Macro-prudential policy in the New Zealand context

Monetary Policy Workshop on Strengthening Macro-prudential Frameworks

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Chris Hunt
Reserve Bank of New Zealand

Outline

1. Broader economic and institutional context
2. Objectives of macro-prudential policy
3. Expanding the macro-prudential toolkit
4. The *core funding ratio* as a macro-prudential instrument
5. Where to from here

The New Zealand context

- Small, open economy
  - Impact of high exchange rate on the tradables sector a key concern
  - Housing market a key driver of the business cycle
- Bank dominated financial system
  - Highly concentrated, foreign owned
- Net debtor economy
  - Banks conduit for foreign borrowing
  - Reliance on short-term wholesale funding

Institutional context

- RBNZ ‘full service’ central bank
  - Enabling legislation: promote soundness (and efficiency) of the financial system
- Explicit macro-financial/prudential focus and analysis has evolved over time
  - Macro-financial Stability team established in 2000
  - Macro-financial Committee established during GFC
- Supporting monetary policy? – the ER dilemma
  - 2006: investigated use of *supplementary stabilisation instruments* (‘tweaky tools’)

Objectives of macro-prudential policy

- Ultimate objective: address systemic (non-diversifiable) risk within the financial system
  - Cross-sectional dimension
  - Time-varying dimension

- Proximate objectives
  - Building institutional resilience through buffers, firewalls etc
  - Reducing the amplitude of the financial cycle (more ambitious?)

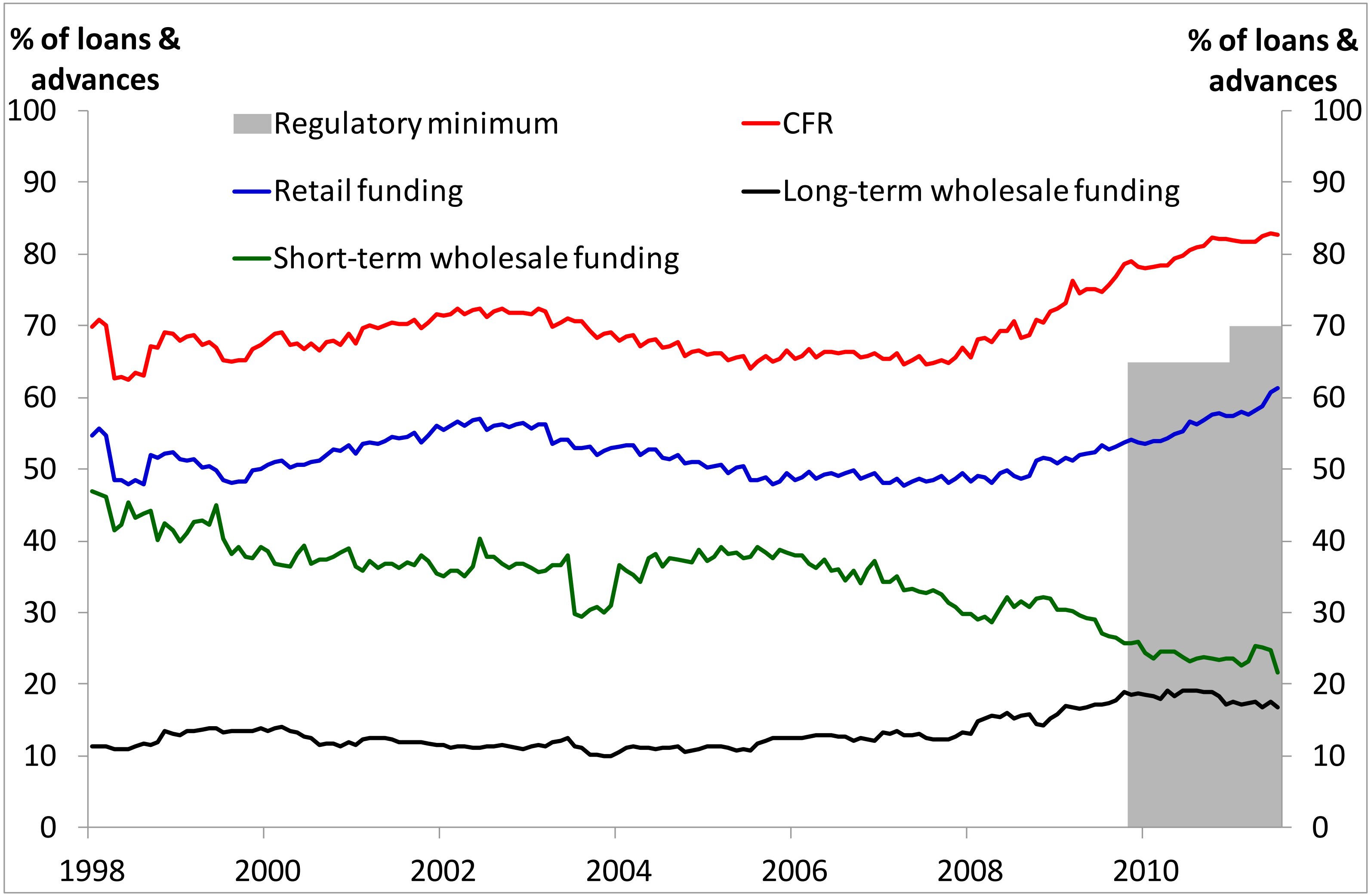
Developing the macro-prudential toolkit at the RBNZ

- Broad assessment of various tools
  - Mainly focused on addressing time-varying systemic risk
    - Basel III counter-cyclical capital buffer (CCB)
    - Adjustments in the core funding ratio
    - LVR restrictions
    - Overlays to sectoral risk weights
  - Note: no current case for deployment of any new tools
- Cross-sectional systemic risk: development of Open Bank Resolution (OBR) policy
- Development of early warning indicator framework to detect emerging financial vulnerabilities and imbalances
- Consideration of legal powers and governance issues

Building liquidity buffers – the core funding ratio (CFR)

- RBNZ's prudential liquidity policy came into effect April 2010
  - Micro-prudential policy aimed at reducing vulnerability of banks to funding/liquidity shocks
  - NZ version of Basel III LCR and NSFR
- CFR: locally incorporated banks required to have a minimum level of 'stable' or core funding
  - Essentially retail funding & wholesale funding greater than 1 year to maturity
- CFR initially set at 65%. Raised to 70% mid 2011
  - Regulatory forbearance: November 2011 decision to delay increase to 75% by six months

Material improvement in banking system funding liquidity buffers



Macro-prudential extension of CFR

- Fixed CFR likely have some stabilisation properties
  - To fund increased lending in a boom banks have to use more expensive funding sources – increases cost of funding for any given policy interest rate – potentially reducing credit growth
  - Hard to rapidly increase long-term wholesale funding – ‘sand in the wheels’ effect
  - But behaviour of credit spreads over cycle could mitigate any counter-cyclical effect

- Discretionary/rule-based adjustments to the CFR
  - Analogous to operation of counter-cyclical buffer
  - Increased resilience as funding buffers built up, then released over cycle
  - Any effect on amplitude of credit cycle depends partly on credit spreads

- Transition arrangements and forbearance mimic discretionary adjustment

Making a case for macro-prudential intervention

Identifying vulnerabilities:

- Macro-prudential indicator report

Some questions to consider – ‘decision tree’:

1. Are debt levels (becoming) excessive or asset prices overvalued?

2. Would macro-prudential overlay be consistent with monetary policy?

3. What is the nature of the imbalance? Sectoral specific risks versus generalised risks.

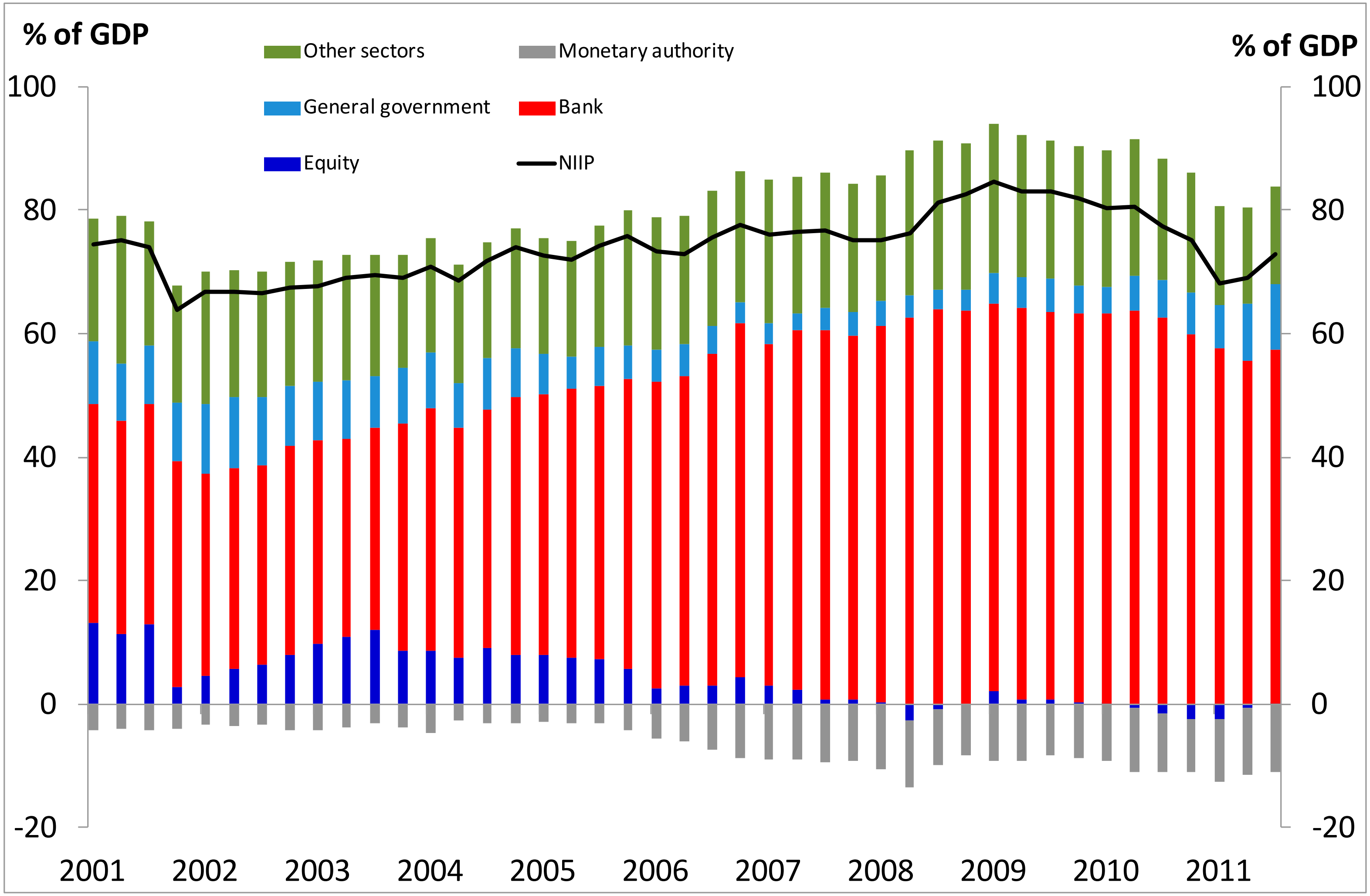
4. Choice of instrument.

Where to from here?

- Refining process to identify vulnerabilities
- Clarifying legal powers and governance structures
  - e.g. use of macro-prudential tools for non-bank deposit-takers (NBDTs)
- Public consultation (for CCB)
- Design and calibration of tools
- Ongoing research and model development

Extra slides

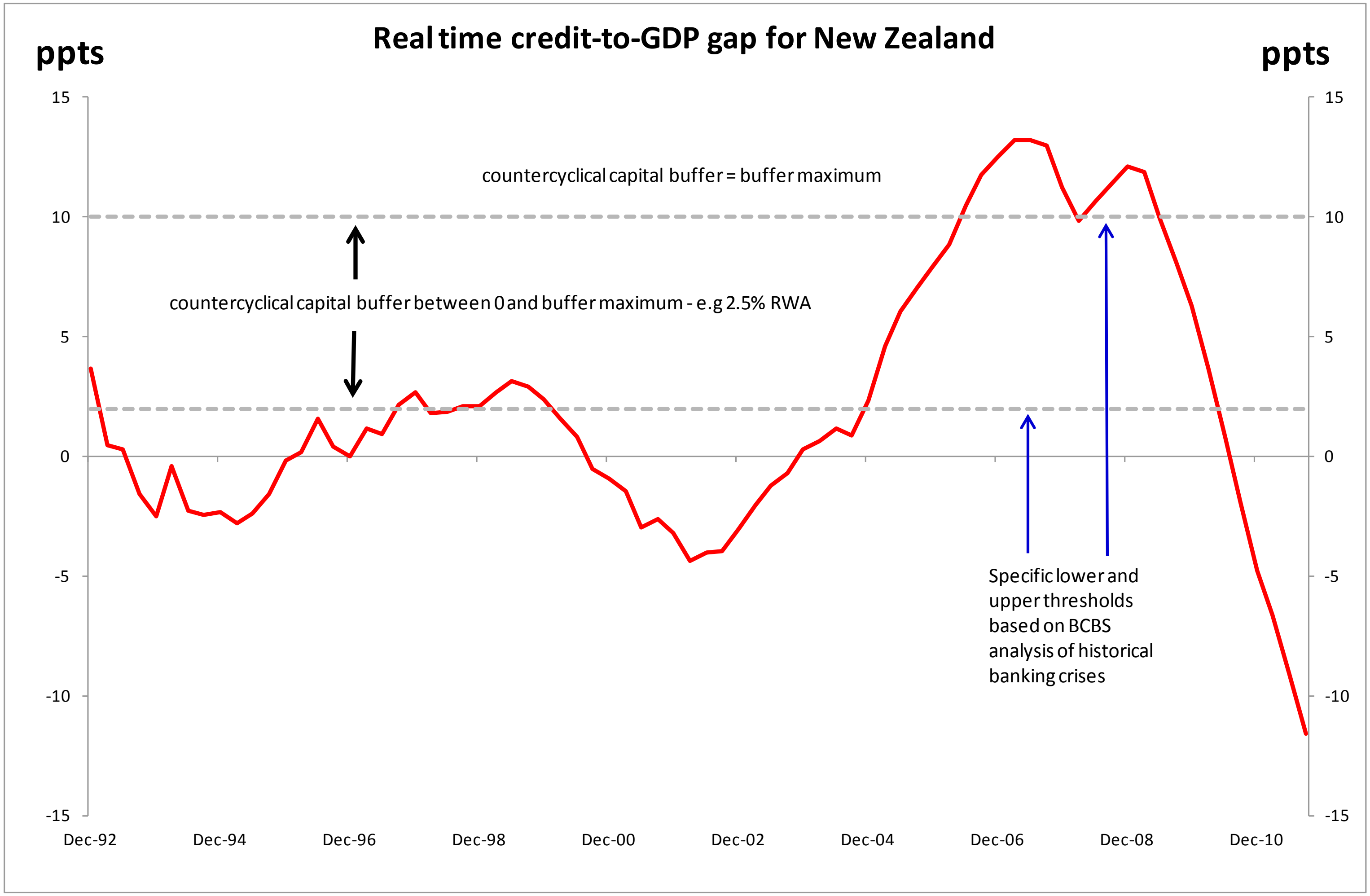
Net external liabilities



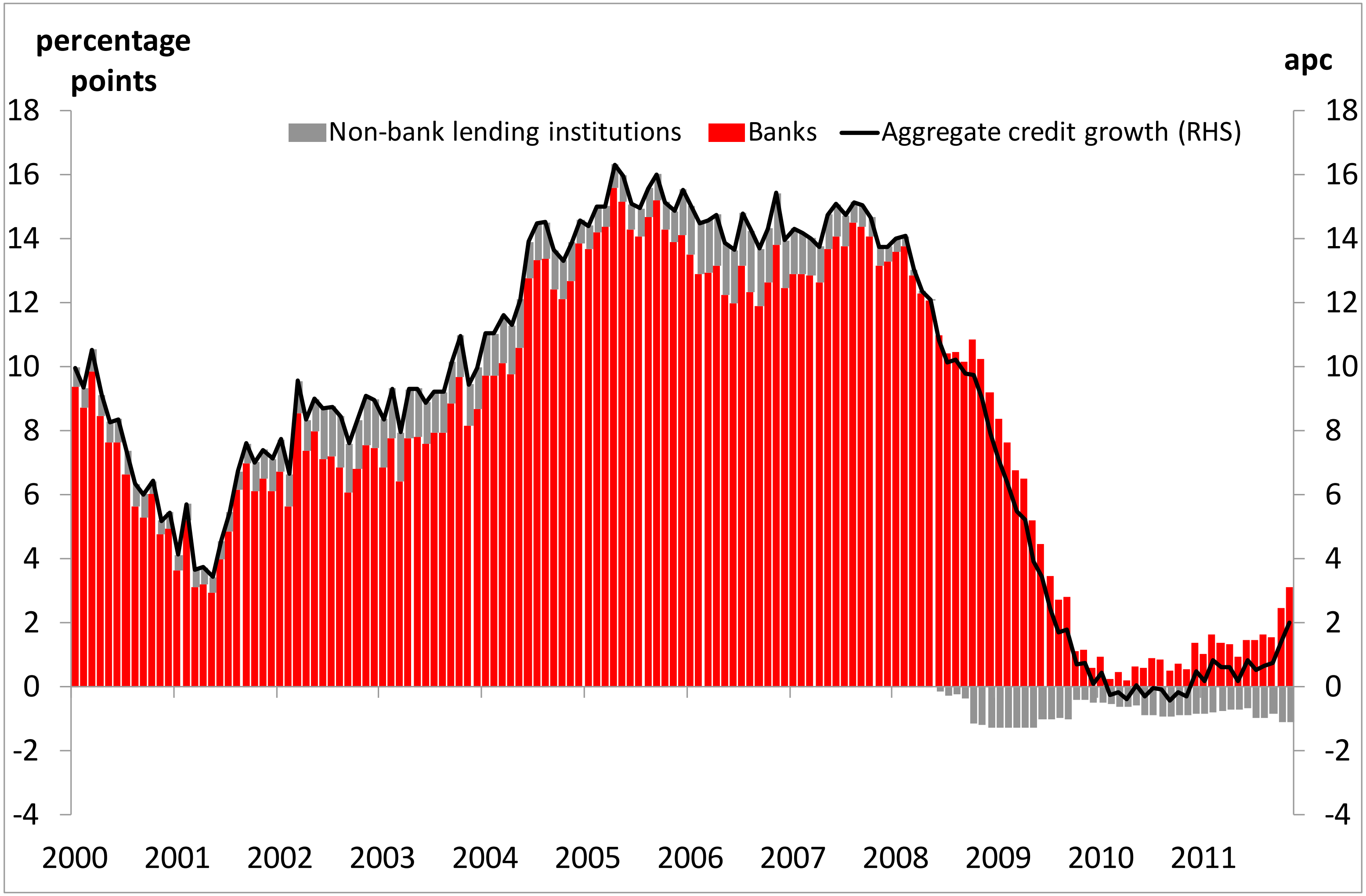
Counter-cyclical capital buffer (CCB)

- Consultation document on core micro-prudential elements of Basel III released November 2012
- Remaining aspects, including CCB, up for further public consultation in April.
- NZ likely adopt Basel III CCB proposal in its generic form
  - Likely use very infrequently
- Issues for implementation
  - Coverage (banks +/- non-bank deposit takers?)
  - Buffer maximum (greater than 2.5%?)
  - Length of notice period (12 months too long?)
  - Governance arrangements
  - Rule-based versus discretion
  - Indicators for application versus release of CCB

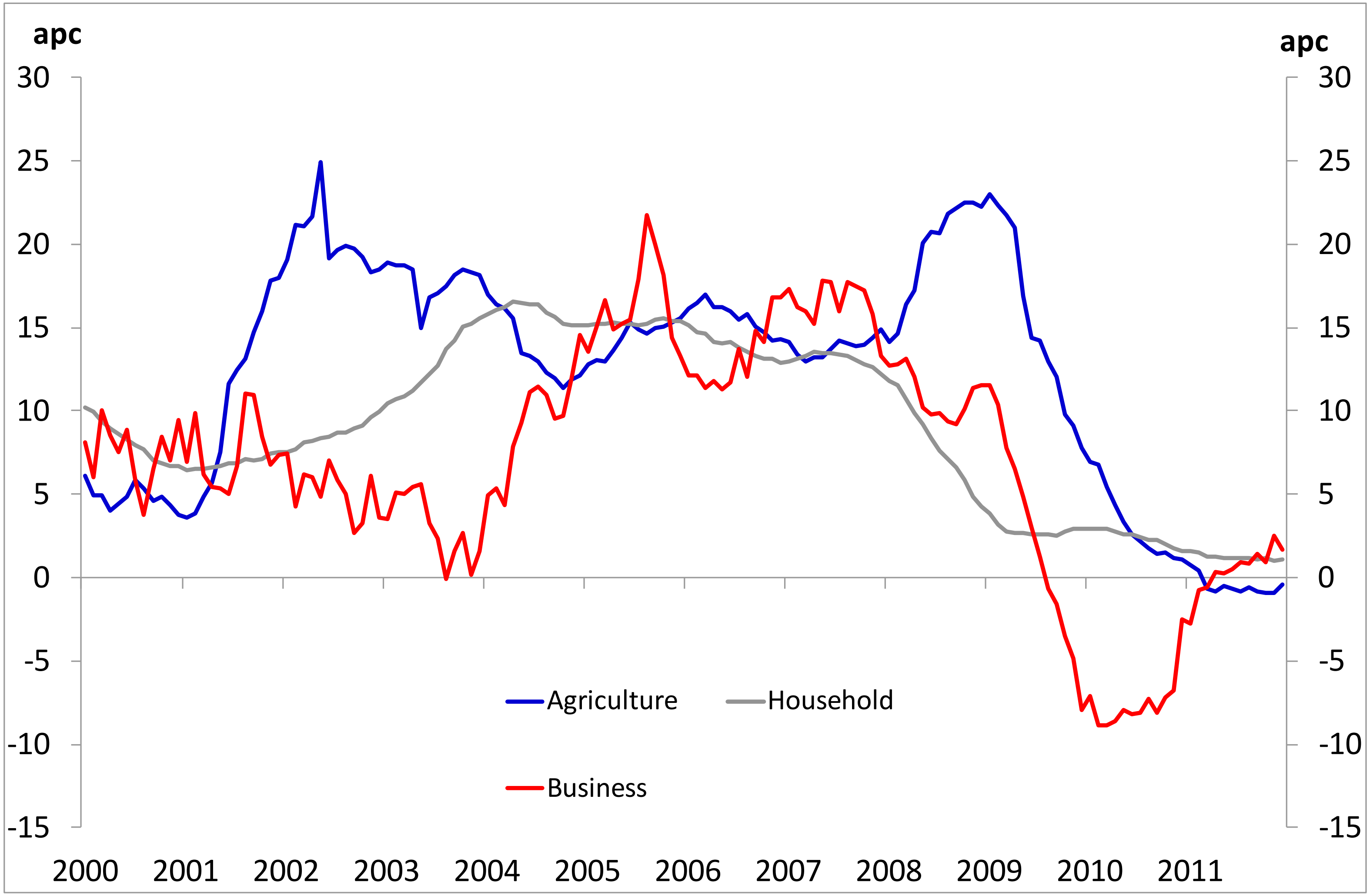
The credit gap and calibration of the CCB



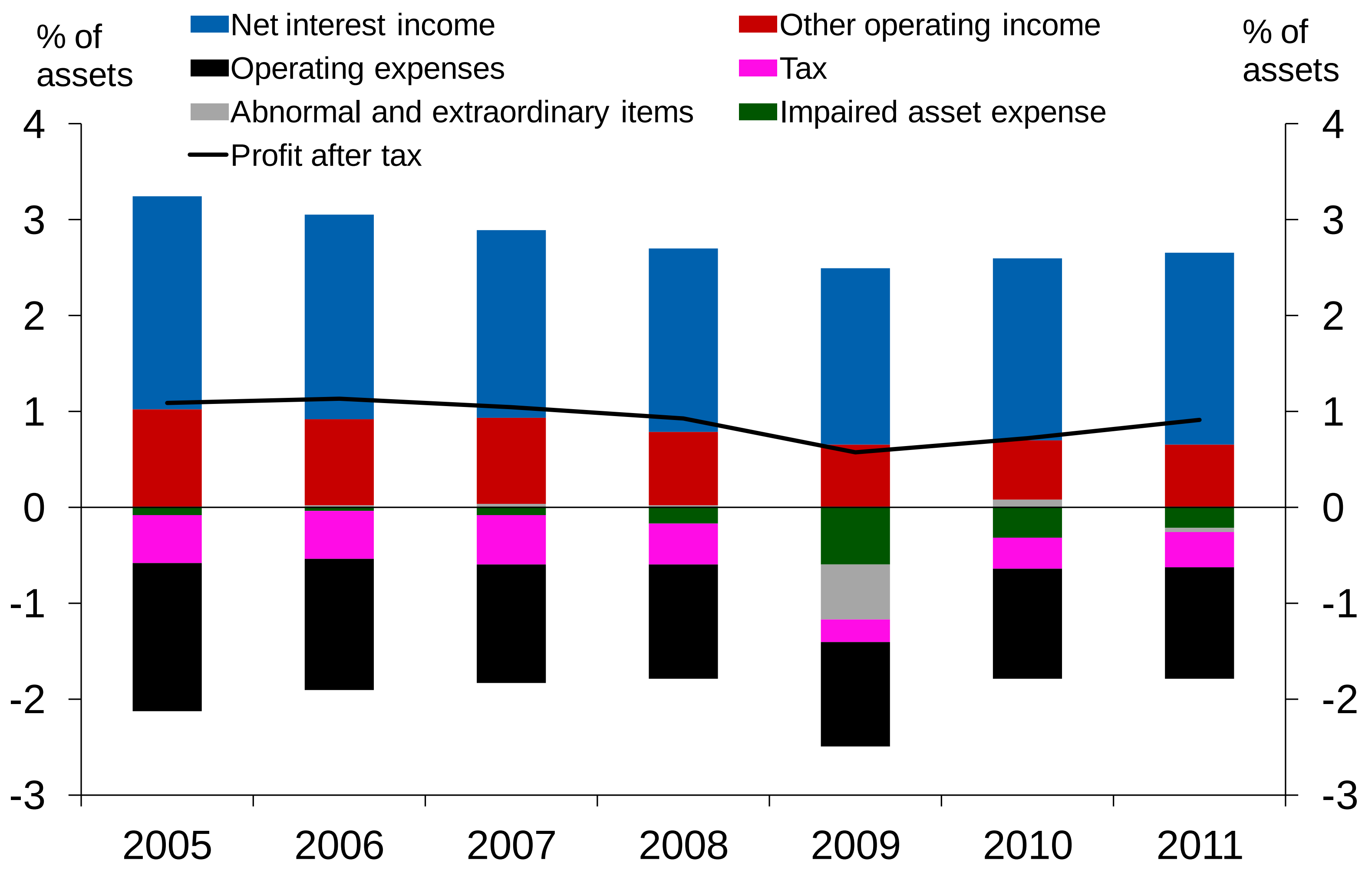
Majority of lending intermediated through banks



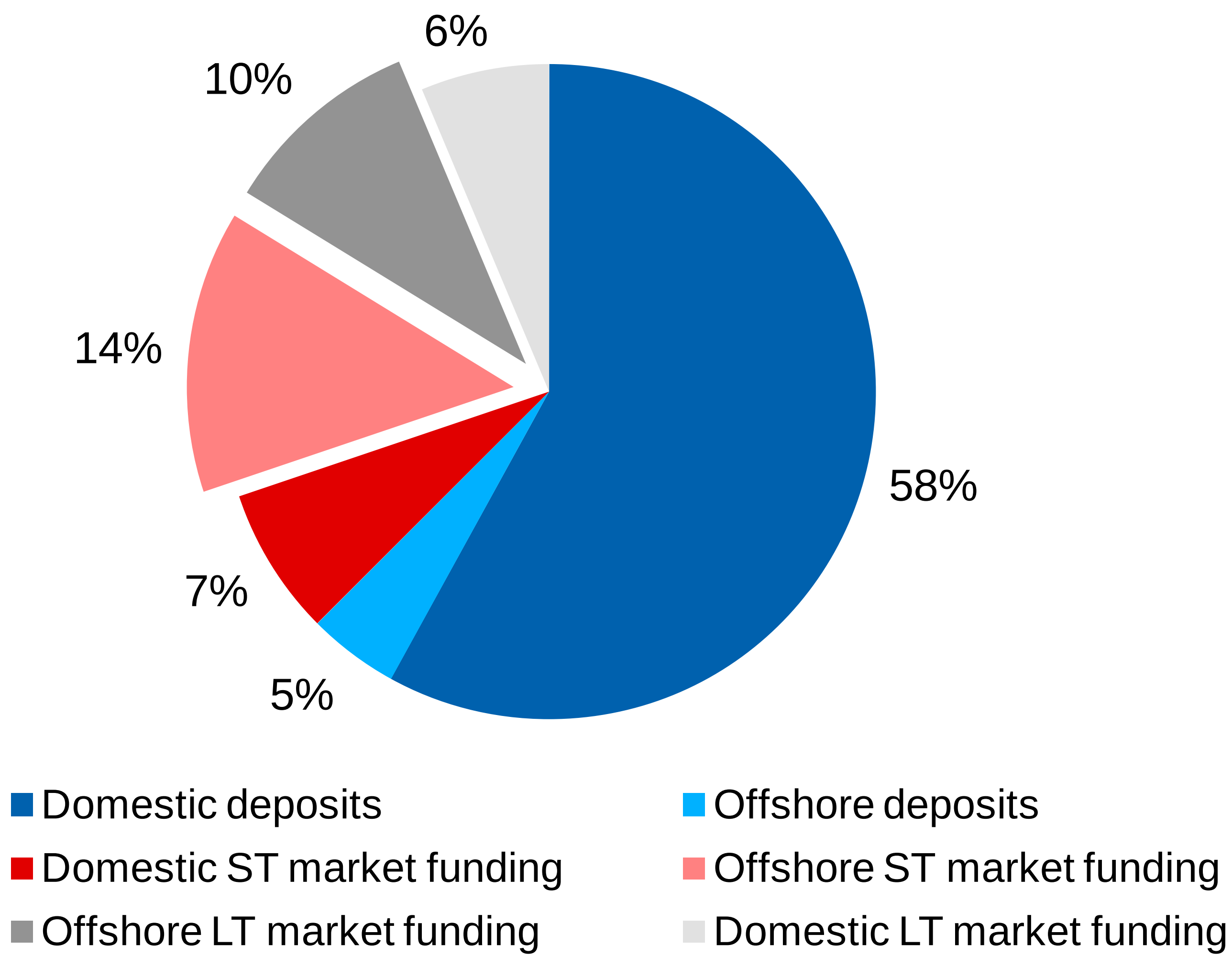
Credit growth by sector



Banking system profitability improving



Composition of bank funding, excluding equity *(as at Sept 2011)*



Bank funding costs