primary objective
- But in addition to those objectives, we want a framework that *supports market liquidity*, that is *consistent with RBNZ regulation*, and that is *operationally simple* for us and our counterparties.

In this consultation, we have split out the OMO into its various parameters and are seeking feedback on each of them. Including how the OMO is run, how often it is run, what the eligible collateral is, and how it is priced.

To give you a bit of an idea about what that might look like, here are two side by side simplified term sheets for an OMO. On one hand we have the status quo, were we to run an OMO currently, which we seldom have in the post pandemic period. This format relies a lot on RBNZ discretion, whether to run an OMO at all and how large it should be. It’s a competitive auction format but is priced with a minimum bid rate of OCR+1 basis point (for Tier 1 collateral), meaning that if the amount offered is comfortably enough to satiate demand, it will clear at essentially the policy rate.

On the right-hand side, we have another possible way to structure an OMO. I want to stress this isn’t necessarily an RBNZ preference at this stage, it’s just an illustrative selection of parameters to demonstrate how else we could do this, but there are other possible configurations. But in this alternative, which looks more like how the RBA currently runs its equivalent, the OMO would be

run on a fixed frequency and critically it would have a fixed price and participants would be able to borrow as much (subject to having the eligible collateral) as they wanted to at that price. This is what's known as fixed rate full allotment.

Now I'd like to focus a bit more on the pricing. Because this is where we do have a preference to articulate. We think that in order to incentivise an efficient distribution of settlement cash, and as an alternative to bringing back credit tiers which existed pre-Covid, the rates at which the RBNZ lends cash and the rates at which it remunerates cash need to be further apart.

We think a spread of at least 15 basis points is needed, but we're relatively agnostic about how that is constructed. We could put it all on the lending side, but this could ultimately prove to be counter-productive to monetary policy implementation if it leads to wholesale rates, particularly repo rates, trading much further away from the OCR. So instead, we could put some of that spread into the deposit rate, meaning essentially that we would remunerate settlement cash – that is cash in ESAS accounts – at a rate slightly below the OCR. And I mean slightly, as in 5-10bps, because any more than that begins to threaten monetary policy implementation also.

We look forward to engaging with market participants and other interested parties on the parameters of the OMO.

Now, I'd like to quickly touch on the other leg of the consultation which concerns the Committed Liquidity Facility or CLF.

As you may recall, the need for a CLF arises from the changes to prudential liquidity policy decided in 2023, for implementation as part of the new Liquidity Standard under the Deposit Takers Act in 2028. That sees a narrowing of qualifying liquid assets to essentially Crown liabilities as Level 1 assets and LGFA and Kauri bonds as Level 2. The remaining categories of assets that are repo eligible with the RBNZ are able to qualify as prudential liquid assets only via the CLF.

The CLF is a committed collateralised borrowing facility. You could think of it as a committed line on the ORRF. In fact, that is how we propose to implement it. But because it is a committed line, that means it attracts a standing fee – payable whether the facility is drawn or not. Essentially this means deposit takers pay a fee to be able to count CLF eligible assets towards their prudential liquidity ratios. It was also proposed through the Liquidity Policy decisions in 2023 that there would be a cap on how much the CLF could contribute to a deposit taker's liquid assets.

Now I have an update on where we see currently see that cap being initialised but first let's recall why we would have a CLF in the first place. The reason is because there is a shortage of assets with sufficient market liquidity, absent a central bank repo facility, to meet the banking system's need for liquid assets. This is why Australia had a CLF from 2015 to 2022, but theirs has been phased out due to the growth in HQLA outstanding (ACGBs and semis in their case). In New Zealand, as you know we have also had material growth in government debt outstanding, so the need for the CLF has, not gone away, but is has reduced.

The teal line on this chart shows NZ government securities outstanding, while the pink line shows those available in the secondary market. So, prior to 2020 those lines were very close. Since then, the difference between the two primarily reflects the RBNZ's holdings through Large Scale Asset

Purchases, but as those holdings mature the pink line is gradually converging towards the teal one again.

The blue line is the total dollar value of deposit takers liquid asset holdings. When the prudential liquidity policy proposal was published in early 2023, you can see that the amount of government securities in the secondary market was less than the total liquid assets of deposit takers – so there was a clear need for a CLF, given the narrowing of qualifying liquid assets. However, fast forward to 2025 and we see that the pink line has now exceeded by around \$30b or so the blue line, meaning that it would be theoretically possible for deposit takers to meet their liquid asset needs solely through holding NZ government securities. Now we're not proposing that. There is still a role for Level 2 (Kauri and LGFA) and CLF (all other repo eligible assets). But whereas in 2023, when we indicated the CLF might make up 40-50% of a deposit taker's liquids, we now think that something in the range of 35-40% is more appropriate.

Similar to the OMO, we are seeking feedback on different features of the CLF, including eligibility, operationalisation, the size and the standing fee. The standing fee is going to be very important because it's going to have a great influence on whether deposit takers want to have a CLF and how they think about the attractiveness of CLF eligible assets versus qualifying liquid assets.

Overall, we are thinking about a CLF that broadly looks similar to what they had in Australia. Although with the standing fee, we are contemplating a possible innovation. Instead of just having a flat fee in basis points, we could have a fee that is a function of the collateral composition of a deposit taker's CLF. We are thinking of making a distinction between marketable and non-marketable assets, with the latter for now consisting solely of internal RMBS. So those would attract a higher fee relative to say bank paper, or corporate bonds, which would attract a lower fee. We think this better reflects underlying liquidity risk and provides an incentive to develop markets – but it would be more operationally complex to implement, so we're interested in feedback on that.

Our consultation opens today and it runs until the end of October. If you only have an opinion on one question in the consultation, we'd still like to hear from you. So please make a submission and feel free to reach out.

Now I look forward to joining my fellow panellists for the discussion.

Thanks very much.