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Westpac Institutional Bank

Tool time

A first look at macroprudential policy tools

- **The Reserve Bank is close to finalising its suite of macroprudential policy tools, aimed at addressing the build-up of system-wide risks in the financial sector.**
- **These tools could theoretically be used as early as the second half of this year, although the RBNZ may not feel the need to act that early. 2014 looks more of a prospect.**
- **Despite the intuitive appeal of loan-to-value limits, we actually see this as the least likely tool to be deployed.**
- **Higher bank capital requirements are more likely, and given the necessary time lag to implementation they won't be a substitute for interest rate hikes.**

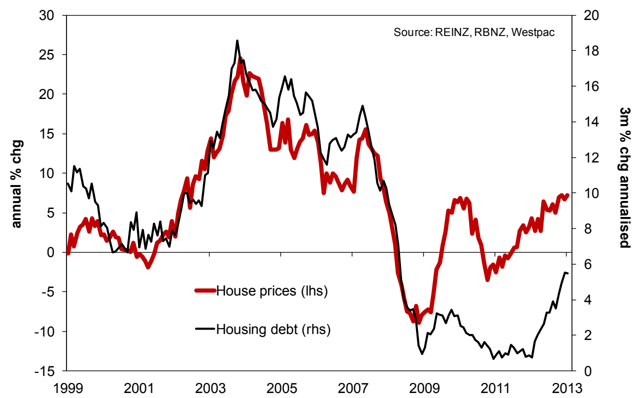
After years of discussion, 'macroprudential' policy tools are on the verge of becoming a reality for New Zealand. The Reserve Bank will begin public consultation on its policy framework this month, and the Minister of Finance has said that a memorandum of understanding between the Reserve Bank and Treasury as to how these tools will be used could be signed off by the middle of the year.

Some might say that these tools couldn't come soon enough. The housing market is running hot again and household debt is picking up from already-high levels, shattering any notion that New Zealanders had amended their ways in the wake of the global financial crisis. We've been saying for some time that these tools could become part of the policy mix in the near future (see for instance our August 2012 *Economic Overview*), and there are a growing number of developed countries that have already taken this path.

Yet there's still a great deal unknown about how these newly-minted policy levers will be used, and what effects (intended and otherwise) they might have. This is the first of what will likely be several articles on macroprudential tools as we get more clarity around the RBNZ's approach. Here we focus on which tools are most likely to be deployed, and how soon this could realistically happen.

One point before we proceed: through this article we've described macroprudential tools in terms of providing a buffer against downturns, which is largely how the RBNZ has framed them. We haven't addressed how these tools could be used to 'lean' against credit market upturns, which seems to be what those who are calling for their immediate use have in mind. We'll discuss this in more detail in later articles, but for now we note that, in most cases, the way in which these tools would work against a credit upswing is by increasing the cost of borrowing. So in that sense they're not really an alternative to interest rate management – in fact they're probably inferior to tools such as the Official Cash Rate, as estimates suggest that the impact they would have on borrowing rates would be very small. At best, they might serve as a complement to OCR hikes over coming years.

House sales and household credit growth



The purpose of macroprudential tools

The RBNZ has been consistently clear about what it sees as the role of macroprudential tools: to address the build-up of risks within the financial system that can't be moderated just through supervision of the individual institutions. These tools are about keeping the banking system safe. They are not a tool for targeting inflation, asset prices, the exchange rate, the mix of bank lending or the affordability of housing.

There are both practical and legal reasons for this. Firstly, the international evidence and research gives little support to the idea that financial regulation can be directed towards much other than financial stability. Secondly, while the Reserve Bank Act 1989 is not prescriptive about the tools that the RBNZ can use, it's quite clear that its prudential powers must be used for the purpose of "promoting the maintenance of a sound and efficient financial system". A policy that can't be justified on these grounds could face a legal challenge.

The range of tools

The RBNZ has focused on developing four types of macroprudential tools:

- **Countercyclical capital buffer (CCB):** Banks are required to hold a minimum amount of capital to absorb unexpected losses. This minimum could be varied over the cycle, with the buffer being increased during the good times and run down during tougher times.
- **Sectoral risk weights:** Capital requirements differ across loan types, reflecting their relative riskiness – for instance, they are higher for business loans than for home loans. These relative weights can be altered if risks are seen to be building up in a particular segment.
- **Variable core funding ratio (CFR):** The RBNZ requires banks to obtain a minimum share of their funding from 'stable', but more expensive, sources such as retail deposits and long-term wholesale funding. This minimum can be varied over the cycle.
- **Loan to value ratio (LVR) limits:** The RBNZ could impose a maximum loan-to-value ratio, on the basis that high-LVR loans are inherently more at risk of losses in a downturn. This is likely to be limited to housing loans, due to the difficulty of establishing a 'value' for other loan types.

The first three of these already play a part in banking regulation in New Zealand, and in fact have been through adjustments in the last few years (just not in a cyclical manner). LVR restrictions are unusual in developed countries and are quite different in nature to the other three, as we'll discuss later.

When could they be used?

Contrary to some popular claims, the RBNZ has never needed to be 'given' additional tools. As we mentioned, the Reserve Bank Act sets out the goal of financial stability, but is largely open-ended on the means to achieve this. In theory, macroprudential tools could have been deployed at any time – and former Governor Alan Bollard has said that with the benefit of hindsight, he would have used them during the housing boom last decade.

The reason that these tools have stayed 'under development' for so long is the need for accountability. Any decision to use these tools would need to consider, among other things: which indicators to monitor, what are the 'trigger' levels for action, whether action would be consistent with the RBNZ's other policy goals, which tool is most appropriate for the current conditions, how broadly it should be applied, how the size of the change should be calibrated, how to communicate the decision to the public, how to enforce the rule, and – if it's to be used in a cyclical manner – under what conditions it would be relaxed again. Hence the need for a well-developed and transparent framework.

The Finance Minister's announcement that a memorandum of understanding could be in place by mid-year gives us a starting point for guessing when these tools might first be used. In itself this seems to suggest a growing urgency to get these tools into position. The RBNZ's last comment on the matter was in the November 2012 *Financial Stability Report*, where it stated that the framework for a countercyclical capital buffer would be implemented in January 2014 as part of the internationally-agreed Basel III bank capital standards, and suggested that the other tools remained a work in progress.

But even if the framework were ready this year, it's not a given that these tools would be deployed immediately. As recently as the December *Monetary Policy Statement* the RBNZ was firmly of the view that credit market conditions at the time did not warrant any macroprudential intervention. That suggests it would take a further acceleration in house prices and credit growth to prompt the RBNZ into action. That said, given our forecast of a 9% rise in national house prices this year, we do expect things to evolve in a direction that could eventually see one or more of these tools being triggered.

Which tool(s) might be used?

The choice of tool depends on the circumstances, in particular whether risks are building up in a specific area or more generally. On the face of it, it might seem that macroprudential policy should be targeted at housing lending, but in our view it's not that straightforward. Housing debt is not growing especially quickly, and certainly not enough to account for the rate of increase in house prices. And while household debt is rising from already-high levels, the same can be said of some forms of business lending, particularly agriculture. Our assessment of the four options, roughly from most to least likely, is:

Countercyclical capital buffer: The advantages of this tool are that it provides a buffer against a range of risks, is relatively non-distortionary, and is well understood internationally (since it forms part of the new 'Basel III' standards). The main disadvantage is the long lead-in time required – although it's possible that this could be shortened, given that banks already hold more capital than the required minimum. Whether it could be deployed this year depends on whether the RBNZ could go back on its previous commitment to having a framework in place in January 2014.

Higher sectoral risk weights: As a more targeted version of the CCB, this tool has similar appeal. It has some precedent – Sweden and Norway recently proposed increasing their capital requirements for housing lending. One disadvantage is that the impact may not be much different from a broad-based CCB. Firstly, housing loans already make up more than half of total bank lending. Secondly, banks may make lending allocation decisions based on a broader assessment of the rate of return on economic capital, for which regulatory requirements are only one input. If housing lending is still seen to offer the best risk-adjusted returns, higher capital requirements may have little impact on the mix of lending.

Increased core funding ratio: This would be relatively easy to implement, and since it has already been increased twice – in July 2011 and January 2013 – its effects are known. The biggest problem is that it doesn't seem relevant to the current situation: the pickup in house prices and lending is not the result of banks subverting monetary policy by drawing on cheap but ‘unstable’ short-term funding from overseas. Core funding ratios have been actually rising as the housing market has warmed up.

One of these things is not like the others

Limits on loan-to-value ratios (LVRs) for housing seem to have captured the popular imagination. However, we view this as the least likely to be deployed in the near future. As we noted earlier, LVRs are different in substance to the other options: the first three are restrictions on lenders, while LVRs are a restriction on borrowers. As the banking regulator, the RBNZ doesn’t have the ability to police the behaviour of individuals in the same way it does with financial institutions.

The biggest risk here is known as ‘disintermediation’. That is, borrowers find ways to work around the banking system. A maximum LVR rule is the same thing as a minimum deposit rule; borrowers can find ways to raise the deposit in ways that might look like ‘equity’ but are actually debt, such as borrowing from family members. Disintermediation not only undermines the effectiveness of the policy, it actually masks the true degree of risk in the financial system.

The other major drawback of LVR limits is they will inevitably politicise the process – putting the decisions in the hands of an independent central bank won’t prevent that. The burden of LVR restrictions will fall much more heavily on some groups than on others, and is likely to lead to lobbying for exemptions. For instance, countries that do apply LVR limits often exempt first-home buyers. We’ve also seen suggestions that LVR limits should only be applied in Auckland, where house prices are rising fastest. Any such exemptions would water down the policy’s effectiveness and make it even more difficult to police.

Conclusion

Although there’s still a lot of preparation to do, there is a chance that macroprudential tools could be activated within the next year. We think that lending would have to be growing faster than it is today in order to trigger their use, though that condition could be met if our forecast of a 9% rise in house prices this year pans out. Even if a change were announced this year, there would probably be a grace period of several months to allow banks to meet the new rules, so the effects might not be felt until next year anyway.

We think that an increase in bank capital requirements is most likely to be the first step; this has been the tool of choice for developed countries facing conditions similar to New Zealand, such as Sweden, Norway and Switzerland. Core funding is not the pertinent risk at the moment, and despite their appeal on paper, LVR limits are difficult to put into practice and could create as many problems as they solve.

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