Submission

to the

Reserve Bank of New Zealand

on the

Consultation Paper: How much capital is enough?

17 May 2019

NEW ZEALAND BANKERS ASSOCIATION
Level 15, 80 The Terrace, PO Box 3043, Wellington 6140, New Zealand
TELEPHONE +64 4 802 3358 EMAIL nzba@nzba.org.nz WEB www.nzba.org.nz

About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes that contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following seventeen registered banks in New Zealand are members of NZBA:
   - ANZ Bank New Zealand Limited
   - ASB Bank Limited
   - Bank of China (NZ) Limited
   - Bank of New Zealand
   - China Construction Bank
   - Citibank, N.A.
   - The Co-operative Bank Limited
   - Heartland Bank Limited
   - The Hongkong and Shanghai Banking Corporation Limited
   - Industrial and Commercial Bank of China (New Zealand) Limited
   - JPMorgan Chase Bank, N.A.
   - Kiwibank Limited
   - MUFG Bank, Ltd
   - Rabobank New Zealand Limited
   - SBS Bank
   - TSB Bank Limited
   - Westpac New Zealand Limited

Background

3. NZBA welcomes the opportunity to provide feedback to RBNZ on the Proposals in its Consultation *How much capital is enough?* – that being the fourth consultation in the Capital Review.

4. As the Capital Review applies only to banks that are incorporated in New Zealand, this submission is made on behalf of those banks only.

5. If you would like to discuss any aspect of the submission further, please contact:

Antony Buick-Constable
Deputy Chief Executive & General Counsel
04 802 3351 / 021 255 4043
antony.buick-constable@nzba.org.nz

Olivia Bouchier
Policy Director and Legal Counsel
04 802 3353 / 021 876 916
olivia.bouchier@nzba.org.nz

Introduction

6. NZBA supports RBNZ's objective of ensuring that New Zealand's banking system has a robust capital framework that is able to withstand significant shocks. NZBA also supports RBNZ's stated review principle that capital regulation should not unduly benefit or disadvantage some banks more than others.

7. However, NZBA submits that an increase in the capital required to be held by New Zealand banks may, subject to individual banks' commercial decisions, make it more expensive for New Zealanders to borrow money and will lead to reduced economic output. Indeed, on the basis of an independent economic review of the Consultation Documents commissioned by NZBA, the Proposals will likely result in a net economic welfare loss of $1.8 billion per annum ($2.7 billion total economic costs - $900 million total economic benefit). That will disproportionately impact agricultural and small business lending, and savers.

8. To avoid the negative impacts of these Proposals, NZBA considers that RBNZ should:

   (a) reduce the total capital requirement;

   (b) allow a more diverse range of capital instruments; and

   (c) create a more realistic transitional framework.

9. Additionally, RBNZ should undertake a cost-benefit analysis as a priority.

Defined terms

- Reserve Bank of New Zealand – **RBNZ**
- RBNZ Capital Review Paper 4: *How much capital is enough?* – **Consultation**
- Proposals set out in the Consultation relating to the amount of capital that banks must hold – **Proposals**
- Additional background information published by RBNZ in April 2019 on its Proposals – **Background Papers**
- Consultation and Background Papers – **Consultation Documents**
- RBNZ review of the capital adequacy framework for registered banks – **Capital Review**
- Common Equity Tier 1 capital, the highest quality, and most expensive, form of capital – **CET1**
- Contingent convertible capital instruments. That is, contingent debt and preference shares that are accepted as regulatory capital – **CoCos**
- Alternative Tier 1 capital. The second highest quality of capital behind CET1 and includes CoCos – **AT1**
- Tier 1 capital is 'going concern' capital, consisting primarily of paid up ordinary shares, retained earnings, some reserves, and AT1 – **Tier 1**

- Tier 2 capital is capital that can generally only absorb losses once a bank has already entered into financial difficulty – **Tier 2**
- Internal Rating Based approach to credit risk – **IRB Bank**
- Standardised approach to credit risk – **Standardised Bank**
- Open Bank Resolution – **OBR**
- RBNZ's outsourcing policy – **BS11**
- Reserve Bank of New Zealand Act 1989 – **RBNZ Act**
- Domestic systemically important banks – **D-SIBs**
- PricewaterhouseCoopers – **PwC**

Evidence to support NZBA's submission

10. As part of NZBA's review of the Consultation Documents, we commissioned two pieces of research.

11. The first is an independent economic review of the Consultation undertaken by former Secretary to the Treasury, Dr Graham Scott, Sapere Research Group. He was assisted in the preparation of that report by Dr Glenn Boyle, Associate Professor Martien Lubberink, and Kieran Murray.

12. NZBA commissioned Dr Scott to review the Proposals (as set out in the Consultation), and the approach taken by RBNZ in developing those Proposals (as set out in the Background Papers), through the lens of good public policy development and economic theory.

13. As part of his review, Dr Scott conducted bilateral interviews with seven banks – a range of locally owned banks and wholly-owned subsidiaries of overseas parents (both Australian and international). He also reviewed in detail the Consultation, the Background Papers released by RBNZ, the literature cited in those papers and other relevant studies.

14. Dr Scott's report is attached to this submission as **Appendix One**.

15. The second is a review of the international comparability of the capital ratios of New Zealand's major banks undertaken by PwC.

16. This updates a study undertaken by PwC in 2017 which was commissioned to provide context to RBNZ's Capital Review. In particular, to respond to RBNZ's concern that comparing New Zealand banks against international peers is not a straightforward task given the need to understand and allow for the idiosyncrasies and relative conservatism of New Zealand's approach to the Basel framework.

17. PwC's 2019 study explores the impact this has on the headline capital ratios of New Zealand banks compared to peer country banks. It concludes that an upward adjustment to capital ratios of around 520 basis points (including a 60 basis point conservatism haircut) is required in order to compare New Zealand's banks against peer country banks that apply Basel pillar 1 rules.

18. Key findings of the 2019 study are as follows:

   (a) New Zealand’s major banks are already well capitalised:

      (i) they are at, or above, what the Australian Prudential Regulatory Authority would consider to be “unquestionably strong”; and

      (ii) they are in the top quartile of large international banks.

   (b) The Proposals would cause New Zealand’s major banks to hold more than double the capital compared to the average held by large international banks.

   (c) RBNZ’s proposed changes would increase internationally comparable ratios to approximately 27 per cent (which assumes all Tier 1 would be satisfied by CET1 and no buffer would be maintained). New Zealand’s major banks have higher risk weights for both retail and non-retail exposures compared to Australian parent groups and to banks in most jurisdictions used as a comparison.

19. PwC’s updated study is attached to this submission as **Appendix Two**.

Capital levels proposed are too high

20. RBNZ’s rationale for increasing capital requirements is to improve the soundness of New Zealand’s financial system. RBNZ says that, in the extreme, financial system instability can culminate in banking crises, which entail severe economic and social costs for the countries in which they occur.

21. NZBA agrees and supports RBNZ in its objective of maintaining a sound banking system and guarding against banking crises, which can have significant adverse economic impacts.

22. However, NZBA considers that, in light of the economic impact study undertaken by Dr Scott:

   (a) RBNZ’s approach to its analysis – whereby it prioritised its stability objective over its efficiency objective – means that its conclusion as to the optimal capital ratio is biased; and

   (b) RBNZ has not presented enough evidence that banks’ current capital holdings are too low; therefore

   (c) RBNZ’s risk appetite is too conservative; and

   (d) banks will, in reality, be required to hold Board and management buffers of around 1-2 per cent over regulatory minima.

23. Those submissions are set out below.

Priority given to soundness over efficiency

24. The RBNZ Act requires RBNZ to promote the maintenance of a sound and efficient financial system. In the context of the Consultation, RBNZ appears to have applied a particular interpretation of its mandate to promote soundness and efficiency – it

has not given equal priority to those twin objectives. Rather, it has first analysed the level of capital at which it can meet its stability target, following which it has considered efficiency.[1]

25. Dr Scott notes that there are significant issues which could arise from considering stability in isolation and without regard to efficiency:[2]

> *… while we would not question the Reserve Bank's view that a high level of comfort about the stability of the system is essential, the question arises as to whether the pragmatic decision to set a stability target in place in isolation first, then turn to efficiency has* ***unnecessarily biased the analysis of the optimal capital ratio****. The question of whether there is a further increase of the capital ratio above the 16 per cent target for stability purposes that improves both stability and efficiency is addressed in the negative. But the analysis does not illuminate whether a lower capital ratio or one with a different composition might have produced a reduction in cost with little or any loss of stability.*
>
> [Emphasis added]

26. In any case, we do not agree that the level of capital proposed in the Consultation is necessary in order to meet RBNZ's soundness goal.

27. Soundness in the financial system reflects a range of factors, in addition to the level of capital held by banks. While requiring banks to hold more equity will generally improve soundness, it will not always be the most cost-effective method for doing so. Conflating financial system soundness in general with the capital banks hold risks undermining other methods of enhancing stability, such as having a well-resourced regulator, and highly engaged executive and Board of Directors.

28. Dr Scott agrees. In his report he observes that requiring an increase to banks' capital levels will not in and of itself insulate New Zealand's economy from bank failure:[3]

> *The analysis of risks leading to the choice of the 1 in 200 year target appears implicitly to envision banks as occasionally subjected to broader economic shocks that threaten their viability. However,* ***bank failures in New Zealand have occurred as a consequence of bad decisions grounded in poor management and governance****. The Reserve Bank is close enough to sense problems at a bank and will intervene more deeply in the affairs of such a bank even if its capital ratios are not currently threatened.* ***There are limits to the extent to which insisting on more capital allows the Reserve Bank to take its eyes off the ball****.*
>
> [Emphasis added]

29. Additionally, New Zealand's banks have recently passed various tests of soundness. For example, RBNZ's own stress testing demonstrates that New Zealand's banks will likely remain solvent under extreme stress events. Given that, and as concluded by Dr Scott, the potential costs of RBNZ's Proposals outweigh the benefit of any increase that may be derived from higher capital requirements.

---

1 Consultation, at [24].

2 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [58].

3 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [52].

No evidence that current capital reserves are too low

30. The Consultation puts forward little analysis of why, from a regulatory perspective, the current levels of capital held by New Zealand's banks are too low. In NZBA's view, the analyses presented in the Consultation are inconclusive and fall short of presenting a convincing case for the far-reaching measures proposed.

31. Indeed, Dr Scott commented:[4]

> ***The Reserve Bank's analysis does not articulate clearly what it believes is wrong with the status quo which justifies the change.*** *The clear implication of its proposal is that it believes the status quo breaches reasonable criteria for stability in the banking system. It is probable that its proposal will cause a permanent upward adjustment in interest rates and some tightening of lending criteria in riskier areas of the economy, particularly for small business and agriculture. So, the authorities will likely be pressured to be clearer about why these negative consequences of the proposal are clearly outweighed by the benefits that flow from addressing what is wrong with the status quo. The size of the required capital injection is large and has an opportunity cost similarly large. These costs are large enough to matter in the economy on a continuing basis so the benefits need to be clear and understood in the same terms.*
>
> [Emphasis added]

32. Accordingly, if RBNZ is to proceed with the Proposals, it must explain and provide clearer evidence demonstrating that the current levels of capital make New Zealand's banking system fundamentally 'unsafe'.

RBNZ's risk appetite too conservative

33. RBNZ articulates its risk appetite in the following terms: New Zealand's banks must hold enough high-quality capital to cover losses that are so large that they may only occur once every 200 years.[5] That 1 in 200 standard is translated into an explicit bank capital requirement of a Tier 1 capital ratio of 16 per cent.

34. However, in NZBA's view, RBNZ does not appear to have a definitive basis for using a 1 in 200 year event as its starting assumption, nor does it adequately explain how it arrived at a capital ratio of 16 per cent. Rather, it acknowledges that research and modelling creates a wide range of plausible optimal capital ratios, depending on input assumption and analytical approaches.

35. Dr Scott agrees, noting that:[6]

> *The Reserve Bank advances its risk appetite framework as the basis for its conclusion that the benchmark should be a probability of a system failure no greater than one in 200 years. It justifies this by reference to international norms, stress tests and attempts to model and cross-check some concept of the public's 'risk appetite'. However, the analysis provided to date* ***does not explain how the Reserve Bank arrived at a capital ratio of 16 per cent****, as opposed to a capital ratio closer to*

---

[4] *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 *May* 2019, at [35].

[5] Consultation, at [18].

[6] *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [139] and [134].

capital levels currently held by the banks (which are significantly higher than the existing regulatory minimum).

… ***the literature cited by the Reserve Bank appears to suggest a capital ratio lower than 16 per cent would be optimal****.*

[Emphasis added]

36. RBNZ also acknowledges in the Consultation that, had its analysis indicated that more than 16 per cent Tier 1 capital would be needed to meet its soundness objective, it would have proposed that higher level regardless of its impact on GDP (within reason).[7]

37. In light of the above, and the fact that RBNZ has:

(a) failed to give appropriate weight to its statutory efficiency objective; and

(b) provided very little convincing evidence to support its view that current capital levels are insufficient,

we submit that RBNZ has not optimised the trade-off between increased bank safety and economic costs. The overall level of capital proposed in the Consultation is beyond what is required for New Zealand's banks to protect their customers and run their businesses.

Capital levels likely to be higher due to operation of management buffer

38. RBNZ's Proposals provide for a 'prudential capital buffer' that sits on top of the proposed Tier 1 and Tier 2 minimums. However, in practice, the level of capital actually held by a bank will inevitably include Board and management buffers. That is because banks' social license to operate and right to trade mandates this, and because of the adverse publicity and reputational damage should the bank dip below the prudential buffer – even though the regulatory regime anticipates this.

39. In his report, Dr Scott observed:[8]

All banks we interviewed stated that they would continue to hold a buffer above the minimum capital ratio set by the Reserve Bank …

The banks we interviewed were still evaluating the size of the buffer they would maintain, but ***most said a buffer of 1.0 to 2.0 percentage points would be needed*** *to cater for economic shocks and avoid breaching the regulatory requirements (or seeking emergency capital from its shareholders). Also,* ***any bank seeking to grow its total lending will need capital in advance of that growth*** *and hence a larger buffer on top of whatever buffer it would set in a no-growth situation.*

[Emphasis added]

7 Consultation, at [78].

8 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [66]-[67].

40. Additionally, Dr Scott noted that some domestic banks advised that they may ultimately hold capital levels equivalent to the large banks so that it does not appear that they are any less capitalised and, by extension, stable.[9]

CET1 is expensive, limited, and may be inaccessible to small banks

41. In the Consultation, RBNZ acknowledges that the Proposals will impact different banks in different ways depending on their current levels of capital, how much extra they choose to hold above the required minimum, and whether they are a large or small bank. It predicts that the industry will be able to meet the proposed capital requirements over a five-year period by retaining 70 per cent of profits.[10]

42. The proportion of CET1 instruments required in the proposed capital stack will have a big impact on the cost of meeting the higher capital requirements. As RBNZ acknowledges, CET1 is the highest quality of capital, and the most expensive.

43. Dr Scott's report notes that RBNZ's Proposals may cause all categories of New Zealand banks to have difficulty raising the quantity of capital required in the time proposed. Banks may need to raise fresh equity, sell non-core assets, lift the interest rates they charge on loans, reduce the interest rates they pay on deposits and/or reduce lending to riskier customers.

44. In particular, some banks operating under a co-operative or mutual structure may have fewer opportunities to raise equity and will therefore struggle to access capital in order to compete and grow.

45. Additionally, there is a lack of a viable vehicle for smaller banks to gain capital. Options discussed to date, while theoretically possible, are unlikely to have significant market appeal making them hard in practice to use.

46. Relevantly, Dr Scott noted the following in relation to smaller banks:[11]

> *Smaller banks without large parents have limited or no access to equity markets, while cooperative banks have no formal equity. For them, the implementation of the regulation will need to be done in a way that permits them to grow their balance sheets nonetheless.*

47. In respect of mutual banks, in particular:[12]

> *New Zealand mutual banks face particular problems in meeting additional capital requirements, because the capital of these banks has typically been built from retained earnings. Unless some form of hybrid capital instrument is acceptable to the Reserve Bank, the New Zealand mutual banks would necessarily have to curtail their growth objectives (relative to their growth objective in the absence of increased capital requirements).*

---

9 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at footnote 5.

10 Consultation, at pg 5.

11 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [54].

12 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor *Martien* Lubberink, Kieran Murray, 7 May 2019, at [110].

48. And in relation to wholly-owned subsidiaries:[13]

> *In relation to the cost of equity, the New Zealand subsidiaries all referred to the internal capital allocation rules of their parent entity. The central theme is that investors cannot buy shares just in the New Zealand subsidiary, only in the overall group. The New Zealand subsidiaries range from being a very small part of the parent group to close to 25 per cent. Any risk reduction might therefore have only a small effect on the group's cost of equity for several major New Zealand banks. As a result, the parent could be expected to continue to set the same required return for the New Zealand subsidiary as for the other parts of the group in its internal capital allocation decisions. As one bank put it to us "the parent sets the return it requires to make capital available, and if that return cannot be achieved, reallocates the capital to other activities within the group."*

49. Finally, we consider that RBNZ's assumption that shareholders will be happy to increase equity in New Zealand banks via retained earnings and lower dividends is implausible.

RBNZ should review position on AT1 capital

50. NZBA submits that, if RBNZ is to proceed with a Tier 1 capital requirement of 16 per cent (15 per cent for non-D-SIBs), it must reconsider:

    (a) its in-principle decision on what should qualify as bank capital; and

    (b) the proportion of AT1 permitted in the proposed capital stack.

51. In addition, NZBA submits that the Proposals that are being consulted on at present cannot be considered in a vacuum. Rather, they should be considered by reference to other related regulatory issues such as OBR, BS11 and deposit insurance.

52. Those submissions are explained in detail below.

In-principle decision on what should qualify as bank capital should be revisited

53. In July 2017 RBNZ published its response to submissions on *Capital Review Paper 2: What should qualify as bank capital?* In it, RBNZ outlined its in-principle decision in relation to contingent debt:[14]

> *By way of a general response to submissions, the Reserve Bank continues to hold the view that contingent debt should not be part of the capital regime and that only common equity and preference shares that are non-redeemable (and have no contingent trigger) should qualify as Tier 1 capital.*

54. NZBA considers that RBNZ must reconsider that in-principle decision and reiterates its submissions on *Capital Review Paper 2: What should qualify as bank capital? Issues and Options*, dated 8 September 2017.

---

13 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor *Martien* Lubberink, Kieran Murray, 7 May 2019, at [89].

14 *Capital Review Paper 2 (Part II): What should qualify as bank capital? Response to submissions*, at [12].

55. In NZBA's view, it is very unlikely that RBNZ's decision about what should qualify as bank capital would pass a cost-benefit analysis in light of the Proposals set out in the Consultation. Dr Scott's report supports that view.[15] We echo his concern that:[16]

> *… the Reserve Bank does not appear to weigh its concerns with CoCos against the economic costs of achieving its stability and efficiency objectives, and whether CoCos might achieve its objectives at less economic cost.*

56. There is good evidence that CoCos are effective and satisfy the first guiding principle of the Capital Review; "capital must readily absorb losses before losses are imposed on creditors and depositors".[17] Dr Scott notes:[18]

> *These instruments absorb losses in going concern banks (Lubberink & Renders, 2018). During the years 2009 – 2013, for example, European banks seamlessly converted €41.55bn of European bank hybrid capital into €32.44bn of equity.*

57. Additionally, in-line with the fifth guiding principle of the Capital Review – that the capital framework should minimise unnecessary complexity – RBNZ seems to be trying to reduce its supervisory burden by focussing on CET1. We do not agree that CoCos should be excluded outright simply because they require additional supervisory resource to administer. Similarly, Dr Scott's view is that focusing on CET1 will not decrease RBNZ's supervisory responsibilities:[19]

> *[T]he analysis is framed largely around the external shocks that may bring on a crisis, whereas New Zealand's experience is that failures in banks and other financial institutions are typically the result—or at least substantially contributed to—by poor governance and management. Policies to resolve bank failures should take this into account,* ***which leads us to scepticism that reliance on a large fraction of CET1 in Tier 1 will enable the Reserve Bank to stand back more than it otherwise might****.*
>
> [Emphasis added]

58. NZBA also submits that RBNZ should consider reviewing the current requirements for AT1 to include a callable option at the issuing banks discretion. NZBA understands this should have market appeal as opposed to the current requirements for AT1 outlined in the proposed framework.

AT1 must form more than a nominal amount of the capital stack

59. The Consultation proposes that, going forward, only 2 per cent of a bank's capital holding can be an alternative to equity capital (ie Tier 2).

60. Given that:

    (a) there is good evidence that AT1 is effective at absorbing loss;

---

15 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [29]-[31].

16 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [40].

17 Consultation, at [7].

18 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [39].

19 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [138].

(b) the significant cost of CET1; and

(c) the likelihood that some New Zealand banks will face difficulties raising the quantity of CET1 required under the Proposals,

NZBA submits that AT1 must form more than a nominal amount of the capital stack. We also consider that allowing a larger proportion of AT1 will mitigate some of the negative impacts of the Proposals (which is discussed in detail below at 64-75).

61. In summary, NZBA submits that:

(a) AT1 must form a reasonable portion of total capital requirement, not just a nominal amount as currently proposed.

(b) AT1 must be in a form that is marketable to investors, not just theoretically possible.

(c) AT1 must be available to all banks incorporated in New Zealand.

Other related regulatory issues not taken into account

62. In addition to the above, this Consultation comes after the finalisation of policy decisions in respect of OBR and BS11, but leaves open questions around the status of Tier 2 Capital and the possibility of deposit insurance. These are all significant and interrelated regulatory issues. That, according to Dr Scott, has "narrowed and prejudiced the scope of the current proposals".[20] His view is that:[21]

> *The order in which the Reserve Bank has sequenced its consideration of various interrelated bank regulations in recent years illustrates this point.* ***Each step along the way has influenced the agenda for the next step and constrained the choices at each further step.*** *These decisions have become heavily path-dependant and influenced by the sequence in which the issues have been addressed.*
>
> [Emphasis added]

63. Based on the interviews he conducted with domestic banks and wholly-owned subsidiaries Dr Scott's report concludes that whether the Capital Review will have the effect of levelling the playing field and enhancing competition will be dependent on the details of implementation of proposals that have yet to be explained.[22]

Consequences of Proposals significantly understated by RBNZ

64. At the outset, NZBA reiterates that each bank will make an independent commercial decision in response to regulatory changes which result from the Capital Review.

65. As part of his review of the Consultation, and off the back of bilateral meetings with seven banks, Dr Scott draws a number of salient conclusions regarding the economic impacts which may, if implemented, flow from the Proposals.

---

20 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [30].

21 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [29].

22 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [32].

Proposals may result in $1.8 billion net loss in economic welfare

66. In his report, Dr Scott concludes that a requirement for banks to hold increased capital will cause a permanent increase in real interest rates, as banks recover the cost of the additional capital. Those higher interest costs will have direct economic costs – borrowers will be out of pocket. He estimates this economic cost (direct economic welfare loss) at $1.6 billion per annum. He notes that RBNZ appears not to have included an estimate of these direct losses of economic welfare in the Consultation.[23]

67. The direct losses of economic welfare will likely be much higher if RBNZ has underestimated the effect of the Proposals on the cost of bank credit – which Dr Scott considers is very likely, adjusting for New Zealand's conditions and based on his interviews with banks. Funding constraints may mean that direct economic costs double to $3.1 billion per annum.[24]

68. The higher interest costs will also have flow-on, or indirect economic costs, as firms invest less because of the higher interest costs. He estimates those indirect economic costs at $1.1 billion per annum.

69. Accordingly, he estimates total economic costs of $2.7 billion per annum.[25]

70. The higher capital ratios are intended to make banks more resilient, and thereby reduce the risk of economic (and social) harm that would result from a banking crisis. Dr Scott estimates the expected annual economic benefit from the reduced risk of a banking crisis at $900 million per annum.[26]

71. Hence, on these estimates, the expected economic costs of the policy would exceed the expected economic benefits by about $1.8 billion per annum ($2.7 billion total economic costs - $900 million total economic benefit). In other words, if the Proposals proceed they would result in a net loss in economic welfare of $1.8 billion.[27] We reiterate, also, that this is a conservative estimate based on RBNZ's assumptions.

72. Finally, Dr Scott states:[28]

> *An entity acting in the best interests of society would not knowingly promote a policy that would impose significantly higher costs than its benefits, after suitable adjustments for risk aversion (that is, a premium to avoid disruption).*

---

23 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [111].

24 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [112].

25 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [114].

26 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [126].

27 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [128].

28 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [137].

Proposals will disproportionately affect agricultural, small business lending and disintermediation, capital rationing likely

73. Dr Scott also analysed the likely spread of the impact on different sectors of the economy. He notes that RBNZ does not seem to have considered the impacts of the Proposals on the broader efficiency of the banking system, beyond reducing the risk of a bank failure.[29] His conclusions on this are noteworthy, and worth reproducing in full:[30]

> *All of the banks we interviewed stressed that the higher cost of bank credit that would result from the Reserve Bank proposals would not be spread evenly across their lending portfolio. Those borrowers with a higher risk weighting would face a disproportionate increase in the cost of credit, and possibly a reduction in the credit available to them.* ***All of the banks we interviewed expected the agricultural and small business sector to face higher than average increases in bank credit charges.***
>
> *The Reserve Bank also considers that some of the cost of additional capital would be met by banks paying depositors less (Reserve Bank of New Zealand, 2019b, p. 36). Some depositors, especially retired people, are sensitive to changes in cash-flows. These customers may look for alternative investments should* ***lower deposit rates not meet their cash-flow needs****.*
>
> *The potential for disproportionate impacts raises the prospect of a fringe of customer groups not being satisfied by products available from the banking sector, or facing increased costs, and hence the* ***risk of disintermediation****; that is, the risk that some of these customers might seek services outside of the banking sector. In the past, entities such as finance companies have emerged offering higher deposit rates than banks and providing finance to entities unable or unwilling to obtain funds from the banking sector. The Reserve Bank consultation paper does not assess this risk.*
>
> [Emphasis added]

74. He also concluded that capital rationing will be a likely result of the Proposals:[31]

> *The Reserve Bank appears to assume that all effects on output operate via higher credit charges.* ***There is no discussion in its consultation paper of the direct effects banks might apply,*** *for example, by applying a* ***higher loan threshold and thus reducing loan growth****. Our interviews with the banks suggested this was a distinct possibility. Consistent with this view, there is a literature that estimates the effects of higher capital ratios on the volume of lending and lending growth. These estimates are invariably negative, statistically significant, and fairly substantial (see appendix E for a summary).* ***Reductions in lending on this scale would have a deleterious effect on GDP.***
>
> [Emphasis added]

---

29 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [103].

30 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [104]-[106].

31 *How much capital is enough – A review of Reserve Bank Tier 1 capital proposals* Dr Graham Scott, Dr Glenn Boyle, Associate Professor Martien Lubberink, Kieran Murray, 7 May 2019, at [109].

Commentators agree that RBNZ has underestimated likely consequences of increased capital levels on consumers

75. Consistent with Dr Scott's analysis, many commentators estimate the Proposals may have an impact on interest rates that is significantly higher than RBNZ's estimates.

Estimates of impact in interest rates	
Reserve Bank Capital Review Media Briefing[32]	Interest rates (borrowing and lending) could change – but we don't expect by much. Lending margins above borrowing cost may **expand by 20-40 basis points**.
Harbour asset management[33]	… The likely economic costs and increases in interest rates will be larger than RBNZ's 20-40 basis point estimate, and a **50-70 basis point increase is more likely**. A 50 basis point increase in the annual interest cost of a $500,000 mortgage is about $2,500 …
UBS[34]	… That is likely to mean the banks paying lower interest rates on deposits. The cost of borrowing could **rise by between 80-125 basis points** – a two-year fixed rate mortgage at 3.99 percent could rise to as much as 5.24 percent, all other things being equal …
Macquarie[35]	… We estimate that banks would need to **raise their average pricing by 90-140 basis points** to offset the reduction in returns …

Longer transitional period required

76. NZBA submits that a longer transitional period would mean that the Proposals would be implemented gradually, which would allow customers and the economy more time to adjust to the expected pricing and credit availability impacts. For any changes to the capital framework, NZBA considers that a one-year preparatory period, followed by a ten-year transition window is reasonable, given we understand that the Reserve Bank has no immediate concerns with the level of capital held by the New Zealand banks with respect to financial system stability.

77. A longer implementation time would also allow RBNZ to invest more in the monitoring and evaluation of the impacts of any changes to regulatory capital requirements, which is consistent with good regulatory practice.

32 https://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/banks/capital-review/Capital-Review-Media-briefing-slides-22-Feb-2019.pdf?la=en&revision=698479f9-6ab8-4112-8cda-3ce30de4cdb1
33 https://www.newsroom.co.nz/@pro/2019/04/24/551536/reduce-bank-capital-target-and-move-slowly-says-harbour
34 https://www.newsroom.co.nz/2019/02/12/441050/rbnzs-capital-proposal-could-lead-to-a-real-time-bank-stress-test
35 Macquarie Research: *Australian Banks: Grinch coming across the Tasman*, 17 December 2018.

Alternative approach to achieving a levelling of the playing field

78. A guiding principle of the Capital Review is to limit the extent to which capital requirements differ between IRB Banks and Standardised Banks, and to create a level playing field between banks. RBNZ's Proposals focus on utilising output floors and a scalar to level the playing field, which substantially increases the risk weightings for IRB Banks to bring overall risk weightings up to 90 per cent of Standardised Banks.

79. There is a potential change to RBNZ's Proposals (as set out in the Consultation) that could materially reduce the total capital needs of Standardised Banks and therefore serve to level the playing field without substantially increasing the risk weightings for IRB Banks. It is intended that this could apply instead of the proposed 1.2 scalar.

80. It is summarised as follows.

Utilisation of latest Basel 3 recommendations

81. The standardised levels used in RBNZ's Proposals are out of date as they are based on Basel 2 numbers (**Historic Basel**) which have been superseded by the latest Basel 3 standards which were finalised in 2017 (**Revised Basel 3**).[36]

82. Utilisation of the Revised Basel 3 standardised weightings (with a more granular approach to asset classes), better reflects the true risk distribution for New Zealand banks (both IRB and Standardised Banks), which has improved as a result of the application of LVR limits over recent years. Given the higher quality of mortgage portfolios for New Zealand banks, a flat (and higher) risk weighting is less appropriate. These risk weightings are particularly pertinent when considering RBNZ's objective of harmonising risk weightings for more generic portfolios (eg residential mortgages) and, as such, have a significant impact on Standardised Banks' competitiveness with regards capital treatment for homogenous portfolios.

83. The significant difference in result between utilisation of Historic Basel and Revised Basel 3 is obvious when considering, for example, residential mortgages. Residential mortgages in particular lend themselves to broad portfolio analysis since the ongoing performance characteristics of these portfolios are more closely correlated to LVR categorisation than any other single statistic.

84. The Revised Basel 3 RWAs for owner occupied mortgages are tabled below, demonstrating the extent of the difference between Historic Basel and Revised Basel 3:

LVR Band	Historic Basel	Revised Basel 3
0-50%	35%	20%
50-60%	35%	25%
60-80%	35%	30%
80-90%	50%	40%
90-100%	75%	50%

36 High level summary of Basel III reforms, BIS December 2017

Next steps

85. We would be happy to discuss this submission or provide further information if required.