Government's contingent risks arising from banking system distress

1. Since the global financial crisis, a key objective of banking regulation has been to eliminate if possible, or at least substantially reduce, government contingent risks associated with banking system distress – i.e. to reduce the risk of taxpayer-funded bank resolution. This has involved a two-pronged approach:

   - initiatives to reduce the probability of bank failure and the extent of losses arising where failure does occur; and

   - initiatives to address 'too big to fail' and thereby avoid or at least minimise the need for government bail-out.

2. Reflecting this, international banking regulation has seen many new initiatives introduced. These have been undertaken principally by the Basel Committee on Banking Supervision (BCBS) and Financial Stability Board (FSB), and have been implemented in many countries, especially the G20 countries (including Australia). The key developments are set out in the table below:

Initiatives to reduce the probability of bank default	**Initiatives to reduce 'too big to fail'**
Basel III capital requirements: • Increase in minimum CET1 capital ratios • Requirement that all capital be loss absorbing • Tightening of exposure risk weights • Capital conservation buffer • Countercyclical buffer • Leverage ratio	***Recovery planning requirements*** to facilitate the ability of banks to restore themselves to financial soundness
Measures to strengthen liquidity: • Liquidity coverage ratio • Net stable funding ratio	***Resolution planning requirements*** to enable least-cost ways of resolving a failing bank to meet financial stability objectives
G-SIB and D-SIB requirements: • Higher capital ratios • More intensive supervision	***Enhanced bank resolution tools:*** • Bridge bank • Bail-in • Banking group resolution • Strong cross-border resolution arrangements
Macro-prudential policy • Residential lending policy instruments • Counter-cyclical prudential tools	***Resolution funding arrangements and measures to reduce contagion risk:*** • Deposit insurance • Systemic resolution funds

Strengthening of governance and risk management requirements • Board composition requirements • Enhanced board responsibilities • Risk appetite and risk management framework requirements	
Strengthening of disclosure requirements • Basel III related disclosure requirements • Other risk-based disclosures	

3. Importantly, the international initiatives to strengthen the resilience of banks and reduce 'too big to fail' have been counter-balanced by a recognition that there are adverse financial system efficiency outcomes if these initiatives are taken too far. For example, increasing bank capital ratios to very high levels would severely impede the ability of banks to meet customer needs, to the detriment of the wider economy and society. Equally, if initiatives to reduce 'too big to fail' are taken too far – such as splitting large banks into smaller ones – this would have adverse impacts on the efficiency of the financial system. Likewise, an excessive level of prepositioning of banks for resolution will have potentially severe adverse efficiency and cost outcomes, to the detriment of bank customers and the economy.

New Zealand initiatives to strengthen banking system resilience

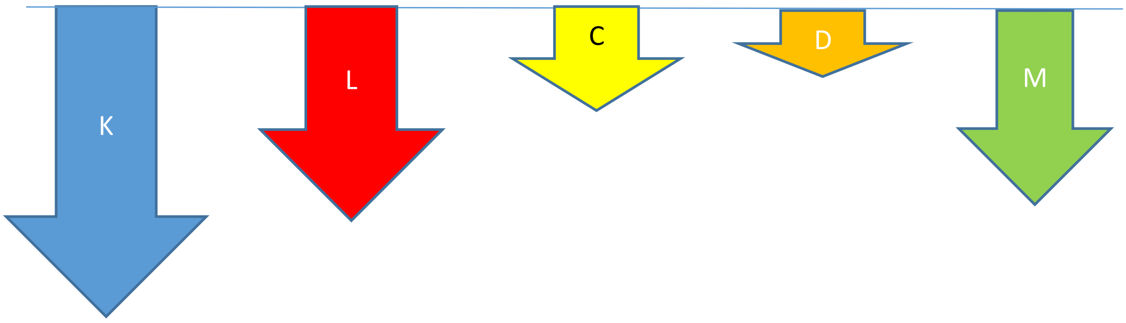
4. In New Zealand, the RBNZ has implemented a number of initiatives to strengthen the banking system (essentially lowering the probability of bank default and loss given default). Initiatives have included:

- strengthened capital requirements similar to Basel III, including a minimum CET1 ratio requirement of 4.5%, total capital ratio requirement of 8.0% and a capital conservation buffer of 2.5%;
- ICAAP requirements;
- liquidity requirements, including minimum requirements for short-term funding mismatch positions and a core stable funding ratio;
- strengthened corporate governance requirements;
- refinements to disclosure requirements (although in this regard there has been a paring back of disclosure in some areas, but proposed enhancements in other areas);
- increased use of stress testing of individual banks and the banking system as a whole; and
- a range of macroprudential measures intended to reduce the risks associated with lending against residential property and to assist in reducing residential property price inflation.

5. The diagram in Figure 1 below visually depicts the effect of these initiatives on government contingent liabilities. The arrows in the Figure 1 are indicative only. They

do not seek to quantify the impact on the government's contingent liabilities; rather, they are broadly illustrative of the direction of impact that these initiatives could be expected to have on the government's contingent liabilities.

Figure 1 – Indicative impact of regulatory initiatives on government contingent liabilities



Key: K = Capital requirements
L = Liquidity requirements
C = Corporate governance requirements
D = Disclosure requirements
M = Macroprudential requirements

6. In strengthening the resilience of the banking system, these initiatives have helped to reduce potential government contingent liabilities.

7. Reflecting these initiatives and banks' ongoing risk management enhancements, and other factors, the New Zealand banking system has strengthened considerably. For example, the average total capital ratio for all locally incorporated banks has increased from 10.5% in December 2007 to 13.5% in December 2015. The average tier 1 capital ratio has also increased sharply – from 7.6% in December 2007 to 12.1% in December 2015. The four large banks have displayed a strong increase in capital ratios, with the total capital ratios ranging from 12.2% to 13.8% as at December 2015. Non-performing loans continue to remain very low by historical and international benchmarks, being under 1.0% of total loans as at December 2015.

8. The Australian parent banks have displayed similar strength since the global financial crisis. As at December 2015, the major banks in Australia had average CET1 capital ratios of around 10.0% - well above the minimum requirement applied by APRA of 8.0% for D-SIBs. Their total capital ratio averaged around 13.8% as at December 2015. By international standards, the major Australian banks are well capitalised, and that is in the context of very low levels of non-performing loans (being under 0.5% as at December 2015).

9. Stress testing undertaken by APRA and RBNZ suggest that the banking systems of both countries would be resilient to severe economic and financial shocks. For example, in its May 2016 *Financial Stability Report*, the RBNZ noted that in late 2015 the four largest banks in New Zealand participated in a common scenario ICAAP test. This test was a hybrid between an internal test (conducted regularly with each institution choosing their

own scenarios) and a regulator-led system-wide stress test (occurring every 2-3 years with common scenarios and assumptions). It was based on a severe economic scenario in which, among other matters, real GDP was assumed to contract by 6% over three years and unemployment to rise to 13%. Dairy incomes were assumed to remain at low levels and residential, commercial and rural property prices were assumed to fall by 40%, with residential property prices in Auckland falling by 55%. Although, inevitably, banks sustained significant losses in the scenario, they did not come close to failing – their CET1 ratios reportedly fell to around 8.0%. Similar stress testing in Australia by APRA has produced broadly similar results, showing the major banks and banking system as a whole to be resilient to severe economic shocks. (Of course, as with any stress testing, the results depend on assumptions relating to probability of default and loss given default, which may or may not prove to be correct in a real economic downturn.)

10. The net effect is that the government's contingent risks in relation to the banking system has declined significantly since the global financial crisis.

New Zealand initiatives to reduce 'too big to fail'

11. Since the GFC, the main initiative taken in New Zealand to reduce 'too big to fail' has been the RBNZ's 'Open Bank Resolution' (OBR) policy and associated proposals to strengthen outsourcing requirements. OBR is a tool that is intended to reduce the government's contingent liability in the event of a bank failure by imposing loss absorption and recapitalisation costs on to depositors, bondholders and other creditors. Although it does have the potential to lower the government's contingent liability by lowering or removing the possible government-funded contribution to recapitalisation, it also creates other risks that could actually *increase* the government's contingent liability. For example, OBR as presently structured (i.e. where the New Zealand subsidiary is separated from the parent bank and where New Zealand has no deposit insurance) could impose significant contingent risks on the government, including:

- the likely need for the government to guarantee the liabilities of the resolved bank's deposits and bonds after the haircut has been applied;

- the possible need for the government to compensate creditors rendered worse off than in a conventional winding up as a result of deeper 'haircuts' to allow for a 'de minimus' exemption (e.g. for small depositors);

- the possible need for the government to contribute to recapitalisation, especially if the bank, once separated from the parent bank, requires considerably more capital than it would have needed had it been retained in the parent group; and

- the possible need for guarantees of other banks' liabilities if the application of OBR triggers a run on other banks – e.g. because of the absence of deposit insurance in New Zealand, coupled with a presumption of OBR being applied to other banks.

12. The government's contingent liabilities associated with 'too big to fail' are more likely to be reduced if the RBNZ, in coordination with Treasury and the Australian authorities, were to establish a whole-of-group approach to bank resolution. Under this approach, the aim would be to keep the group intact by recapitalising the parent bank to a sufficient

degree to cascade capital, as needed, to the New Zealand subsidiary. This could be achieved either by a government burden-sharing approach or through bail-in of creditors in the NZ subsidiary. In the latter case, the bail-in would involve converting a proportion of the New Zealand's subsidiary's debt into equity in the parent bank, enabling the parent bank to then recapitalise the New Zealand subsidiary.

13. A whole-of-group resolution approach would help to lower the New Zealand government's contingent liabilities by:

- substantially reducing the amount of capital needed to restore the New Zealand subsidiary to financial soundness compared to what would be required if the subsidiary is removed from the parent group, given that a stand-alone bank separated from the parent would very likely require a higher capital ratio than if it were to remain in the group;

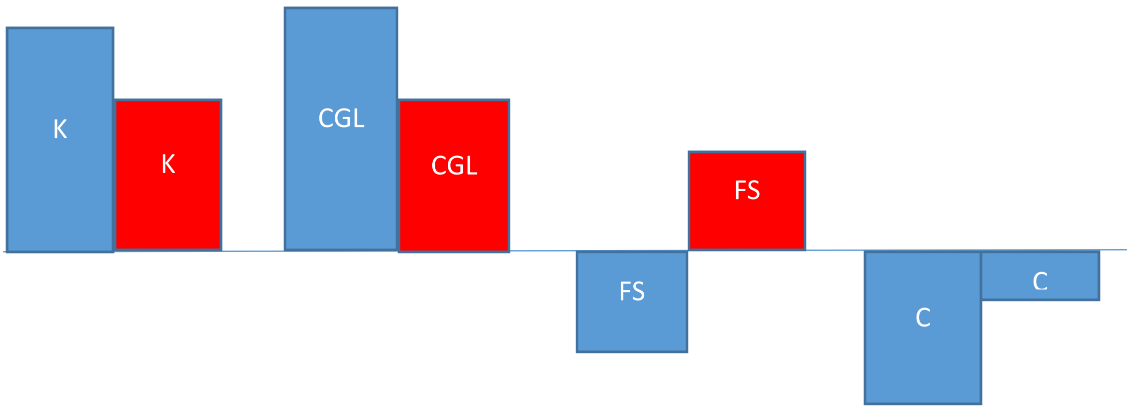
- reducing the potential need for compensation of creditors on the grounds of them being made worse off than under a conventional winding up;

- reducing the need for a government guarantee on the remaining and new liabilities of the New Zealand subsidiary, given that creditors would be more likely to have confidence in the bank's soundness if it remains in the parent group than as a new, untested stand-alone bank;

- reducing the risk of contagion to other banks, and hence the possible need for guarantees of other banks.

14. Figure 2 provides an indicative depiction of the potential impacts of a stand-alone resolution (under the OBR approach proposed by the RBNZ) compared to an OBR approach where this is done in the context of a whole-of-group resolution, where the subsidiary remains part of the parent group under a coordinated Australian – New Zealand cross-border resolution.

Figure 2 – Indicative impact of OBR on a stand-alone versus whole-of-group approach



Key:

Blue columns = OBR on a stand-alone basis (subsidiary separated from parent bank)
Red columns = OBR used to fund (or partly fund) a recapitalisation of NZ subsidiary via parent bank, keeping the group intact

K	Capital injection required (and therefore liability haircut needed)
CGL	Contingent government liability (e.g. government guarantees of liabilities net of haircut)
FS	Impact on financial stability
C	Costs of prepositioning (initial and ongoing)

15. To the extent that a whole-of-group resolution also helps to maintain investor and consumer confidence, it is likely to have less severe impacts on the economy than would a stand-alone form of resolution. Government revenues would therefore be less adversely impacted.

16. A whole-of-group resolution would also significantly lower the resolution prepositioning costs for banks and bank customers compared to the RBNZ's proposed outsourcing requirements which are based on a presumption of separation.

17. Overall, therefore, the most effective means of reducing the government's contingent liabilities associated with 'too big to fail', and to avoid imposing excessive compliance costs and efficiency taxes on banks and their customers, is to implement a whole-of-group form of bank resolution, with no presumption of splitting the New Zealand bank subsidiary from the parent bank.