Grant Spencer: The impact of the global financial crisis on financial policy

Summary of remarks by Mr Grant Spencer, Deputy Governor of the Reserve Bank of New Zealand, at the Symposium on Financial Sector Governance, Auckland, 20 September 2010.

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In this presentation, I would like to discuss New Zealand's financial policy response to the Global Financial Crisis. My focus here will be on permanent changes to policy following the crisis rather than the initial short term "emergency" responses. I will cover financial policies overseen by the Reserve Bank, namely monetary policy, liquidity management and the prudential supervision of banks and non-banks.

Monetary policy

In New Zealand, monetary policy focuses on the maintenance of price stability. This alone provides no guarantee of economic stability or financial stability. However, the experience in New Zealand and overseas suggests that maintaining price stability over the medium term is the best and most worthwhile contribution monetary policy can make to achieving broader economic and financial stability.

Our inflation targeting framework served us well during the financial crisis and helped guide sensible policy responses. Immediately prior to the crisis, monetary policy in New Zealand had been relatively restrictive with the Reserve Bank increasing the Official Cash Rate (OCR) between 2004 and 2007 in response to elevated inflation pressures associated with a booming housing market. As the global crisis emerged and deepened, we responded by reducing the OCR aggressively. The OCR was cut during 2008 and early 2009 from a high of 8.25 percent to just 2.5 percent. These reductions were appropriate, despite high headline rates of inflation at the time due to record high oil prices. The policy easing was consistent with an outlook for rapidly diminishing inflation pressures as the global and domestic economies turned sharply downwards.

Going forward, medium term price stability will remain the primary objective of monetary policy. However, we expect that monetary policy will have more bite over the next few years than it has had for many years; for a number of reasons:

First, following the crisis our banks now face a higher cost of funds. It is now more expensive for them to borrow offshore, which in turn has seen them compete more aggressively for funds raised in the domestic retail deposit market. We currently estimate that the spread of the banks' average cost of funds over the OCR is some 150 basis points higher than prior to the crisis. This state of affairs is likely to persist for some time. It means that, for any given OCR, the rates the banks charge their customers for lending will be higher than before.

Second, the evidence to date suggests that, following the global crisis, households and businesses are considerably less willing to take on new debt. Credit growth remains very subdued. We believe that this diminished appetite for debt will remain for some time as people and companies work to gradually strengthen their financial positions.

Third, unlike the situation over much of the past twenty years, New Zealand is now facing an upward sloping yield curve – longer term interest rates are higher than short-term rates. This means that fixed rate mortgages are now more expensive than floating or very short-term fixed rate mortgages. This has seen many borrowers shift back to floating rates over the past two years. As a result, as we move the OCR higher it is likely to have more "bite" than it did previously.

Liquidity management

As the global financial crisis broke, a key policy response from the Reserve Bank was the expansion of liquidity facilities that we provide to banks and other financial institutions, including a broadening of acceptable collateral instruments. This expansion of facilities was needed to ensure that the financial system remained liquid and that institutions could continue to make payments as required without creating undue stress in the interbank market. In particular, as the banks' access to global markets became very restricted in late 2008–early 2009, the Reserve Bank provided access to term funding secured over mortgage backed securities. The banks also increased their use of parent funding during this period.

With the crisis behind us, we have been reconsidering the appropriate role and scope of the Reserve Bank's liquidity facilities. The crisis has demonstrated the value of liquidity support for fundamentally sound institutions in the face of systemic market disruptions. While it is important that institutions provide for their own liquidity in the first instance, it is clear that central bank liquidity facilities are an essential backstop at times when shocks to confidence cause market liquidity to dry up. Key requirements for central bank facilities are that: their pricing encourages a return to normal market trading; they are targeted at system liquidity, not individual institutions; and they are fully collateralised.

In light of the GFC experience and the Bank's broader mandate to promote the efficiency of the financial system, we intend in the future to adopt a somewhat broader approach to liquidity management than was the case prior to the crisis. The range of securities that we accept as collateral will be wider than in the past in order to help support liquidity in a number of key financial markets. Such markets include: the NZ dollar, Bank bills, NZ Government securities, and local authority/SOE stock. In addition, access to the Bank's overnight facility will be extended to major NZ dollar settlement systems.

Prudential policy: banks

Turning to prudential policy, the global financial crisis has prompted a major review of policy internationally. In New Zealand, the financial crisis highlighted shortcomings in the banks' management of funding and liquidity rather than credit losses of the sort seen in the major economies. A heavy reliance on short-term foreign borrowing by the NZ banks meant they were vulnerable to the sort of liquidity shock experienced in late 2008–early 09. While the banks' funding shortfall was met through parent funding and the Reserve Bank's expanded liquidity facilities, the experience underlined the need for banks to lengthen the maturity of their liabilities relative to assets, in order to reduce their vulnerability to such shocks.

To address these issues, the Reserve Bank introduced a new prudential liquidity policy for banks in April 2010. This policy requires that the banks hold sufficient eligible liquid assets to meet one-week and one-month liquidity mismatch ratio requirements. In addition, the banks must meet a Core Funding Ratio requirement of at least 65 percent. Core funding consists of customer deposits (weighted by size) and market funding of one year or greater to maturity. The Core Funding Ratio requirement will rise to 75 percent by mid 2012. The banks have already made good progress in lifting their Core Funding Ratios to be well in excess of the 65 percent minimum requirement.

Internationally, the moves to strengthen banking regulation are being led by the Basel Committee on Banking Supervision (BCBS), made up of banking supervisors from the major economies and convened by the Bank for International Settlements (BIS). The BCBS has developed a number of proposals under the broad "Basel 3" label which are expected to be agreed at the upcoming G-20 meeting in November. The proposals are focussed on strengthening banks' minimum capital and liquidity requirements. These include higher Tier 1 capital requirements, a greater emphasis on common equity in Tier 1 capital, and a leverage ratio to act as a backstop to the risk weighted capital regime. Other proposals include more explicit liquidity requirements (similar to those described above for New Zealand), arrangements for greater international coordination of supervision and revisions to international financial accounting standards. The crisis has shown that existing accounting standards are problematic for financial institutions in a number of areas such as mark-to-market asset valuations and provisioning rules for loan losses.

Another area to receive attention under Basel 3 is the possible use of macro-prudential policy adjustments to help counter pro-cyclical behaviour in financial systems. The BCBS has proposed that banks be required to build up additional capital buffers at times of rapid credit growth that could then be drawn down in times of stress. The intention of the instrument would be to lessen the impact on the economy when the boom turns to bust as well as possibly constraining excessive credit growth. A number of central banks, including the RBNZ, are also looking at other macro-prudential tools that could possibly be used to help limit the extremities of the credit cycle. The challenge here is to find instruments that will actually work without imposing major efficiency costs on the financial system.

Prudential policy: non banks

New Zealand's non-bank deposit taking sector comprises a number of different institutional types. The savings institutions (building societies, credit unions and the PSIS) have generally weathered the crisis well. The finance company sector, on the other hand, has faced considerable upheaval over the period since 2006, with only about a third of the companies in early 2006 now remaining active. While the Global Financial Crisis added to the difficulties faced by the finance companies, the sector's issues have been largely home-grown as a result of poor lending decisions, particularly with respect to property development lending, and inadequate capital support. While the Crown retail deposit guarantee scheme has provided some liquidity protection for the sector, allowing time for the sounder institutions to rebuild investor confidence, the companies that have been unable to recapitalise or restructure have ultimately been forced to exit the industry.

An amendment to the Reserve Bank Act in late 2008 saw the Reserve Bank become the new prudential regulator of the non-bank deposit taking sector; with trustees remaining the front line supervisors. Since then the Reserve Bank has been developing a new regulatory framework and phasing in the new prudential requirements. Key elements include mandatory credit ratings, connected lending limits, an 8 percent minimum capital requirement, and fit and proper tests for senior managers and directors. While these reforms are clearly too late to avert the negative consequences of earlier finance company practices, the overall aim is to raise safety standards in the sector so that the remaining players are more resilient to future business cycles.

Conclusion

The Global Financial Crisis had major effects on the NZ financial system and economy. It prompted responses across the full range of Reserve Bank policies, including monetary policy, liquidity management and prudential policies. Many of these responses were short term in nature but there have also been important long term policy consequences. Indeed, in the prudential policy area, there is significant policy change still yet to come from the strengthening of international standards under the "Basel 3" initiative. Most of the permanent policy changes undertaken by the Reserve Bank have related to liquidity: requiring banks to better protect themselves against liquidity shocks; and recognising a somewhat broader role for the Reserve Bank in supporting financial system liquidity in times of stress. This should not be surprising given that the dominant transmission channel for the Global financial Crisis was an unprecedented reduction in global financial system liquidity.