

The Treasury

DEV-23-SUB-0169: Financial Arrangements for the Reserve Bank of New Zealand Information Release

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Cabinet Document Details

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Key to sections of the Act under which information has been withheld:

[29] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand

[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

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Financial Arrangements for the Reserve Bank

Proposal

- 1 I am informing the Committee of my decisions relating to the financial arrangements of the Reserve Bank of New Zealand (the Bank). I am seeking Cabinet's agreement to provide the Bank with a capital contribution of \$1.3 billion.
- 2 Subject to my consideration of the public interest test under section 65ZD of the Public Finance Act 1989, I intend to provide the Bank with an indemnity to cover risks resulting from policy interventions that the Bank may need to undertake to support financial stability, such as interventions in the New Zealand Government Bond market. I would expect these interventions would be aimed primarily to support New Zealand's financial stability. I intend to terminate the existing indemnity to support the Large Scale Asset Purchase (LSAP) programme. This would not terminate the liability for LSAP bonds purchased to date but would terminate this indemnity for future bond purchases.

Relation to Government priorities

- 3 These arrangements will ensure the Bank can manage a range of current and future costs and risks related to achieving its objectives. This supports New Zealand's economic resilience.

Executive summary

- 4 The Reserve Bank of New Zealand Act 2021 (the Act) continues the Reserve Bank's role as New Zealand's independent central bank. The Bank is responsible for taking actions to pursue its objectives of achieving and maintaining stability in the general level of prices over the medium term and supporting maximum sustainable employment; and protecting and promoting the stability of the New Zealand financial system.
- 5 Some actions in pursuit of these objectives may require the Bank to bring financial costs or risks on to its balance sheet. To manage these risks the Bank holds financial resources (such as capital and indemnities) to absorb potential losses. Although central banks can operate with negative equity (where liabilities exceed assets), significant negative equity may have reputational impacts that could affect the Reserve Bank's policy credibility. Providing financial resources ex-ante ensures that the Bank has the necessary financial support to intervene, where necessary, in pursuit of its objectives.

- 6 Following advice from the Bank and the Treasury, I am asking Cabinet to agree to provide the Bank with \$1.3 billion of capital. In addition, and subject to my consideration of the public interest test under section 65ZD of the Public Finance Act, I also intend to provide the Bank with an indemnity covering losses of up to \$5 billion. This is aimed primarily at supporting interventions that the Bank may need to undertake to promote financial stability and financial market functioning, such as interventions in the New Zealand government bond market. Once established, I intend to terminate the existing Large Scale Asset Purchase (LSAP) indemnity. This would not terminate the liability for LSAP bonds purchased to date but would terminate this indemnity for future bond purchases.
- 7 These arrangements will ensure the Bank has sufficient financial resources to intervene for financial stability purposes and to undertake conventional monetary policy, including some support to establish a negative interest rate if required. The financial backing also provides support for some risks already on the Reserve Bank balance sheet. Should the Bank require further financial resources, for example to undertake a Large Scale Asset Purchase programme (beyond that provided for by the new, proposed indemnity), I would expect they will consult the Minister of Finance at the time to seek financial backing. To that end, there is a Memorandum of Understanding (MoU) between the Bank and the Minister of Finance, which sets out a process by which the Bank would request additional financial backing.
- 8 Providing the Bank with additional capital or an indemnity will not directly impact net debt, as the Bank is consolidated within the Crown balance sheet. Any gains or losses from the activities the Bank undertakes will impact on the Crown balance sheet. The quantum of financial backing has been determined on the basis of a severe loss scenario. The Bank may also make gains on their interventions and any losses, if they do occur, would be expected to be significantly smaller than the maximum loss coverage this financial backing provides.

Background

- 9 In 2021, following a Treasury and Reserve Bank led review, I introduced the Reserve Bank of New Zealand Act, which came into force in July that year. The Act created a new Governance Board for the Bank. The legislation is clear that the Monetary Policy Committee independently formulates monetary policy in pursuit of its economic objectives. The Governance Board makes decisions relating to its financial stability objective. As Minister, I issue a Monetary Policy Remit and a Financial Policy Remit which provide guidance on these objectives. The Board has a collective duty to ensure the Bank acts in a financially responsible manner, and, for this purpose, that it prudently manages its financial assets and liabilities.
- 10 In November 2022, I informed Cabinet of my intention to agree a Foreign Reserves Coordination and Management Framework with the Bank and informed Cabinet of my intent to provide the Bank with an indemnity [29], [37] to manage potential risks arising from interventions with the foreign reserves. I also sought Cabinet's agreement to a capital contribution of \$500 million for the Bank to manage risks to its capital from holding the increased level of reserves [CAB-22-MIN-0532 refers]. In addition, I informed Cabinet of my intention to issue a direction under the Act conveying my expectations as to the Bank's financial risk management. After consulting with the

Bank, in conjunction with completing the broader review of the Bank's financial resources, my view is that such a direction is unnecessary in the current context.

The Bank's financial resources

- 11 As an independent central bank, the Reserve Bank of New Zealand, like most central banks, uses its balance sheet to support its objectives of achieving and maintaining stability in the general level of prices over the medium term and supporting maximum sustainable employment (the 'economic objectives'); and protecting and promoting the stability of the New Zealand financial system (the 'financial stability objective').
- 12 For many of the Bank's tools, there are relatively limited financial impacts on the Bank's balance sheet, such as conventional monetary policy, prudential policy settings, supervision of individual institutions and managing the payment system. In other areas, the Bank's actions in pursuit of its objectives could have financial costs or bring financial risk on to its balance sheet. For example, when undertaking large scale asset purchases in 2020/21, the Bank purchased fixed rate debt and issued floating rate liabilities. This exposed the Bank's balance sheet to rising interest rates. Past and expected future losses on the Bank's balance sheet as a result of LSAPs are approximately \$10.5 billion. The Bank are reimbursed for these losses through an LSAP indemnity issued under the Public Finance Act 1989.
- 13 These risks can be managed either through additional capital or through an indemnity under section 65ZD of the Public Finance Act 1989 to offset potential losses. Providing financial backing to the Bank, either through an indemnity or capital, would not impact net debt. This is because the Bank is consolidated onto the Crown balance sheet: at a whole of government level the transaction is eliminated on consolidation.¹ However, gains and losses on the underlying activity the Bank undertakes e.g., bond purchases, will impact the Crown balance sheet.
- 14 I am seeking cabinet agreement to provide a \$1.3 billion capital contribution to the Bank and informing Cabinet of my intention to provide an indemnity under the Public Finance Act 1989. These resources will ensure the Bank have the necessary financial backing to undertake a range of activities in pursuit of its objectives.
- 15 If the Bank deems it necessary to use tools beyond what it has sufficient financial resources for, I would expect it to engage with the Minister of Finance of the day to seek additional resources where practicable. With respect to alternative monetary policy tools, this expectation is captured in an existing memorandum of understanding which sets out a process by which the Bank would request additional financial backing.
- 16 Section 208 of the 2021 Act provides for the Minister of Finance to issue a direction to the Bank relating to the Bank's financial risk management. This provides a mechanism for me to influence the potential risks and costs the Bank's activities could bear on the Crown and set my expectations as to when it is appropriate to take on risk that could result in negative equity. At this time, I do not intend to issue such a direction to the Bank.

¹ Although technically the form of financial backing could affect the Crown's interest rate exposure, which could have an impact on net debt over time.

A capital contribution to support monetary policy and financial stability

- 17 The Bank has assessed its capital needs and has requested a capital contribution from the Crown to meet updated estimates of risks currently on the balance sheet, as well as additional capital to support the future use of tools to meet its objectives. As discussed above, I am asking Cabinet to agree to provide the Bank with \$1.3 billion of additional capital. This will require the establishment of a new appropriation.
- 18 The \$1.3 billion reflects the following underlying estimates:
- Approximately [29], [37] to support the future use of negative interest rates as a monetary policy tool. This amount reflects the direct losses that would result on the Bank's balance sheet if the OCR were to be taken to negative [29], [37]
 - Approximately [29], [37] to support business-as-usual liquidity management and implementation of the OCR framework, as well as tactical interventions to support financial stability and market functioning. This is envisioned to be complemented by the \$5b indemnity, discussed further below.
 - Approximately [29], [37] to cover the Bank's other risks – relating to COVID-19 interventions already on the balance sheet, and changes to other risk estimates.
- 19 In addition, the Bank had requested a further \$900 million to support it to undertake interest rate exemption tiering.² However, I am not seeking capital for interest rate exemption-tiering.

A financial stability indemnity

- 20 I believe that the Bank should have pre-positioned financial backing to undertake interventions to support and promote market functioning and financial stability. This can happen when a financial market, e.g., the New Zealand Government Bond (NZGB) market, becomes dysfunctional and warrants intervention. To support the functioning of the market, it might be necessary for the Bank, at times, to intervene in order to re-establish the market and support liquidity, such as by purchasing bonds.
- 21 To ensure the operational independence of the Bank to intervene for financial stability, I propose to provide upfront financial backing of an indemnity capped at \$5 billion of losses.³ [29], [37]

This has been set at a scale that the Bank consider would be sufficient for interventions primarily for market functioning purposes. It would not provide for a future LSAP program of the scale of the 2020/2021 program. This means the financial backing will be put in place to allow the Bank to intervene to a limited extent without seeking additional financial resources from the Minister of Finance.

² Exemption tiering is a policy whereby the Bank pays 0% interest on an initial tier of commercial banks settlement cash holdings at the Bank when the OCR is negative (as opposed to the negative rate of interest that would otherwise apply).

³ This indemnity would complement the additional capital to support tactical interventions to support financial stability and financial market interventions.

- 22 Because I am responsible for the fiscal position of the Crown (which includes the Bank, within the consolidated balance sheet), and because intervention by the Bank could relate to other information or decisions being made by the Government during a crisis, I would expect the Bank to engage and inform me if the Bank undertakes an intervention. To avoid administrative hurdles in a time of crisis, the above requirements to brief me, and provide information and reporting, would only apply as is practicable in the circumstances. It would be clear that the Bank remains the independent decision maker.
- 23 I am yet to receive final advice on the indemnity, including an assessment of whether this is in the public interest, as required by the Public Finance Act 1989.
- 24 Once the new indemnity is established, I intend to terminate the current indemnity for LSAP, which was granted in August 2020. This would not terminate the liability for LSAP bonds purchased to date but would terminate this indemnity for future bond purchases. The Bank would be able to rely on the new indemnity discussed above if they needed to intervene for financial stability purposes. Beyond this, consistent with the Memorandum of Understanding on the use of alternative monetary policy tools, I would expect that the Bank would make a request for further financial backing from the Minister of Finance at the time.

Next steps

- 25 I will request further advice on the public interest of the financial stability indemnity.
- 26 I will terminate the current LSAP indemnity signed in August 2020, following agreement of the new indemnity.

Human rights

- 27 There are no inconsistencies with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Cost-of-living Implications

- 28 There are no immediate cost of living implications.

Financial Implications

- 29 Providing the Bank with additional capital or an indemnity will not directly impact net debt, as the Bank is consolidated within the Crown balance sheet. Any gains or losses from the activities the Bank undertakes will impact on the Crown balance sheet. The impacts could be positive or negative.
- 30 The impact on the government's bond funding programme will depend on how the transaction is executed. If, like previous capital injections to the Bank, the Bank re-invest the proceeds in non-market New Zealand government bonds, this will not impact the government's funding programme.

Use of external Resources

- 31 A contractor at the Treasury provided incidental support and advice during the development of this policy.

Consultation

- 32 The underlying policy has been developed by the Treasury in consultation with the Reserve Bank.
- 33 The Department of the Prime Minister and Cabinet has been consulted.

Communications

- 34 The indemnity will be presented to the House.

Proactive release

- 35 This paper will be proactively released following issuance of the indemnity. Parts of this Cabinet paper will be withheld as appropriate.

Recommendations

The Minister of Finance recommends that the Committee:

- 1 **agree** to issue a capital contribution of up to \$1,300.000 million to the Reserve Bank of New Zealand to ensure the Bank can manage a range of current and future costs and risks related to achieving its objectives
- 2 **agree** to establish the following new appropriation:

Vote	Appropriation Minister	Appropriation Administrator	Title	Type	Scope
Finance	Minister of Finance	The Treasury	Capital Contribution to the Reserve Bank of New Zealand - Current and Future Risk Management	Non-Departmental Capital Expenditure	This appropriation is limited to a capital contribution to the Reserve Bank of New Zealand for the management of current and future costs and risks in support of its objectives.

- 3 **approve** the following changes to appropriations to give effect to the policy decision in recommendation 1 above, with no impact on net debt:

Vote Finance Minister of Finance	\$m – increase/(decrease)				
	2023/24	2024/25	2025/26	2026/27	2027/28 & outyears
Non-Departmental Capital Expenditure: Capital Contribution to the Reserve Bank of New Zealand - Current and Future Risk Management	1,300.000	-	-	-	-

- 4 **note** that the Minister of Finance may elect to provide a lower level of capital than \$1,300.000 million, in particular upon considering the Reserve Bank’s forthcoming dividend proposal
- 5 **agree** that the proposed change to appropriations for 2023/24 above be included in the 2023/24 Supplementary Estimates and that, in the interim, the increase be met from Imprest Supply
- 6 **note** that providing the Bank additional financial backing does not directly create an additional cost to the Crown or directly impact net debt, because the Bank is consolidated within the Crown balance sheet; however, any additional risk the Bank takes would flow through to the Crown
- 7 **note** that subject to further advice including the public interest test, I intend to provide the Bank with an indemnity under Section 65ZD of the Public Finance Act 1989 for up to NZD\$5 billion to cover potential losses from interventions the Reserve Bank may need to undertake to support financial stability
- 8 **note** I intend to terminate the existing remaining indemnity for the Large Scale Asset Purchase (LSAP) programme, following establishment of the new indemnity
- 9 **note** that I no longer intend to issue a direction under section 208 of the Reserve Bank of New Zealand Act 2021.

Authorised for lodgement

Hon Grant Robertson

Minister of Finance