New Zealand Banking Association
Te Rangapū Pēke

Submission

to the

Reserve Bank of New Zealand – Te Pūtea Matua

on the

Liquidity Policy Review Consultation Paper #2: Significant Policy Issues

12 May 2023

NEW ZEALAND BANKING ASSOCIATION – TE RANGAPŪ PĒKE
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About NZBA

1. The New Zealand Banking Association – Te Rangapū Pēke (**NZBA**) is the voice of the banking industry. We work with our member banks on non-competitive issues to tell the industry's story and develop and promote policy outcomes that deliver for New Zealanders.

2. The following eighteen 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.
    - KB Kookmin Bank Auckland Branch
    - Kiwibank Limited
    - MUFG Bank Ltd
    - Rabobank New Zealand Limited
    - SBS Bank
    - TSB Bank Limited
    - Westpac New Zealand Limited

Introduction

NZBA welcomes the opportunity to provide feedback to the Reserve Bank of New Zealand – Te Pūtea Matua (the **Reserve Bank**) on its second consultation paper for the Review of Liquidity Policy (BS13) (**Consultation Paper**). NZBA commends the work that has gone into developing the Consultation Paper.

Contact details

3. If you would like to discuss any aspect of this submission, please contact:

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Summary

4. As noted in our submission on the first consultation paper for this review, NZBA agrees that it is an appropriate time to review BS13. NZBA supports the Reserve Bank's objective of ensuring the policy remains fit for purpose.

5. Below we first request market certainty for existing/upcoming issuances as a matter of priority, followed by responses to some of the specific questions asked by the Reserve Bank. Given NZBA's role as an industry body, our submission focuses on in-principle concerns with the proposals, particularly where they have or may give rise to unintended consequences for the broader markets. We understand individual submissions by member banks may cover the quantification of costs, comparison of quantitative metrics or other impacts bilaterally discussed between members and the Reserve Bank.

High priority request to provide the market with certainty on existing/upcoming Non-NZGB Highly Rated Securities

6. As an initial point, the Consultation Paper has created considerable uncertainty in the market for debt securities that are currently considered PSLA but potentially may not be treated this way in the future, given the proposals in the Consultation Paper – in particular Kauri bonds, Local Government Funding Agency securities ("**LGFA Bonds**") and other highly rated debt securities (excluding New Zealand Government Bonds or "**NZGBs**"). Such securities are referred to in this submission as "**Non-NZGB Highly Rated Securities**".

7. **NZBA submits that the Reserve Bank should prioritise publishing an initial review outcome as soon as possible, that Non-NZGB Highly Rated Securities issued before the full policy review is finalised will be subject to transitional arrangements** (as further described in paragraph 13 below).

8. This is required to give investors and issuers confidence in the ongoing liquidity of new issues of Non-NZGB Highly Rated Securities. Such action is vital to maintaining confidence and diversity in the New Zealand capital markets.

9. In particular, registered banks[1] generally seek to hold a range of Non-NZGB Highly Rated Securities for BS13 liquidity purposes, providing a considerable source of liquidity in the general market for many Non-NZGB Highly Rated Securities. The Consultation Paper has created significant doubt for investors and issuers as to the extent that registered banks will continue to invest in existing and future Non-NZGB Highly Rated Securities.

[1] For simplicity we generally refer to "registered banks" in this submission, but this would generally include licensed deposit takers under the proposed Deposit Takers Act.

10. This investor/issuer uncertainty is due to the fact that the changes proposed by the Consultation Paper may incentivise registered banks to prioritise holding of NZGBs for BS13 liquidity purposes. The paper leaves open that:

(a) Non-NZGB Highly Rated Securities may not be treated as PSLA/HQLA. Even Kauri securities and LGFA Bonds are categorised in the Consultation Paper as assets that "could" be eligible as PSLA/HQLA, on the basis that they are "assets whose classification as PSLA/HQLA is not entirely clear". Other Non-NZGB Highly Rated Securities are categorised as assets that "should not" be eligible as PSLA/HQLA;

(b) if they are treated as HQLA/PSLA, limits or haircuts may apply; and

(c) if they are not treated as HQLA/PSLA, the CLF facility limit may be set to only allow a small amount of Non-NZGB Highly Rated Securities to be included in the CLF facility. Although the expectation may be that the CLF should practically be sized to allow registered banks to utilise it for material amounts of Non-NZGB Highly Rated Securities in any year (as with other jurisdictions that have utilised a CLF, such as Australia[2]), the concern is that there is no explicit comfort on this, or past experience with the use of a CLF in New Zealand to draw from.

11. Because Non-NZGB Highly Rated Securities frequently have a maturity of 5 years or greater, investors look to the likely liquidity throughout that term. Where such liquidity is unclear in the future, they are less likely to invest now. The Consultation Paper has therefore had an unintended consequence of immediately reducing liquidity and dislocating the market for such securities, regardless of the final decisions to be made.

12. This reduced liquidity also creates uncertainty for further issuance, reducing supply of new Non-NZGB Highly Rated Securities. Reduced supply is expected to have additional market consequences, including:

(a) Generally reduced size of New Zealand's capital markets and reduced diversification of funding by New Zealand issuers.

(b) Adverse impacts on the cross-currency swap market. As Kauri bond issuers typically swap large volumes of NZD proceeds to USD, reduced demand from them is expected to lead to increased costs for New Zealand businesses swapping USD to NZD (the key FX market for NZD). As a specific example, this may make offshore funding by banks more difficult and expensive, potentially creating financial stability concerns (as discussed under Question 1 below).

13. Therefore, from a transitional perspective, NZBA submits that the Reserve Bank should publish an initial review outcome, **as soon as possible**, that Non-NZGB Highly Rated Securities issued before completion of the review will receive clear

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2 However, note our discussion of the limitations of the Australian CLF in relation to question 6 below.

ongoing liquidity treatment, regardless of what final policy decisions are made. This could be achieved by:

(a) confirming that the existing BS13 Liquidity Policy treatment would continue to be applied to Non-NZGB Highly Rated Securities issued before changes to the Liquidity Policy are finalised and published. This would provide the clearest message of ongoing liquidity for investors and issuers; **or**

(b) applying an annually increasing 'haircut' to the liquidity treatment of any Non-NZGB Highly Rated Securities. This would be similar in some ways to the approach taken to legacy regulatory capital instruments, with the increasing 'haircut' applying at the portfolio level to reduce the overall percentage of securities held for liquidity that could be in Non-NZGB Highly Rated Securities.

For instance, on day 1 of the new Liquidity Policy, banks may hold 100% of required liquidity in Non-NZGB Highly Rated Securities; after 1 year they may hold a lower [x]% of required liquidity in Non-NZGB Highly Rated Securities, and so on.

Responses to specific questions

14. We set out below answers to certain specific questions raised in the Consultation Paper.

Question 1: Do you agree with our proposal to tighten our existing eligibility criteria for PSLA so that PSLA/HQLA consist of assets that are both of high quality and liquid in private markets in a stress period (not just liquid given the presence of the Reserve Bank's repo facilities)?

15. NZBA generally agrees with the proposal to tighten the existing eligibility criteria for PSLA. However, the ability of the private market to function effectively in the absence of the Reserve Bank's support during a period of stress is uncertain. This is particularly relevant in New Zealand given the size and shape of our market. Although international metrics of 'high quality' and 'highly liquid' are a useful starting point, domestic factors need to be taken into account.

16. Therefore, any decisions on settings (including in relation to establishment of a CLF, as discussed below under Question 6 below) should consider potential private market liquidity, but should also be made in the broader context of ensuring:

(a) **Ongoing depth and development of the New Zealand capital markets in support of the Reserve Bank's financial stability mandate**. We have already discussed some immediate effects of the review on the New Zealand capital markets above in the context of our initial high priority submission.

Those effects are likely to continue if the initial proposals proceed without adequately catering for Non-NZGB Highly Rated Securities. In addition, the dislocation effects on the domestic market will also further incentivise registered banks to rely on offshore funding (noting that bank covered bonds are also typically 'repo-eligible' in relevant offshore markets). While offshore funding is a key part of a diversified funding approach, over-reliance can create risks to financial stability (as was shown in the 2008 Global Financial Crisis).

(b) **Appropriate diversification of assets held for liquidity purposes**. As the Consultation Paper notes, NZGBs are, on their face, the primary candidate for inclusion under PSLA/HQLA tests given the increased amount on issue since COVID.[3] However, this may strongly incentivise focus on a single asset class when diversity of assets is also a key consideration to ensure financial stability by providing liquidity in a wider range of circumstances. We note, for comparison, that Australia provides for both state and federal government securities as HQLA.

17. In addition to the points discussed under Question 2 below, a policy that includes NZGBs as the sole class of market securities in PSLA/HQLA may create risks:

(a) to liquidity in particular stress periods, if those stress periods also affect the market for NZGBs (and noting that, given the role of banks in the New Zealand economy, there is a risk that a stress period affecting New Zealand sovereign credit may affect New Zealand banks, creating a need for liquidity at a time when liquidity is reduced and value has potentially decreased); and

(b) from a general concentration perspective. Holding a very narrow range of securities for liquidity purposes means that the registered bank would necessarily be exposed to any idiosyncratic factors affecting those particular securities or the relevant market, with the risk of over amplification of that factor given the holding of a concentrated portfolio (as discussed in relation to Question 2 below).

Question 2: Do you agree with our proposed categorisation of assets as PSLA/HQLA in Table 2? Please provide support/evidence for any proposed alternative classification of assets as PSLA/HQLA.

18. As discussed for Question 1 above, NZBA submits that the categorisation of assets as PSLA/HQLA needs to provide for some diversity and flexibility beyond NZGBs.

19. A policy that sets NZGBs as the sole class of market securities in Category 1 assets:

(a) (as discussed in Question 1 above) will increase correlation between credit quality of banks and the New Zealand government, and create further concentration risk;

3 'Cash', ESAS balances and RB bills are also included, but as they are not market securities we do not discuss them further in this submission.

(b) may ultimately reduce liquidity of Crown debt if registered banks are required to hold significant volumes of NZGBs on their balance sheet;[4] and

(c) given the increased need for registered banks to hold NZGBs, may result in banks being more impacted by political decisions on the level of government spending and the flow on effect of the Crown's debt issuance profile over election cycles.

20. NZBA submits that a wider range of securities should be included as PSLA/HQLA (potentially with some limits to ensure diversification). For example:

(a) In categorising Kauri bonds, consideration should be given to the fact that Kauri bond issuers have very large number of securities on issue (in many different currencies). A very large number global investors will have 'on-boarded' Kauri bond issuers and therefore will be able to purchase those securities. Further, due to their size and credit quality, Kauri bond issuers have also historically demonstrated the ability to continue to issue securities in periods of global stress, demonstrating the strength and depth of markets for their securities. For the purpose of determining liquidity under the revised Liquidity Policy, the identities of the issuers, and the size and robustness of their global debt programmes, should be factored in rather than focusing solely on the size of the Kauri bond market in particular.

(b) Kauri bonds are less likely to be pro-cyclically impacted by any change in New Zealand government credit quality or local liquidity events.

(c) There are also large volumes (from a relative perspective in New Zealand's market) of LGFA Bonds on issue to the broader market – over $18bn in total, including several series larger than $2bn. These bonds provide further high quality alternatives to NZGBs, maintaining diversity. We also note that this would be consistent with approach that the Reserve Bank took to the Large Scale Asset Purchase Programme (LSAP), which included both NZGBs and LGFA Bonds.

(d) Including relevant foreign-denominated globally-issued securities as HQLA/PSLA (subject to appropriate limits) would also provide flexibility to registered banks to assist with financial stability. This category could, for instance, include securities that are international equivalents to the categories of NZD securities included as PSLA/HQLA, or securities that are included as HQLA or equivalent in the jurisdiction of the relevant currency.

New Zealand registered banks often face liquidity requirements in foreign currencies as well as New Zealand dollars (particularly as practical requirements to seek offshore funding increase). Allowing a portion of HQLA/PSLA to be held in foreign currencies would help ensure that banks can continue to meet outgoings, particularly in stress scenarios that may

4 We note that this constraint is specifically referred to in Table 3 of the Consultation Paper.

make it difficult to immediately convert New Zealand dollars to foreign currency.

Similar to Kauri bonds, foreign-denominated globally-issued securities are also unlikely to be pro-cyclically impacted by any change in New Zealand government credit quality or local liquidity events.

21. As an additional point, we note some further clarity is needed for the types of securities referred to in the paper. In particular:

(a) When discussing NZGBs, the categories of nominal bonds, treasury bills and inflation-indexed bonds are mentioned. This should also specifically include nominal green bonds (and any future variants of Crown debt).

(b) It should be clarified that "Kauri securities" refers to the usual category of Kauri bonds that are currently treated as repo-eligible.

Separate reference is made to NZD securities guaranteed by the NZ government or by AAA rated sovereigns; it should be clarified that this is intended to capture any such securities that do not fit the usual Kauri bond requirements (for instance, 'eurokiwi' issuances).

Question 6: Do you agree with our proposal to fully address any shortage of PSLA/HQLA in New Zealand through the establishment of a Reserve Bank CLF?

22. NZBA supports the introduction of a CLF as a measure to assist with ongoing flexibility of assets held for liquidity, in addition to expanding eligible PSLA/HQLA assets. To be effective, the CLF would need to be:

(a) **appropriately calibrated** to allow its regular use for a significant number/volume of securities beyond those classified as PSLA/HQLA (and taking into account any limits in that definition). This includes any Non-NZGB Highly Rated Securities that (despite our submission above) are not included as PSLA/HQLA, internal RMBS and covered bonds; and

(b) established as a facility with **long term availability**. We consider this to be particularly important from a financial stability perspective.

Appropriate calibration

23. The CLF as described in the Consultation Paper is designed to favour HQLA/PSLA to the maximum extent possible – so investors would have no ongoing certainty whether there will be a market for sale of other Non-NZGB Highly Rated Securities to banks in any year (particularly as there will be no 'track record' of previous years' approaches to refer to). Registered banks would also have no certainty as to their ability to use internal RMBS for liquidity purposes.

24. If a CLF is to be introduced, NZBA submits that:

(a) **Settings to ensure the CLF can be used appropriately**: The Reserve Bank should set the facility limit at a level that ensures it is in practice available for a substantial amount of securities, internal RMBS and covered bonds that are not treated as HQLA/PSLA (rather than effectively forcing registered banks to focus on the available market for HQLA/PSLA). It should also:

(i) take into account that registered banks may look to hold a range of maturities of HQLA/PSLA (i.e. that total supply/availability of HQLA/PSLA is not the sole consideration, availability of a range of maturities and other features is also important); and

(ii) not make it unduly onerous to utilise the CLF. We note for instance that the Australian CLF required the relevant bank to demonstrate that it has made every reasonable effort to manage liquidity risk independently, rather than using a CLF, with accompanying attestations. The Australian CLF could only be used for the 'non-liquid' portion of banks' liquidity portfolio. Such an approach in New Zealand would severely restrict the necessary flexibility of the CLF and impact its usefulness.

(b) **Forward-looking comfort on facility size**: The Reserve Bank should also provide investors and registered banks with comfort as to the facility size over a standard bond term (i.e. 5 years). This could be in the form of a tapered approach to guaranteed facility size (for example, given a facility limit in any year, at a minimum 90% of that limit is guaranteed to be available in the following year, 80% in the year after that, and so on).

This will be important to demonstrate to investors considering a bond purchase now that registered banks will be able to practically use the facility for a substantial amount of securities purchases in addition to those classified as PSLA/HQLA, throughout the term of that bond.

Long term availability

25. A CLF would need to be introduced on the basis that it will be continue to be available over the long term.

26. Although the Australian CLF was recently phased out, in our view such an approach would not be appropriate in the New Zealand market:

(a) **Flexibility and diversity**: As discussed above in relation to Questions 1 and 2, given the size and shape of New Zealand's market it is important to maintain flexibility and diversity in the assets that registered banks can hold for liquidity purposes.

(b) **Purchase of internal RMBS is a key tool for financial stability and monetary policy purposes**. On the basis that internal RMBS is not included as HQLA/PSLA, use of an internal RMBS programme for liquidity purposes will rely on the ongoing availability of the CLF.

Reserve Bank facilities for the purchase of internal RMBS have proved to be a valuable tool for financial stability purposes (such as their use after the 2008 Global Financial Crisis) and implementation of monetary policy (such as the Funding for Lending Programme). Long term availability of a CLF would help ensure that those Reserve Bank facilities remain available as tools for policy implementation.

Question 10: What are your views on the technical and other matters related to the MMR/LCR?

27. Although this submission does not generally consider the use of an MMR or LCR, we note the comment on page 35 of the Consultation Paper that "some changes will likely be made to outflow assumptions in the MMR to reflect the Depositor Compensation Scheme (DCS) under the proposed Deposit Takers Act (e.g., by including a distinction between insured and uninsured deposits)."

28. NZBA strongly supports this statement, and stresses the importance of early stage engagement by the Reserve Bank with registered banks on the relationship between the DCS and the MMR (if retained). The effects that the MMR are intended to measure and address will be directly impacted by the DCS (i.e. amounts protected by the DCS are expected to be subject to a lower withdrawal/run-off rate in times of stress).

29. However, the aggregation rules underlying the MMR do not directly align with the approach to be taken by the DCS:

    (a) MMR calculations to determine expected withdrawal/run-off rates aggregate accounts. This aggregation does not allow registered banks to factor in or adjust for the impact on withdrawal/run-off rates of the DCS.

    (b) The DCS, when introduced, will provide depositor protection based on a different 'single customer view' approach to aggregating accounts. The DCS will reduce incentives on depositors to withdraw protected deposits in times of stress. Therefore, whether a deposit is covered by a DCS under this 'single customer view' approach will be a key factor in determining expected withdrawal/run-off rates going forward.

30. The wider liquidity policy review by the Reserve Bank provides an ideal opportunity to ensure that the impact of deposit protection flow through to relevant customers appropriately for the purposes of the MMR, without adding unnecessary compliance cost to registered banks when making calculations.

31. If an LCR is adopted consistent with the BCBS, the granular approach to categories of deposits/funding run-off rates should reflect the DCS by design.

32. Aligning relevant liquidity calculations when the DCS is implemented will be complex, and will require substantive decisions to be made on the approach going forward. NZBA therefore encourages the Reserve Bank to consider and engage with registered banks on the effects of the DCS as part of the current review process.