The Treasury

COVID-19 Information Release

April 2020

This document has been prepared for release by the Treasury.

Context

Agreed recommendations in this Minute reflect decisions taken by Ministers with Power to Act with delegated authority from Cabinet [see COVID-19 Ministerial Group Minute "Transitioning to an Enhanced Wage Subsidy Scheme"].

Information Withheld

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Where this is the case, the relevant sections of the Act that would apply have been identified.

Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Key to sections of the Act under which information has been withheld:

[25] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information

[29] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;

[36] 9(2)(h) - to maintain legal professional privilege

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

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THE TREASURY

Treasury Report: Expanding the indemnity of the Reserve Bank to cover Local Government Funding Agency bonds

Date:	06 April 2020	**Report No:**	T2020/881
		File Number:	MC-1-1-1-2 (RBNZ Institutional Frameworks)

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Agree** to the recommendations	Monday 6 April 2020

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Matthew Galt	Analyst, Macroeconomic and Fiscal Policy	39 [redacted]	N/A (mob)	✓
Renee Philip	Manager, Macroeconomic and Fiscal Policy	[redacted]	35 [redacted]	

Minister's Office actions (if required)

Return the signed report to Treasury.
Arrange for statement under Section 65ZD of the Public Finance Act to be presented in the house

Note any feedback on the quality of the report	

Treasury Report: Expanding the indemnity of the Reserve Bank to cover Local Government Funding Agency bonds

Purpose of Report

1. The Governor of the Reserve Bank ('the Bank') has written to you requesting an expansion of the indemnity for their large scale asset purchase (LSAP) programme (annex 1). This report outlines Treasury's analysis and recommendations relating to the Reserve Bank's request. This advice has been produced under significant time constraints.

Context

The LGFA

2. The LGFA is a funding vehicle for local councils. Its bond issues are jointly guaranteed by all local council members. It has a AA+ credit rating from Standard and Poors and Fitch. There are approximately $11b of LGFA bonds in the market, compared to around $75b of NZGBs.

LSAPs and the Bank's request

3. The COVID-19 outbreak is leading to a significant economic downturn in New Zealand. As part of the response to this, on 21 March 2020, you indemnified the Bank under the Public Finance Act 1989 for losses associated with the purchase of up to $30b of New Zealand Government Bonds (NZGBs) over the next 18 months through its Large Scale Asset Purchase (LSAP) programme.[1] You also signed a Memorandum of Understanding regarding the use of alternative monetary policy tools, which outlined the process by which the Bank could request further indemnities.[2]

4. The Bank subsequently commenced their NZGB LSAP programme. To date, the LSAP programme has been successful in improving conditions in the NZGB market, helping the MPC achieve its economic objectives.

5. However, as noted in their attached letter, over recent weeks, the Bank has observed signs of significant dislocation in other New Zealand debt markets. The Bank is particularly concerned about the dislocation and lack of liquidity in the market for New Zealand LGFA debt. The Reserve Bank Governor has therefore written to you to request that the Crown indemnity provided to the Reserve Bank on 21 March 2020 be extended to cover losses associated with the purchase of up to $3 billion of LGFA debt, in addition to purchase of $30 billion of New Zealand Government debt previously agreed.

6. Today (Monday 6 April) the Bank opened an offer to purchase Local Government Funding Agency bonds on a small scale for liquidity management purposes and to

[1] The letter of indemnity is available here: https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Monetary%20policy/ump/Letter-of-indemnity-from%20MOF-RBNZ-for-purchase-of-NZ-domestic-governement-bonds.pdf?revision=a22c2a56-92c9-4665-a867-8686db434ddf&la=en

[2] The MOU is available here https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Monetary%20policy/ump/March-2020-Memorandum-of-Understanding-regarding-the-use-of-alternative-monetary-policy-tools.pdf?revision=f2d36ca4-ca86-4d5f-a3e7-eafac07e2e1d&la=en

support market functioning. They are doing this small scale intervention under their financial stability mandate, rather than as an alternative monetary policy tool.

Analysis of LGFA indemnity request

7. **We agree that dislocation in the LGFA market will inhibit the Bank from achieving its economic objectives of price stability and maximum sustainable employment, and that indemnifying the Bank to undertake LSAPs of LGFA bonds is an appropriate policy response in the circumstances.**

8. **The market for LGFA bonds has become dysfunctional.** No dealers are willing to provide prices on LGFA bonds, such that there is no price transparency and hence no market for LGFA bonds. Dealers have pulled back because of general market volatility, in turn caused by a combination of the near-closure of global credit markets, domestic intermediaries reducing risk due to increased market volatility, and fund managers liquidating their holdings in order to meet redemptions. The dysfunction is not due to risks to the LGFA's solvency, which we consider to be robust.

9. **LGFA serve as a key pricing benchmark for the rest of the credit market**, and so as a flow on the lack of LGFA pricing has affected the entire credit market. This will impact on wider economic activity if sustained, impacting on the MPC's achievement of their objectives.

10. **The dysfunction in the LGFA market will make it hard for the LGFA to complete a funding issue this week.** The LGFA have a $1.03 billion bond maturity on 15 April 2020. We understand LGFA plan to refinance a portion of this (approximately $500 million) before Thursday 9 April to meet council funding needs, and they have concerns from the LGFA about the ability to get this transaction executed due to the market dysfunction.

Financial implications

11. **Net core Crown debt is not impacted when an LSAP transaction is first undertaken, regardless of whether NZGBs or LGFA bonds are purchased.** Net debt is only impacted if actual losses or gains occur over time (likely either due to interest rate movements or credit risk).

12. **However, LSAPs of LGFA bonds have some different fiscal impacts to LSAPs of NZGBs:**

    a **With LSAPs of NZGBs**: the Bank exchanges a long duration Crown liability (the NZGB) for overnight settlement cash (generally remunerated at the OCR). The overall size of the Crown balance sheet is unchanged, and net debt is unchanged. The only change is a shortening in the duration of the Crown's overall liabilities.

    b **With LSAPs of LGFA bonds**:

        i the Bank purchases an asset (the LGFA bond) that is not already part of the consolidated Crown. This means that the consolidated Crown's assets and liabilities increase equally when the purchase is done – the assets by the amount of the purchase, and the liabilities by the amount of the settlement cash issued.

        ii the Crown will take on <u>credit risk in addition to interest rate risk</u>. However, this credit risk is very small as the probability of the LGFA defaulting is extremely low. Our assumption is a 0.03% probability of default in a given year. Modelling indicates that in 99.9% of circumstances expected credit losses are below $153m. This risk will be managed by revising the risk control framework. In addition, there is existing interest rate risk. A large but plausible loss from interest rate risk would be around $250m, but the Bank could also make only small losses or a profit depending on the path of interest rates.

a Given there is credit risk involved, we will charge the value of the guarantee against vote Finance. The amount in essence represents the concession the Crown is making to the Reserve Bank in providing this indemnity without consideration. It will unwind over the life of the indemnity This has the following financial implications: We are still determining the value of it but it will be no greater than $153m. Once we determine the value of the contract it will sit in Vote Finance. The amount in essence represents the concession the Crown is making to the Reserve Bank in providing this indemnity without consideration. It will unwind over the life of the indemnity

b No appropriation is required for the expense in Vote Finance as you are giving the guarantee under the authority of s.65ZD of the Public Finance Act, and section 65ZG provides permanent legislative authority for expenses to be incurred in relation to such guarantees.

c The indemnity will not be reported as a liability in the financial statements as it is an internal transaction within the core-Crown. Rather, any expected credit losses that the Government makes on holding LGFA debt will be reported in the consolidated financial statements if and when expected losses emerge as with the impairments of any other assets held.

Alternatives to LSAPs of LGFA bonds

13. Dislocation in the LGFA bond market may be able to be addressed using several existing tools. However, there is a high risk these tools alone will be insufficient to restore market confidence and functioning The tools are:

a The Bank can continue to intervene in the LGFA market on a small scale to assist market functioning.

b The Bank could choose to increase the pace of their NZGB LSAP purchases. This could drive increased demand for LGFA bonds as investors rebalanced their portfolios towards similar assets to NZGBs.

29 [redacted]

14. Another alternative would be to keep the total LSAP programme at $30b and reallocate $3b from NZGBs to LGFA bonds. However, we do not recommend this as we have significant concerns that this would reduce market expectations for LSAP purchases of NZGBs. This would increase government bond interest rates and make it more difficult for the Crown to issue debt.

LSAPs of other assets

Clarification regarding inflation indexed NZGBs

15. The existing indemnity that you have already signed covers domestic NZGBs but does not state whether this applies to nominal and/or inflation indexed bonds (IIBs). The Bank did not initially intend that the indemnity would cover IIBs, however both the Treasury and the Bank think there would be value in the Bank having the option to

purchase IIBs as part of the existing $30bn indemnity to give the Bank the ability to avert any further dislocation in this market. The way that the indemnity is drafted would already allow them to do this, so no action is required other than to come to an agreement that this is the intention. If the Bank did purchase IIBs, this would alter the composition of the Crown’s liabilities (by purchasing inflation indexed bonds and issuing settlement cash instead). We do not think this would significantly alter the risk on the Crown’s balance sheet.

33 [redacted]

Next Steps

18. If you agree that it is necessary or expedient in the public interest to give the indemnity then, you will need to sign a letter of indemnity.

19. The Reserve Bank have indicated that a large but possible loss would be around $400m ($153m credit risk plus around $250m interest rate risk). We therefore recommend that if you decide to grant the indemnity, that you present the required statement to the House. We will provide you a draft statement. Your office can liaise with the Office of the Clerk of the House about the necessary arrangements for presenting the statement to the House.

Recommended Action

We recommend that you:

20. **note** that the Crown indemnity for the Reserve Bank’s Large Scale Asset Purchase programme currently covers interest rate risk on purchases of up to $30b of New Zealand Government bonds over the next 18 months.

21. **note** that the Reserve Bank have requested the indemnity be expanded to cover interest rate risk and credit risk on up to $3b of Local Government Funding Agency bonds, in addition to the existing $30b of NZGBs (allowing total purchases of up to $33b).

22. **agree** to the Reserve Bank's requested indemnity.

    Agree/disagree

23. **agree** that inflation indexed NZGBs are covered within the existing $30b indemnity for NZGB purchases.

    Agree/disagree

33 [redacted]

25. **agree** that the attached noting paper be lodged for the Thursday 9 April COV cabinet committee.

    Agree/disagree

26. **agree** to present a statement to the House of Representatives that th s indemnity has been amended and restated, as soon as practicable after giving the indemnity, as the contingent liability of the indemnity exceeds $10 million We will provide suggested wording to your office.

    Agree /disagree

Renee Philip
Manager

Hon Grant Robertson
Minister of Finance

Annexes

Annex 1: The Reserve Bank's letter

Annex 2: Public interest test assessment under Section 65ZD of the PFA

Attachments: Draft indemnity and draft COV committee paper

Annex 1: The Bank's letter

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Adrian Orr
Governor

6 April 2020

Hon Grant Robertson
Minister of Finance
The Beehive
Wellington

Dear Hon Grant Robertson

As you are aware, on 21 March 2020, the Crown provided the Reserve Bank (the 'Bank') with an indemnity for the purchase of up to a maximum of $30 billion New Zealand Government debt on the secondary market over the following 18 months, financed by central bank money. Following that decision, the Monetary Policy Committee (MPC) agreed on 22 March 2020 to approve a programme of large scale asset purchases (LSAP) of New Zealand Government debt to a total volume of $30 billion over 12 months. This reflected the impact of the COVID-19 outbreak on the global and domestic economies, which compromised the MPC's ability to meet its economic objectives using its conventional monetary policy tool (a positive Official Cash Rate (OCR)).

The Bank began purchases under the LSAP programme on 25 March 2020. To date, the LSAP programme has been successful in improving conditions in the New Zealand Government debt market. Liquidity in the market has improved, bond yields have declined and the yield curve has stabilised relative to conditions a few weeks ago. This provides stimulus to the New Zealand economy as a well-functioning government bond market is essential for the pricing of other debt instruments in New Zealand and lowering Government bond yields lowers the interest rates faced by New Zealand households and businesses. As a result, the LSAP programme is helping the MPC achieve its economic objectives as specified in the remit and section 8 of the Reserve Bank of New Zealand Act (1989)), namely: (a) achieving and maintaining stability in the general level of prices over the medium term; and (b) supporting maximum sustainable employment.

Over recent weeks, however, the Bank has observed signs of significant dislocation in other New Zealand debt markets, caused by a combination of the near-closure of global credit markets, domestic intermediaries reducing risk due to increased market volatility, and fund managers liquidating their holdings in order to meet redemptions.

There is particular concern about the dislocation and lack of liquidity in the market for New Zealand Local Government Funding Agency (LGFA) debt. LGFA debt provides a critical benchmark for non-government credit instruments in New Zealand, and in normal times is the most liquid part of this market. A persistent lack of liquidity would have a deep and lasting detrimental impact on the confidence in New Zealand's debt capital markets, which will increase interest rates in New Zealand more broadly and inhibit the transmission of monetary policy. This presents a threat to the achievement of the MPC's economic objectives.

I am therefore writing to you to request that the Crown indemnity provided to the Reserve Bank on 21 March 2020 be extended to cover losses associated with the purchase of up to $3 billion of LGFA debt, in addition to the purchase of $30 billion of New Zealand Government debt previously agreed. The Bank is not seeking a change to the existing 18 month duration in which assets purchased by the Bank are eligible under the indemnity. The Bank asks that LGFA debt purchased as a reinvestment of LGFA debt held within the LSAP programme, within or after the 18 month timeframe, be eligible under the indemnity.

This request is in accordance with the *Memorandum of Understanding between the Minister of Finance and the Reserve Bank of New Zealand regarding the use of alternative monetary policy tools* (MoU) dated 21 March 2020.

The case for purchasing LGFA debt under the LSAP programme has been assessed against the principles set out in the Bank's *Unconventional Monetary Policy Principles and Tools* document. As described above, purchasing this debt will help lower interest rates and improve the transmission and effectiveness of monetary policy. It will support market efficiency and financial stability by bringing confidence and stability to New Zealand debt markets, through the provision of much needed liquidity, currently unobtainable through normal market channels. In addition, it will not materially increase the public balance sheet risk associated with the LSAP programme and the Bank is operationally ready to purchase LGFA debt.

The LSAP programme would continue to be designed to minimise distortions in the Government debt market, as well as minimising distortions in other credit markets including the market for LGFA debt. The Bank will closely monitor the effect of its Government debt purchases on the functioning of financial and credit markets and on financial stability risks, and will adapt its purchase operations when necessary. The Bank will also continue to work with the Treasury's Capital Markets unit when planning operations under the LSAP programme.

The risk control framework, agreed with the Treasury following announcement of the LSAP programme on 23 March, will also be updated to reflect the risks associated with the purchase of LGFA debt. As with the purchase of New Zealand Government debt, the key financial risk relates to interest rate risk, which is influenced by the future path of the OCR. The Bank will face some credit risk when purchasing LGFA debt, however, this risk is relatively small given its high credit quality. We ask that the Crown indemnify the Bank against losses due to both the interest rate risk and credit risk that is associated with the purchase of LGFA debt under the LSAP programme.

The Bank will continue to report to the Treasury monthly on the transactions undertaken as part of the LSAP programme, including information on the scale of operations and the associated gains or losses associated with the purchase of each asset class. This information will also be included in the Bank's Annual Report and in more frequent public reporting, provided that information can be provided in a way that did not compromise the efficacy of the LSAP programme.

The MPC will continue to monitor the effectiveness of monetary policy, including the LSAP programme, and its broad impact on the economy and financial system. This includes an assessment of whether the current monetary policy settings provide the right amount of stimulus to meet the MPC's economic objectives. This analysis will be set out in the upcoming May *Monetary Policy Statement*. Should the MPC determine that a change in the scale, duration or asset classes included in the LSAP programme is necessary to meet its economic objectives, the Bank will write to you to request a change in the indemnity, as per the MoU.

I look forward to receiving your reply.

Yours sincerely

Adrian Orr
Governor

Annex 2: Public interest test assessment under Section 65ZD of the PFA

The following contains legal advice and parts of it are subject to legal professional privilege.

Your power under section 65ZD of the Public Finance Act 1989 to give an indemnity on behalf of the Crown

1. The Letter of Indemnity is intended to be legally binding and, if you decide to execute it, will constitute a commitment by the Crown indemnify the Bank as described in its terms.

2. Section 65ZD of the Public Finance Act 1989 (the Act) empowers you, as the Minister responsible for the administration of the Act, to give an indemnity to a person, organisation or government if it appears to you to be 'necessary or expedient in the public interest' to do so, and to give such an indemnity on any terms and conditions that you think fit.

Officials' assessment that giving an indemnity to the Bank on the terms outlined in the Letter of Indemnity is 'necessary or expedient in the public interest'

3. It is a matter for you to decide whether you are satisfied that it is necessary or expedient in the public interest to indemnify the Bank on the terms outlined in the Letter of Indemnity.

4. The following paragraphs set out factors that officials consider are relevant to that assessment. [redacted] 36

Public interest

5. The Act does not define 'the public interest'. [redacted] 36

6. The COVID-19 pandemic has had a significant impact on people and the economy, worldwide. The current and expected impact of the COVID-19 outbreak on the global and domestic economies compromises the Bank's ability to meet its economic objectives using its conventional monetary policy tool (a positive Official Cash Rate (OCR)). As such, as mentioned in the letter from the Bank, the MPC believes alternative monetary policy tools are urgently required.

7. The Bank's economic objectives with respect to monetary policy include (a) achieving and maintaining stability in the general level of prices over the medium term; and (b) supporting maximum sustainable employment. Parliament has recognised (through section 1A(1)) of the Reserve Bank of New Zealand Act 1989 that formulating and

implementing monetary policy directed to these objectives contributes to the overall purpose of that Act to "promote the prosperity and well-being of New Zealanders, and contribute to a sustainable and productive economy". Officials consider that there is a clearly identifiable public interest in ensuring that the Bank remains empowered to deliver on its economic objectives.

8. As noted elsewhere in this report, the Bank considers market functioning in the LGFA bond market requisite for the effective operation of monetary policy. LGFA debt market dysfunction threatens both the Bank's financial stability objectives and monetary policy objectives.

9. As noted above, the Bank considers that LSAPs of LGFA bonds will ease conditions in this market, supporting the MPC to achieve its objectives. Therefore, the Bank is requesting a further indemnity for purchases of up to $3 billion of LGFA debt over the next 18 months. To the extent the Crown indemnity (as set out in the attached Letter of Indemnity) is required to enable the Bank to undertake LSAPs effectively, the indemnity can fairly be described as securing outcomes that benefit the public interest.

Necessary or expedient

10. As noted above, dislocation in the LGFA bond market may be able to be addressed using several existing tools. However, there is a high risk these tools alone will be insufficient to restore market confidence and functioning.

11. Further, there is evidence that the already agreed LSAP programme of NZGBs has been effective in supporting the MPC's economic objectives. The effectiveness of the NZGB purchases to date is a positive sign that LGFA LSAPs would also improve conditions in the LGFA debt market.

12. The Bank is already empowered under its legislation to engage in AMP generally. However, as per the MOU, the Bank has indicated that without an indemnity for its potential financial exposure, the Bank's view is that it would not have sufficient capital to use these AMP tools were they necessary to achieve the economic objectives. While the Bank has the capacity to use AMP tools such as the LSAP of LGFA bonds, the Bank recognises that the use of some of these tools results in a significant increase in financial exposure for the Crown. The Bank recognises that this needs to be balanced against its operational independence.

13. In particular, the Bank has noted that their Bank's balance sheet would expand significantly under any LSAP programme. This does not technically inhibit the Bank's ability to undertake LSAPs but could curtail their use if the Bank is concerned about the risk to its balance sheet position.

14. Given the above, the Bank has indicated that although it has capacity to use AMP tools such as LSAP of LGFA bonds, it would not be able to do this to the scale contemplated by the Programme without a Crown indemnity.

15. In the circumstances, officials consider that that the more appropriate threshold under section 65ZD would be the 'expedient' threshold rather than the necessity threshold.

Risks and mitigations

16. The usual risks associated with indemnifying an organisation, particularly in uncertain times, are present. As with the agreed Programme, because there is no dollar cap on the indemnity, this means that there is greater risk that the Crown's liability under the indemnity is significantly greater than expected.

17. As noted above, the proposed LSAPs of LGFA debt increase the Crown's financial risk exposure. The risk mitigation features for LGFA LSAPs are substantively the same as those features agreed for NZGB LSAPs.

18. The attached Letter of Indemnity has been undertaken in a compressed timeframe and within a dynamic economic environment. That said, the terms of the Letter of Indemnity mitigate the risks for the Crown through:

- **Risk control framework (RCF):** the RCF seeks to identify, measure, and manage the risks associated with implementing alternative monetary policy tools. In the Letter of Indemnity the Bank commits to work with Treasury to revise the RCF within 7 days of the date of the indemnity to account for differences of risk associated with LGFA asset purchases].

- **Reporting requirements**: The Programme will be reviewed under existing requirements set out in the Act. Additionally, the Bank commits to providing monthly reports to the Treasury on the transactions undertaken as part of the Programme, and to inform you if conditions change such that the financial isk of the Programme increases.

- **Time-limited indemnity**: the indemnity covers losses arising out of NZGB and LGFA debt purchases over the next 18 months.

  In 18 months, the Minister of Finance will have the opportunity to terminate the indemnity should they consider it in the public interest. At the expiration of the indemnity period, the Bank will remain indemnified for losses on bonds purchased during the indemnity period but not for losses on any new purchases, except for new bond purchases that 'roll over' initial bonds when they reach maturity. This enables the Bank to maintain its por folio of bonds acquired under the Programme, which protects against an unwarranted tightening of monetary policy. Having a time limit ensures that the indemnity does not bind the Crown for an indefinite period of purchases.

Benefits

19. The principal benefit of providing the indemnity is that it will likely lead to the Bank undertaking LSAPs of LGFA debt immediately. This increases the ability of the Bank to use LSAPs to pursue its economic objectives (which is expected to have positive flow-on effects for the wider economy and the public interest).

No viable alternatives to an indemnity

20. As noted above, the Bank has said within the context of the MOU that, without an indemnity, it wou d be unable to undertake LSAPs on the scale contemplated by the Programme. The Bank has operational independence and therefore the Crown cannot require the Bank to use any particular monetary policy tool. Other than the Crown, there is no other entity within New Zealand that would be able – or willing – to indem ify the Bank for the amounts required.

Assessment of risks and benefits against the public interest threshold

21. In light of the above, officials consider that:

   a there is a public interest in giving an indemnity to the Bank on the terms set out in the Letter of Indemnity;

   b based on the limited time available to assess the risks to the Crown associated with the indemnity, the benefits of the proposed indemnity appear to outweigh those risks when mitigations are taken into account; and

   c although there are viable alternatives to easing dislocation in the LGFA debt market, these alternatives are less preferred to providing an indemnity to support the Bank to undertake LSAPs of LGFA bonds.an indemnity when it comes to enabling the Bank to undertake LSAPs.

22. Accordingly, on balance, officials are of the view that the indemnity appears to be expedient in the public interest.