Memorandum of Understanding between the Minister of Finance and the Governor of the Reserve Bank of New Zealand

Macroprudential policy and operating guidelines

This memorandum of understanding (memorandum) between the Minister of Finance (the Minister) and the Governor of the Reserve Bank of New Zealand (the Bank) defines macroprudential policy and the operating guidelines that the Bank shall operate under when considering the use of macroprudential policy.

The international practice of macroprudential policy is an ongoing area of development and it is expected that the Bank's macroprudential policy framework will evolve over time. Accordingly, this memorandum may be amended from time to time.

The proper purpose for macroprudential policy that underlies this memorandum is provided for in Section 1A(1)(b) of the Reserve Bank of New Zealand Act 1989 (the Act), which requires the Bank to be responsible for "promoting the maintenance of a sound and efficient financial system". In conducting macroprudential policy, the Bank seeks to reduce or manage the risks to the financial system arising from extremes in the credit cycle or developments in liquidity conditions and global debt markets, through the use of the prudential instruments listed below.

Effective macroprudential policy depends on the timely use of instruments. This memorandum provides clarity over the purpose and instruments of macroprudential policy, so that emerging systemic risks are able to be addressed in a timely manner.

This memorandum covers the application of macroprudential policy instruments to the registered banks, which account for the major share of domestic lending to households and businesses in New Zealand. However, it is acknowledged that, in some circumstances, it may be desirable to apply macroprudential instruments more widely. The Bank will advise the Minister of any proposed changes to the macroprudential framework that would extend the use of macroprudential instruments to non-banks, including any changes to the Bank's powers or involvement of other agencies that might be required.

This memorandum restates and replaces the previous memorandum of understanding between the Minister and the Governor dated 13 May 2013, with effect from the date of this memorandum. The parties have entered into this replacement memorandum, following consideration of additional policy instruments best suited to maintain a sound and efficient financial system and support more sustainable house prices (see section 2.1.5).

The Minister and the Governor agree as follows:

1. Objective of macroprudential policy

The objective of the Bank's macroprudential policy is to increase the resilience of the domestic financial system and counter instability in the domestic financial system arising from credit, asset price or liquidity shocks. The instruments of macroprudential policy are designed to provide additional buffers to the financial system (e.g. through changes in capital, lending and liquidity requirements) that vary with the macro-credit cycle. They may also help dampen extremes in the credit cycle and capital market flows. As such, these instruments can play a useful secondary role in stabilising the macro economy. As a result, the Reserve Bank will consider any interaction with

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monetary policy settings when implementing macroprudential policy and will explain the implications, if any, for monetary policy.

2. Operating guidelines

This memorandum confirms the guidelines the Bank will operate under, in discharging its obligations under the Act.

2.1 List of macroprudential instruments

The following macroprudential instruments are considered useful in the New Zealand context for addressing the systemic risks of financial instability:

2.1.1. Adjustments to the Core Funding Ratio – a minimum core funding ratio requirement that could vary the proportion of lending the banks are required to fund out of stable 'core' funding sources over the cycle, and is intended to reduce the vulnerability of the banking sector to disruptions in funding markets.

2.1.2 Countercyclical Capital Buffer – an additional capital requirement that may be applied in times when excess private sector credit growth is judged to be leading to a build-up of system-wide risk. The buffer would be able to be released when the credit cycle turns down, helping to reduce the risk of a sharp contraction in the availability of credit.

2.1.3 Adjustments to sectoral capital requirements – an additional capital requirement that may be applied to a specific sector or segment in which excessive private sector credit growth is judged to be leading to a build-up of system-wide risk.

2.1.4 Quantitative restrictions on the share of high loan-to-value ratio (LVR) loans to the residential property sector. These could include, but are not limited to:

- Restrictions on the share of new high-LVR lending that banks may undertake;
- Outright limits on the proportion of the value of the residential property that can be borrowed to create a minimum equity buffer for the lender.

2.1.5 Debt serviceability restrictions on loans to the residential property sector, which encompass a set of potential tools that limit lending relative to borrowers' income. These tools may complement other tools targeting housing-related risks such as LVR restrictions set out in section 2.1.4.

Debt serviceability restrictions could include, but are not limited to:

- Debt-to-income ratio restrictions – cap on mortgage debt (or total debt of a borrower including mortgage debt) as a multiple of income;
- Debt-servicing-to-income ratio restrictions – cap on the percentage of a borrower's income that can be allocated to servicing debt payments;
- Interest rate floors – floor on test interest rates used by banks in their serviceability assessments.

In the design and implementation of a debt serviceability restriction, the Bank will have regard to avoiding negative impacts, as much as possible, on first-home buyers, to the extent consistent with the Bank's purposes and functions under Part 5 of the Act.

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Development of any additional macroprudential instruments will be undertaken in consultation with the Treasury, given the Treasury's role in advising the Government on risks to the Crown's balance sheet.

2.2 Operation of macroprudential instruments

The Bank will assess financial system developments, and monitor risks to the system. The Bank will publish information on its risk assessment framework, including the macroprudential indicators that are used to guide its macroprudential policy settings. Where significant risks are judged to be emerging, a case for macroprudential intervention – in the form of deployment of a macroprudential policy instrument or instruments – will be considered by the Bank. Macroprudential instruments do not replace conventional prudential regulation but may be used from time to time to help manage the risks associated with the credit cycle. In most instances macroprudential instruments will reinforce the stance of monetary policy.

The selection of macroprudential instrument(s) will depend on the type of risk being addressed.

The decision on macroprudential intervention will be taken by the Governor.

2.3 Relevant legislation

This section sets out the Bank's prudential powers over the registered banks. Under section 67 of part 5 of the Act, the Bank is charged with undertaking "prudential supervision of registered banks".

Under section 68 of part 5 of the Act, the Bank is conferred with powers for the purpose of "promoting the maintenance of a sound and efficient financial system".

Under section 74 of part 5 of the Act, the Bank may impose conditions of registration relating to a range of specified matters, including "carrying on business in prudent manner".

Section 78 of the Act – Carrying on business in prudent manner. The Bank is confined to considering, inter alia, the following matters:

- (1)(c) "capital in relation to the size and nature of the business or proposed business" – allows the imposition of a counter-cyclical capital buffer and/or sectoral risk weights in the conditions of registration;
- (1)(fa) "risk management systems and policies or proposed risk management systems and policies" – allows the imposition of the Core Funding Ratio in the conditions of registration. It also provides the basis for the implementation of quantitative restrictions on housing LVR limits, and debt serviceability restrictions.

Under section 68B of the Act, the Minister may direct the Bank to have regard to a government policy that relates to the Bank's functions under Part 5. For the avoidance of doubt, the Bank must have regard to any section 68B direction in force, in implementing any of the macroprudential instruments outlined in this memorandum. This includes, as at the date of this memorandum, the direction issued on 25 February 2021 in relation to the Government's housing policy objective, *"to support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers"*. This direction will remain in effect until it is revoked or section 68B is repealed under the Reserve Bank of New Zealand Bill (following its enactment).

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3. Consultation

The Bank will keep the Minister and the Treasury regularly informed on its thinking on significant policy developments relating to macroprudential policy, and of emerging risks to the financial system.

The Bank will consult with the Minister and the Treasury from the point where macroprudential intervention is under active consideration, and will inform the Minister and the Treasury prior to making any decision on deployment of a macroprudential policy instrument.

The Bank will consult with the registered banks prior to deployment of a macroprudential policy instrument in the manner required under Section 74(3) of the Act.

The Bank will advise the Minister if it considers further legislative change is required to give full effect to any of the instruments outlined in Section 2.1.

4. Reporting and accountability

The Bank's Financial Stability Report will report on matters relating to the soundness and efficiency of the financial system including any build-up of systemic risk, and the reasons for, and impact of, any use by the Bank of macroprudential policy instruments.

The Bank shall be fully accountable to the Board, Minister and Parliament for its advice and actions in implementing macroprudential policy, under the normal conventions outlined by the Reserve Bank Act.

The appropriateness and effectiveness of macroprudential policy decisions will be reviewed on a regular basis. This will include an assessment of the key judgements that led to decisions on whether or not to adjust macroprudential policy. The Bank will report the results of its assessment in its Financial Stability Report.

Hon Grant Robertson

Minister of Finance

Adrian Orr

Mr Adrian Orr

Governor
Reserve Bank of New Zealand

Dated 2 August 2021

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