



2007/08 Financial review of the Reserve Bank of New Zealand

Report of the Finance and Expenditure Committee

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Reserve Bank of New Zealand

Recommendation

The Finance and Expenditure Committee has conducted the financial review of the 2007/08 performance and current operations of the Reserve Bank of New Zealand, and recommends that the House take note of its report.

Introduction

The Reserve Bank of New Zealand's main functions include managing monetary policy to maintain price stability, operating a banking supervision system designed to encourage banks to manage their risks carefully, providing inter-bank settlement facilities, and managing foreign exchange reserves to enable intervention in the foreign exchange market if necessary. Under the Policy Targets Agreement, the Reserve Bank is required to maintain inflation, as measured by the Consumers Price Index (CPI), between one and three percent per annum on average over the medium term.

In July 2007, the Reserve Bank raised the Official Cash Rate (OCR) from 8.0 percent to 8.25 percent, where it remained until 24 July 2008. Despite the relatively high OCR, the CPI inflation rose from 2.0 percent for the year ended June 2007 to 4.0 percent for the year ended 30 June 2008.

Management of monetary policy

We are interested in the extent to which the Reserve Bank's approach to managing monetary policy contributed to the high New Zealand dollar in the year ended June 2008. In our examination of the Reserve Bank, we asked the governor for his view on this. The governor told us that the Reserve Bank's monetary policy was a relevant factor, but not the major one. He stressed that it was important to maintain price stability in New Zealand at a time when it was affected by the inflationary policies adopted by overseas Governments.

We understand the need to ensure that appropriate tools to manage monetary policy are available. We asked the governor whether more tools for managing monetary policy would be desirable. The governor commented that he would prefer to manage monetary policy in an environment where no distortion was present. While overseas distortions are unavoidable, the governor noted that there are domestic distortions, such as tax advantages on property investment, which could also make managing monetary policy difficult. We will continue to keep a watching brief on the management of monetary policy. We acknowledge the issue raised by the governor, and encourage the Government to consider whether potential domestic distortions could be minimised.

Foreign exchange position

We asked the Reserve Bank whether it will reduce its open foreign exchange position, which progressively increased during the year ended June 2008. The Reserve Bank told us that it retained the ability to intervene in the foreign exchange market when the New

Zealand dollar reached extreme levels. The Reserve Bank expects to reduce its open foreign exchange position.

We note that the Reserve Bank intervened when the New Zealand dollar was very high in 2008. The governor commented that, while the Reserve Bank has only limited influence on the foreign exchange markets, it would continue to undertake foreign exchange interventions aimed at stabilising the cycle of the New Zealand dollar.

Risk management

We sought assurance from the governor that the Reserve Bank has a sound risk management system. The governor commented that the Reserve Bank has to manage many different kinds of risks, such as those associated with interest rates, exchange rates, and residential-mortgage-backed securities. He also said that the bank may face more risks than before because it has invested in a broader range of securities, which may include a small amount of lower-grade securities.

Nevertheless, the governor assured us that the Reserve Bank has the Assets and Liabilities Committee, which monitors and sets the risk limits. It also uses the best available tools to assess its financial risks. The governor commented that some of these tools may not work well in a highly volatile financial market, and may fail to draw correlations between different market risks.

Retail deposit guarantee scheme

We were interested in the governor's view on the rules on the retail deposit guarantee scheme, which was implemented in October 2008. The governor assured us that the scheme was well-designed, given the urgent situation where the then Minister of Finance and the Treasury had to make a decision very quickly after the Prime Minister of Australia had announced a similar scheme. The governor considered that the scheme succeeded in its primary purpose of restoring public confidence in the banking system.

We understand that the Minister of Finance has discussed with the Treasury whether the retail deposit guarantee scheme should be reviewed to address any shortcomings. Should there be such a review, we understand that the Reserve Bank, the Minister, and the Treasury will work together on that review.

Fee structure

We questioned the level of fees that the financial institutions covered by the retail deposit guarantee scheme are required to pay. For example, an A-minus-rated institution with Government-guaranteed deposits of less than \$5 billion does not have to pay any fee to the Crown if its deposits do not increase by more than 10 percent in a year. Even if they do, this institution will have to pay an annual fee of 0.20 percent for any growth in its deposit.

The Reserve Bank told us that it was the Minister of Finance who made the final decision on the fee structure of the retail deposit guarantee. It also said that the fee structure was fixed because the Treasury had already signed off the deeds of guarantee for each of the institutions covered by the scheme. It would therefore be difficult to revise the fee structure.

We are interested in the pricing structure of the deposit guarantees, given the risk profile of the market.

Approval process for financial institutions

We are aware that a finance company has failed since the implementation of the retail deposit guarantee scheme. We are therefore concerned that the procedures for approving financial institutions to participate in the scheme may not be sufficient to minimise the risk exposure of the Crown.

The governor commented that there is a clear set of criteria that have to be met by financial institutions to qualify for the retail deposit guarantee scheme. The Reserve Bank will advise the Treasury that it does not object to granting a guarantee to a finance institution if the institution meets the criteria, its trustees are satisfied that the institution is not in breach of its trust deed, and the Reserve Bank is not aware of any reasons for refusing to grant the guarantee.

We understand that trustees have the primary responsibility for ensuring that the financial institution concerned is not in breach of the trust deed or not likely to be so. However, in order to minimise the risk exposure of the Crown, we would encourage the Reserve Bank to gather as much information as possible on the financial health and financial management of the financial institutions that apply to be covered by the retail deposit guarantee scheme. We note the underlying policy issue as to whether trustee accountability is a sufficient protection for the Crown's investment, or whether more extensive external review is required.

Monitoring of non-banks

We noted that non-bank financial institutions covered by the retail deposit guarantee scheme are carefully monitored to reduce the risk of failure. The Reserve Bank commented that the trustees of non-banks are required to report to the bank monthly on the non-banks' balance sheets, credit risks, and asset impairments. The Reserve Bank also monitored the non-banks more intensively through surveillance and more regular dialogue, particularly with the trustees.

Availability of corporate credit from banks

We understand that a large majority of the New Zealand banking system is owned by Australian banks.

The Reserve Bank Governor noted concerns that “as far as Australasian banks are concerned, New Zealand should always be considered a core market”, and he would not wish to see a “home-country bias” to Australia. We are concerned that New Zealand businesses find it increasingly difficult to access credit from the major Australian-owned banks, where lending decisions are reportedly now being made by offshore bank parties rather than onshore relationship managers.

The Reserve Bank told us that there is widespread concern about this issue, and that it had discussions with the banks. According to the banks, they reduced the availability of credit and tightened the terms and conditions of loans because it became more difficult to raise funds from the money markets, and they had to pass on these risks and costs to corporate

borrowers. The Reserve Bank believes the banks should continue lending on reasonable terms to support business investment and therefore economic recovery. The Reserve Bank said that it will continue to monitor the accessibility of credit from banks.

We sought assurance from the governor that the Australasian banks treat New Zealand corporations and Australian corporations of similar financial strengths identically, and avoid any perception of New Zealand being treated as a marginal market. The governor told us that he could not give us such an assurance, and that the Reserve Bank was pressuring banks not to discriminate against New Zealand corporations unjustifiably.

We agree with the governor, and urge the Australian-owned banks not to tighten the supply of credit to New Zealand corporations unnecessarily.

Pass-through of OCR cuts

We are concerned that banks are not passing through the full extent of the OCR cuts to their short-term lending interest rates. While the Reserve Bank has cut the OCR by 5.25 percentage points, banks reduced the floating mortgage interest rate by only about 4 percentage points. We remain concerned at the impact upon the economy of not passing through interest rate reductions.

We note the Reserve Bank's observation that gross corporate lending in New Zealand has not fallen significantly since the international financial crisis unfolded. However, we note that long-term lending rates have begun to increase despite the marked reduction in the OCR and short-term interest rates. We understand the trading banks' view that this increased margin is required to attract capital into the New Zealand market. But we remain concerned to ensure that New Zealand businesses and consumers have access to liquidity on fair and reasonable terms. We expect that the Reserve Bank will closely monitor this situation.

Break fees

We are concerned about the cost applied by banks to customers who wish to break a fixed-term mortgage. The Reserve Bank said that it wanted to see banks making these costs very clear to customers, but also suggested that the public should understand the terms and conditions of their loan agreements in order to manage the costs of breaking their loan agreements before maturity.

The Reserve Bank commented that the break fee charged by a bank could reflect the bank's real economic cost in relation to changing its funding arrangements. Banks were likely to have sourced funds for mortgage lending through derivative contracts, such as swaps. If a bank customer wanted to repay a mortgage before the agreed fixed term, the bank would have to cancel the swap. Since the value of swap has plunged in the latest financial crisis, the bank would incur a cost upon cancellation of the swap and would have to pass on the cost to the customer.

We are aware that some banks have provided information on break fees on their websites. However, as it remains unclear how banks calculate break fees, we encourage more transparency in this regard. We will continue to monitor this issue, and look forward to further updates from the Reserve Bank on it.

Liquidity requirements

We are concerned that the New Zealand financial system is vulnerable because New Zealand financial institutions are heavily dependent on funding from the international market. To address this concern, the Reserve Bank believes financial institutions should meet the capital adequacy ratios, and should also monitor liquidity requirements to ensure that they have secure funding for the longer term.

The Reserve Bank informed us that it consulted on the appropriate liquidity policy last year. The Reserve Bank's intention is that banks will be subject to some disclosure requirements and some quantitative restrictions on liquidity management, such as a specified amount of liquid assets, and a specified proportion of funds that are sourced from long-term wholesale funding. The Reserve Bank expects that the policy will be formulated in May 2009.

Appendix

Approach to this financial review

We met on 4 March and 1 April 2009 to consider the financial review of the Reserve Bank of New Zealand. We heard evidence from the Reserve Bank of New Zealand and received advice from the Office of the Controller and Auditor-General.

Committee members

Craig Foss (Chairperson)
Amy Adams
David Bennett
John Boscawen
Brendon Burns
Hon David Cunliffe
Raymond Huo
Rahui Katene
Peseta Sam Lotu-Iiga
Stuart Nash
Dr Russel Norman
Chris Tremain

Evidence and advice received

Office of the Controller and Auditor-General, Financial Review briefing to the Finance and Expenditure Committee—2007/08 financial year, 4 March 2009.

Reserve Bank of New Zealand, Response to committee's supplementary questions, received 26 March 2009.

Reserve Bank of New Zealand, Response to committee's written questions, received 13 February 2009.

Reserve Bank of New Zealand, *Annual Report 2007–2008*.