The Treasury

Indemnifying Further Large Scale Asset Purchases Information Release

June 2020

This document has been prepared for release by the Treasury:

https://uniteforrecovery.govt.nz/updates-and-resources/legislation-and-key-documents/proactive-release/

Context

The Minister of Finance subsequently agreed to provide an expanded indemnity for the Reserve Bank's Large Scale Asset Purchases (LSAPs). The Letter of Indemnity provided by the Minister of Finance can be found at:

https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Monetary%20policy/ump/10-May-2020-Letter-of-Indemnity-Amendment-between-RBNZ-MOF.pdf?revision=b7522a75-43d2-47c1-82f5-d46a94306853&la=en.

This report notes that the Treasury intended to issue a public statement to clarify the impact of LSAPs on net debt. An explanation of how the Reserve Bank's LSAPs affect the Crown balance sheet can be found at:

https://treasury.govt.nz/publications/guide/how-reserve-banks-large-scale-asset-purchases-affect-crown-balance-sheet.

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

[23] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[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

Where information has been withheld, a numbered reference to the applicable section of the Act has been made, as listed above. For example, a [23] appearing where information has been withheld in a release document refers to section 9(2)(a).

Accessibility

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Indemnifying further Large Scale Asset Purchases

Date:	1 May 2020	**Report No:**	T2020/1036
		File Number:	MC-1-1-1-2 (RBNZ Institutional Frameworks)

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Sign** the attached indemnity, to support potential expansions of the Reserve Bank's Large Scale Asset Purchases.	**Monday 4 May 2020**, to lodge Cabinet paper for DEV on 6 May.

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Elle Hughes	Analyst, Macroeconomic and Fiscal Policy	[39]	N/A (mob)	✓
Renee Philip	Manager, Macroeconomic and Fiscal Policy		[23]	

Minister's Office actions (if required)

Return the signed report and letter of indemnity to the Treasury.

Arrange for a Statement to be presented to the House after 13 May.

Note any feedback on the quality of the report	

Enclosure: Yes (iManage links)

Executive Summary

In response to COVID-19, the Monetary Policy Committee (MPC) initiated Large Scale Asset Purchases (LSAPs) of $30bn of New Zealand Government bonds (NZGBs) and $3bn of Local Government Funding Agency (LGFA) bonds over the next 12 months. You provided indemnities for these purchases made prior to 30 September 2021, to manage the associated financial risks.

The Reserve Bank (the Bank) has now requested an indemnity for an expanded LSAP programme. The requested indemnity covers LSAPs of nominal NZGBs, inflation-indexed NZGBs, and LGFA bonds for up to 50%, 30% and 30% of the respective markets, until 30 September 2021. This proposal significantly expands the scale of recently agreed indemnities for LSAPs, but does not expand the type of assets the Bank may purchase. Assuming current forecasts of debt issuance, the upper limit of the LSAP programme would reach approximately $75 billion by September 2021. Expressing the indemnity limit as a market share, rather than a dollar amount, means the MPC can expand the LSAP programme alongside debt issuance, to ensure effective stimulus and lower borrowing costs.

Contrary to our previous advice, LSAPs will increase recorded net debt in the near term, although LSAPs remain fiscally neutral over the lifetime of the bonds. This corrects a technical assumption on the accounting treatment of NZGBs purchased under the LSAP programme. However, this correction does not materially alter the fiscal risk associated with the LSAP programme and it will not affect the Government's debt issuance requirements. Consequently, the correction does not change our overall advice on the use of LSAPs.

The impact on recorded net core Crown debt is highly uncertain, but expanding the LSAP programme is likely to add in the order of a few billion dollars to net debt compared to what is captured in the Budget forecasts. We will report back to you with an estimated impact next week. However, we expect this impact to be offset by higher OBEGAL (due to lower interest expenses) over the life of the bonds, so over time the impact on net debt will be unwound. The Treasury intends to issue a public statement to correct our previous advice about the impact of LSAPs on net debt, which has been picked up in various media reports.

Section 65ZD of the Public Finance Act 1989 empowers you, as Minister of Finance, to give an indemnity on behalf of the Crown if it appears to you to be necessary or expedient in the public interest to do so.

LSAPs present fiscal risks. The Bank's best estimate of large but plausible losses arising from the expanded LSAP programme is a net loss of $2.3bn. However, we consider these fiscal risks are outweighed by the likely economic benefits of LSAPs. If effective, LSAPs will support the economic recovery and lower Crown financing costs. In turn, this would support the fiscal position.

Officials are of the view that giving the indemnity would be expedient in the public interest. We recommend that you agree to provide the requested indemnity.

Recommended Action

We recommend that you:

a **note** that the Reserve Bank has requested the indemnity be expanded to cover financial losses arising from LSAPs, until 30 September 2021, of:

a. Up to 50% of outstanding nominal NZGBs;

b. Up to 30% of outstanding inflation-indexed NZGBs; and

c. Up to 30% of outstanding LGFA bonds.

b **note** that the proposed indemnity would replace the existing LSAP indemnities.

c **note** that section 65ZD of the Public Finance Act 1989 empowers the Minister of Finance to give indemnities on behalf of the Crown if it appears to the Minister to be necessary or expedient in the public interest to do so.

d **note** that officials' view that the proposed indemnity would be expedient in the public interest.

e **agree** that the proposed indemnity (as set out in the attached Letter of Indemnity) is necessary or expedient in the public interest.

Agree/disagree

f **agree** that the attached noting paper be lodged for the 6 May DEV Cabinet committee.

Agree/disagree

g **note** that section 65ZD requires you to present a statement to the House of Representatives if the contingent liability under the indemnity is greater than $10 million.

h **agree** to present a statement to the House of Representatives that this indemnity has been amended and restated as soon as practicable after 12 May, the effective date of the indemnity. We will provide suggested wording to your office.

Agree /disagree

i **agree** that the Treasury should issue a public statement clarifying the impacts of LSAPs on the fiscal position.

Agree /disagree

Renee Philip
Manager

Hon Grant Robertson
Minister of Finance

Treasury Report: Indemnifying further Large Scale Asset Purchases

Purpose of Report

1. The Governor of the Reserve Bank has written to you requesting an expanded indemnity for losses arising from potential LSAPs (see attached). An expanded indemnity for potential LSAPs aims to give the MPC and the Bank greater flexibility to adjust the use of alternative monetary policy (AMP) tools at pace.

2. This report seeks your agreement to the proposed indemnity, should you consider that it is necessary or expedient in the public interest to do so for the purposes of section 65ZD of the Public Finance Act 1989.

Background

3. With the Official Cash Rate (OCR) at 0.25%, the MPC considers that it has exhausted conventional monetary policy options and is now using LSAPs as its preferred AMP tool.

4. Compared to conventional monetary policy (non-negative movements of the OCR), AMP tools support the same outcomes, but present different risks. In particular, LSAPs pose financial risks to the Crown.

5. You and the Governor recently agreed a Memorandum of Understanding (MoU) (T2020/728 refers) to manage the risks associated with the use of AMP tools, and to provide clarity over the MPC's mandate to use AMP tools. The MoU sets out a process for agreeing the type and scale of AMP tools for which the Government is willing to provide an indemnity.

6. **Under the MoU, you have recently agreed to indemnify the Bank for financial losses arising from LSAPs of:**

   a Up to $30bn of NZGB purchases until 30 September 2021, on 21 March (T2020/728 refers), and

   b Up to $3bn of LGFA bond purchases until 30 September 2021, on 7 April (T2020/881 refers).

7. Since then, the Treasury and the Bank have been working together to design a broader indemnity, to support the MPC to achieve its economic objectives. Work on this indemnity was noted at COV Cabinet Committee on 9 April (CAB-20-MIN-0130 refers).

8. **Under the MoU, the Governor has written to you to formally request an expansion of the indemnity for LSAPs.** The existing indemnities were agreed under haste, to address urgent economic and financial market disruption. Since then, the economic outlook has evolved and debt issuance has increased, which is expected to dampen the stimulus provided by the existing LSAP programme. Given this, the Bank would like to provide the MPC with options for additional monetary easing. The Bank's view is that, without an indemnity for its potential financial exposure, it would not have sufficient capital to expand its LSAP programme.

9. The proposed indemnity increases the scale of LSAPs the Crown will indemnify the Bank for, but does not indemnify a broader range of asset purchases (e.g. private sector bonds) or other AMP tools. There is an option to provide an even broader

indemnity. For example, you could indemnify LSAPs of other assets or AMP tools, such as foreign exchange intervention and term lending.

10. We do not recommend indemnifying broader interventions at this time. The Bank is still evaluating these potential interventions, and it is difficult to determine whether these interventions would be in the public interest in advance of this analysis.

11. The Bank and the Treasury recommend that the new indemnity the Bank has requested is in place ahead of MPC deliberations in early May. This will give the MPC options to expand the LSAP programme at its 13 May announcement, as market participants are expecting. There is a risk that not announcing further easing may tighten monetary conditions, relative to expectations.

Indemnity Proposal

12. **The Governor has requested an indemnity to expand the existing LSAP programme of nominal NZGBs, inflation-indexed NZGBs and LGFA bonds.**[1] The proposed indemnity would cover financial losses arising from LSAPs of up to 50%, 30% and 30% of the respective markets. This indemnity would replace the two existing LSAP indemnities. Bonds already purchased under the existing indemnities would continue to be indemnified, but count towards the new indemnity limit. Like the existing indemnities, the indemnity would cover purchases made to 30 September 2021.

13. The next section evaluates the (i) assets, (ii) scale and (iii) duration of the proposed indemnity.

Asset Coverage

14. **At this time, the Bank is only proposing purchases of NZGBs and LGFA bonds, which are already indemnified at smaller scales.** We agree with the Bank's assessment that LSAPs of these assets are likely to be the most effective, with least risk. The NZGB and LGFA bond markets are large enough to sustain significant LSAP programmes and provide benchmarks for pricing in other credit markets, supporting effective monetary policy transmission. Compared to other AMP tools, LSAPs of NZGBs and LGFA bonds present limited fiscal risks, and support lower Crown borrowing costs. The existing and proposed indemnities specify that the Bank will undertake LSAPs in the secondary markets.

15. **The Bank has considered, but chosen to exclude, other assets and AMP tools.** The table below sets out other potential AMP tools that are excluded. The Bank is continuing to evaluate these tools for potential future use.

AMP intervention	Reasons for exclusion
LSAPs of Kauri bonds[2]	Generally held by long-term investors, which would limit effectiveness.
LSAPs of Housing New Zealand limited bonds	Limited market size ($3.6bn) and not a benchmark market, limiting effectiveness.
LSAPs of Corporate bonds, e.g. Meridian Energy, Fonterra.	Limited market size, especially for highly rated bonds, limiting effectiveness. Poses increased credit risk and

[1] Note that you recently received a report on the fiscal impacts of COVID-19 on local authorities (LG202000352 refers).

[2] A Kauri bond is a highly-rated New Zealand dollar denominated security, issued and registered in New Zealand by a foreign entity. Kauri bonds act as partial substitutes to NZGBs.

	distributional/distortionary risks.
FX intervention	More analysis required on the benefits, risks and effectiveness. Generally poses much greater fiscal risk than LSAPs.
Term lending	More analysis required on the benefits, risks and effectiveness. There may be scope to substitute term lending with fiscal policy alternatives (e.g. guarantees).
Interest rate swaps	The Bank considers LSAPs are more effective as swap rates have already declined due to forward guidance on the OCR and the use of LSAPs.

Scale of Purchases

16. **The proposal would indemnify the Bank for interest rate and credit risk for the purchases of:**

- Up to 50% of outstanding nominal NZGBs;
- Up to 30% of outstanding inflation-indexed NZGBs; and
- Up to 30% of outstanding LGFA bonds.

17. Expressing the indemnity limit as a percent of each bond market differs from the existing indemnities, which indemnify the purchase of bonds up to a specified dollar amount. In practice, indemnifying up to X% of outstanding bonds means:

a The Bank will not hold more than X% of the respective bond type at the point of purchasing new bonds in that market.

b The Bank may subsequently hold more than X% of that bond market, as a result of the bond market reducing in size (e.g. through a fiscal consolidation).

c The Bank would remain indemnified for bonds, so long as the Bank held no more than X% of that bond market at the time of purchase.

18. **The potential scale of LSAPs would automatically adjust with the fiscal position.** This presents dual benefits. First, higher bond issuance unwinds some of the benefits of LSAP purchases, so a greater level of purchases is required in order to deliver the same stimulus. Second, increasing LSAPs alongside debt issuance would help to mitigate liquidity risks in bond markets and keep Crown financing costs low. At the same time, limiting indemnified LSAPs as a percentage of outstanding bonds guards against Bank dominance in the targeted markets.

19. However, expressing the indemnity limit as a percentage of the market introduces more uncertainty about the interest rate and credit risk the Crown is taking on. The scale of the indemnity, and the scale of potential losses, will be larger if NZGB and LGFA bond issuance is greater than assumed.

20. **The proposal would provide space for significantly more monetary easing, in proportion to increased debt issuance.** Currently, there are $11bn of LGFA bonds on issue, allowing for up to $3.3bn of indemnified LSAPs under the proposed indemnity. Currently, there are $61.6bn of nominal NZGBs on issue (allowing up to $30.8bn of indemnified LSAPs) and $17.4bn of inflation-indexed NZGBs (allowing up to $5.2bn of indemnified LSAPs). By September 2021, NZDM forecasts approximately $130bn of nominal NZGBs on issue (allowing up to $65bn of LSAPs) and approximately $20bn of inflation-indexed NZGBs (allowing up to $6bn of indemnified

LSAPs). Taking into account future NZGB issuance, expanding the indemnity could increase the size of the LSAP programme from $33bn to approximately $75bn by September 2021.

21. However, the scale of LSAPs would continue to be determined by the MPC based on its assessment of the prevailing economic outlook and financial conditions.

22. As a rule of thumb, we estimate that $30bn of LSAPs provides stimulus equivalent to a 150 basis point (bps) cut in the OCR, although there is considerable uncertainty around this estimate. On this basis, $75bn of LSAPs could support monetary easing equivalent to 375bps of cuts to the OCR. However, increased debt issuance may dampen the stimulus provided by LSAPs.

23. The Bank and the Treasury will continue to work together to ensure that the LSAP and debt management programmes are coordinated.

Duration of Indemnity

24. The proposed indemnity covers financial losses arising from LSAPs made before 30 September 2021. The Minister of Finance will then have the opportunity to terminate the indemnity should it not continue to be in the public interest.

25. At the termination of the indemnity, the Bank will remain indemnified for assets purchased within the initial programme (before 30 September 2021), and for assets that 'roll over' purchases made within the initial programme when they mature. This enables the Bank to maintain its portfolio of bonds acquired under LSAP programmes, which protects against an unwarranted tightening of monetary policy. The roll over feature means that the Crown will not be able to determine an end date for the indemnity coverage.

26. Having an ability to terminate the indemnity ensures that the indemnity does not bind the Crown for an indefinite period of purchases.

Financial Implications

Correction to previous advice on impact on net debt

27. Previous Treasury Reports and Cabinet Papers advised you that LSAPs do not impact on net core Crown debt when the transaction is initially made. LSAPs swap one liability (a bond) for another (settlement cash) at current market prices. Therefore, we did not expect there to be any immediate impact on net debt. We advised that net debt would only be impacted by subsequent gains or losses over time.

28. **Our previous advice was incorrect. We now realise LSAPs of NZGBs will have a near term impact on recorded net core Crown debt due to their accounting treatment, which is incorporated into the fiscal forecasts (T2020/1208 refers).**[3] This is because LSAPs trigger a revaluation of the liabilities involved in the transaction. This arises through the following mechanism:

    a. NZGBs are generally recorded as a liability in the Crown accounts based on the market price on the day of issue.

    b. When conducting LSAPs the Bank will need to pay for bonds based on the current market price. The price at which the Bank repurchases NZGBs in the market may be higher or lower than their value at initial issuance. Given that interest rates have

[3] As set out in: Public Benefit Entity International Public Sector Accounting Standard 29 Financial Instruments: Recognition and Measurement.

fallen, bond prices are now higher than their initial value. Therefore the Bank will issue settlement cash (equal to the market value) which is higher than the initial value.

c. When the Bank's balance sheet is consolidated with the rest of the Crown, the NZGBs held by the Bank are swapped for the higher Reserve Bank settlement account liabilities.

29. **In the near term, the 'revaluation effect' of further NZGB LSAPs could add in the order of a few billion dollars to net debt compared to what is captured in the Budget forecasts.** We will report back to you with an estimated impact next week. The actual revaluation effect would depend on the specific bonds the Bank purchases and market conditions at the time of purchase. All else equal, we would expect the revaluation effects to decline as the LSAP programme expands. This is because, as the LSAP programme expands, more recently issued bonds would be derecognised upon consolidation. There is likely to be less difference between the initial and purchase value on more recently issued bonds, resulting in smaller revaluation effects when derecognised.

30. **The Treasury's Budget 2020 fiscal forecasts have incorporated the revaluation effect of the initial $30bn NZGB LSAP programme (T2020/1208 refers).** As a high estimate, the $30bn NZGB LSAP programme was forecast to add $3.8bn to recorded net core Crown debt. This reflects that, on average, the Bank estimates that bonds purchased through the initial $30bn LSAP programme will have a market price 13% higher than at their point of issue. As with the expanded indemnity, the actual revaluation effect will depend on the specific bonds the Bank purchases and market conditions at the time of purchase.

31. The price of the bonds is inversely related to the interest rate paid on those bonds. Therefore, although the value of settlement cash is higher than the initial recorded value of the bonds, the Bank is paying a lower interest rate (the OCR) on that settlement cash than what the Crown would have been paying on the bonds.

32. **The revaluation effect is fiscally neutral over time.** This is because it capitalises interest costs on bonds purchased up-front in the Crown accounts, and by the time the bonds mature the Crown will be no worse off. For example, the 2029 NZGB on issue pays 3.0% interest per year, compared to current market interest rates for an equivalent bond of around 0.7%. Rather than the Crown paying investors 2.3% above the market rate to investors over each of the next nine years, the LSAPs will capitalise a loss of approximately 20% of the bond value up-front. However, the revaluation effect is not likely to be fully unwound until significantly beyond the forecast period.

33. **In sum, the revaluation effect impacts OBEGAL and net debt as follows:**

a The revaluation effect is immediately reported as a loss on financial instruments. This is below OBEGAL in the accounts, so does not impact OBEGAL but does impact the operating balance and net debt immediately.

b Interest expenses reduce as the overall borrowing will be at a cheaper rate after the LSAPs. These lower interest costs are included in OBEGAL (and therefore also the operating balance). They accrue to net debt year-by-year.

34. The revaluation effect only appears on consolidation – not on the Bank's balance sheet – and is not covered by the indemnity. Only losses incurred by the Bank due to interest rate risk and credit risk are covered by the indemnity.

35. **We propose that the Treasury publish a notice clarifying the impact of LSAPs on the Crown accounts**. This could be published alongside the public release of the expanded indemnity. This would correct public mis-statements arising from our

previously incorrect advice. Consistent with our previous advice, your press release for the initial $30bn NZGB LSAP programme stated that LSAPs "*do not affect core Crown net debt, or the Government's operating balance other than reducing finance costs for the Government's borrowing programme*". This comment was repeated by some media outlets.[2] Clarifying this will ensure that any questions you or the Bank are asked on the matter can be answered correctly during the publicity for the MPS and the Budget.

Other financial impacts of indemnifying further LSAPs are as per our previous advice

36. **LSAPs pose financial risks to the Crown.** Compared to the existing indemnities, the proposed indemnity poses the same types of fiscal risk, but at an increased scale. The indemnity would cover interest rate risk for all assets, and credit risk for LGFA bonds. There is significant uncertainty about the financial returns on LSAPs, and therefore about the gains or losses likely to be charged against the indemnity.

37. **The LSAP programme may return a net gain over time.** For example, if the Bank undertook $70bn of LSAPs over the next 12 months, held the bonds until maturity and market pricing for the OCR was realised, the Bank estimate there would be a net gain of $3.0bn (in addition to the revaluation effect being fully unwound over time).

38. **However, there are significant downside risks.** The Bank's best estimate of large but plausible interest rate losses arising from the programme is a net loss of $2.3bn. This estimate assumes:

- The Bank undertakes $70bn of LSAPs over the next 12 months,
- The OCR remains at 0.25% for 12 months, then increases linearly to 1.0% in 2023, then increases to 2.5% in 2028 and remains at that level, and
- The programme terminates in 2040, with no rolling over of bonds.

39. In addition to interest rate risk, LGFA bonds would also be indemnified for credit risk. 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 $203m on $4.0bn of LSAPs of LGFA bonds. In reality, if the LGFA defaulted the loss would be well in excess of $203m.

40. The accounting treatment of the credit risk will be analogous to the treatment for the 7 April LGFA debt indemnity, as set out in T2020/881. Given there is credit risk involved, we will record the value of the guarantee against Vote Finance. The amount in essence represents the concession the Crown is making to the Bank in providing this indemnity without consideration. We are still determining the value of the charge, but it will most likely be less than $203m. This amount will unwind over the life of the indemnity. No appropriation is required for the expense in Vote Finance.

41. The credit loss on the indemnified LGFA bonds will be reported in the consolidated financial statements throughout the life of the indemnity. Additionally, actual losses will be reported as they are incurred. The remaining features of the indemnity will not be reported as a liability in the financial statements as it is an internal transaction within the core Crown.

[2] The two articles we have identified are:

https://www.interest.co.nz/news/104206/rbnz-will-buy-30-bln-government-bonds-negative-impacts-emergency-intensify-new-zealand

https://www.stuff.co.nz/national/health/coronavirus/120485461/coronavirus--reserve-bank-gets-approval-for-30b-spendup-to-protect-economy

42. **The financial impacts are highly sensitive to economic developments**, in particular: the future path of the OCR over the medium term, forecasts of NZGB and LGFA debt issuance over the next 18 months, and when the Bank unwinds its LSAP portfolio. While the Crown has a degree of control to manage the fiscal risk associated with NZGBs (through controlling the amount of bonds on issue), the Crown does not control LGFA debt issuance. This presents a risk that LGFA bond issuance is significantly greater than expected, and total losses on LGFA bonds may be greater than expected.

43. **The potential gains or losses on LSAPs referenced above are only partial estimates of their broader impacts.** If effective, LSAPs are likely to support the economic recovery and lower Crown financing costs, therefore supporting the fiscal position. These broader economic benefits are likely to outweigh any losses on the LSAPs themselves. Further, interest rate losses are expected to occur only as the economy recovers from the impacts of COVID-19. Therefore, interest rate losses would likely be buffered by simultaneous improvements in the operating balance.

44. Should you agree to the indemnity request, we will work with the Bank to update the Risk Control Framework, to reflect changes to the risk profile of the LSAP programme.[4]

Officials' Public Interest Assessment

45. Section 65ZD of the Public Finance Act 1989 empowers you, as Minister of Finance, to give an indemnity on behalf of the Crown if it appears to you to be necessary or expedient in the public interest to do so.

46. **We consider that the proposed indemnity is expedient in the public interest.** The annex provides more detailed advice on whether the proposed indemnity meets the public interest test assessment under Section 65ZD of the PFA. It is a matter for you to decide whether the proposed indemnity is necessary or expedient in the public interest.

Next Steps

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

48. Should you choose to grant the requested indemnity, section 65ZD of the PFA requires that you present a statement to the House that the indemnity has been given, given that the contingent liability exceeds $10 million. We recommend that you present the statement shortly after the indemnity comes into effect on 12 May. This will avoid being perceived to signal MPC intentions. We will provide your office with a draft statement.

49. Over the next month, the Bank will advance its analysis of other AMP tools. These tools are not included in the current indemnity proposal due to significant uncertainty about the scale that would be required and the risk the interventions would pose. We will advise you on any further indemnity requests from the Bank.

[4] The Risk Control Framework identifies financial risks associated with implementing AMP tools and sets out how those risks will be measured, monitored and managed.

Annex: 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 to 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. [36]

Public interest

5. The Act does not define 'the public interest'. [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 OCR). As such, as mentioned in the letter from the Bank, the MPC believes AMP tools are 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 above, the Bank considers that further LSAPs of NZGBs and LGFA bonds will ease conditions in these credit markets, supporting the effective operation of monetary policy and enabling the MPC to achieve its objectives. Therefore, the Bank is requesting a further indemnity for purchases of up to 50% of outstanding bonds in the nominal NZGB and up to 30% of outstanding bonds in each of the inflation-indexed NZGB and LGFA bond markets prior to 30 September 2021. 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.

9. There are also market expectations that the MPC will signal further monetary easing at its May Monetary Policy Statement. There is a risk that not announcing further easing may be perceived as a tightening in monetary policy, relative to expectation. Therefore to the extent the Crown indemnity is required to enable the MPC to signal further monetary easing (or to do so to a greater extent or more effectively than it otherwise would or could do) this further benefits the public interest.

Necessary or expedient

10. 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, including expanding its LSAP programmes, 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.

11. In particular, the Bank has noted that its 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. In the near term, the MPC also has scope to accelerate the pace of its LSAPs within the existing indemnities. Accelerating already announced LSAP plans would likely provide some further monetary easing, but not to the extent the proposed indemnity would allow.

12. Given the above, the Bank has indicated that although it has capacity to use AMP tools such as LSAPs of NZGBs and LGFA bonds, it would not be able to do this to the scale it considers necessary without a Crown indemnity.

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

Risks and mitigations

13. 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.

14. As noted above, the proposed potential LSAPs (if indemnified) would increase the Crown's financial risk exposure. The risk mitigation features for the proposed indemnity are substantively the same as those features agreed for the existing indemnities.

15. 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 before the effective date of the indemnity (12 May 2020) to account for differences of risk associated with an expansion of the LSAP programme.

- **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 risk of the Programme increases.

- **Time-limited indemnity**: the indemnity covers losses arising out of NZGB and LGFA debt purchases made prior to 30 September 2021.

  The Minister of Finance will then have the opportunity to terminate the indemnity should it not continue to be in the public interest. At the termination 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 portfolio 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

16. The principal benefit of providing the indemnity is that it will likely lead to the Bank undertaking further LSAPs of NZGBs and LGFA debt as the MPC deems appropriate. We expect the MPC will announce a moderate increase in the LSAP programme at the May MPS, and then announce further changes as economic circumstance warrant. 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

17. As noted above, the Bank has said within the context of the MOU that, without an indemnity, it would 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 indemnify the Bank for the amounts required.

Assessment of risks and benefits against the public interest threshold

18. 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; and

    b the benefits of the proposed indemnity appear to outweigh those risks when mitigations are taken into account.

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