

SUBMISSION

TELEPHONE 0800 327 646 | WEBSITE WWW.FEDFARM.ORG.NZ



To: Ian Woolford
Manager Financial Policy
Prudential Supervision Department
Reserve Bank of New Zealand
PO Box 2498
WELLINGTON 6140

By email: capitalreview@rbnz.govt.nz

Submission on: **Issues Paper: Review of the Capital Adequacy Framework
for Locally Incorporated Banks**

From: **Federated Farmers of New Zealand**

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NICK CLARK
MANAGER GENERAL POLICY

Federated Farmers of New Zealand
PO Box 1992, Christchurch, New Zealand

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www.fedfarm.org.nz

**SUBMISSION TO THE RESERVE BANK OF NEW ZEALAND ON THE
ISSUES PAPER FOR THE REVIEW OF THE
CAPITAL ADEQUACY FRAMEWORK FOR LOCALLY INCORPORATED BANKS**

1. INTRODUCTION

- 1.1 Federated Farmers of New Zealand welcomes the opportunity to submit to the Reserve Bank of New Zealand on the Issues Paper for the Review of the Capital Adequacy Framework for Locally Incorporated Banks.
- 1.2 Federated Farmers is not qualified to make detailed comment on bank capital requirements. At this early stage we wish to make some general comments on the importance of bank lending to the agricultural sector and the need for any changes to bank capital requirements to be subject to rigorous cost benefit analysis and for any changes to be implemented carefully.
- 1.3 Federated Farmers will consider and, if necessary, comment on specific proposals when they are consulted upon later in this review.

2. RECOMMENDATIONS

- 2.1 Federated Farmers recommends that the review should undertake rigorous cost-benefit analysis, with proposals assessed for their impact on bank lending policies and the cost of credit, and how they will affect the banks, their customers, the financial system, and the economy.
- 2.2 Federated Farmers recommends that if the review finds that changes should be made to the capital adequacy framework to make them more conservative then the changes should be carefully implemented to ease any adverse impacts on banks, their customers, the financial system, and the economy.

3. COMMENT

- 3.1 In April 2017 agricultural sector debt was \$59.2 billion. Bank mortgages are an important source of funding for investment by farmers, whether it is for buying a farm or spending to improve a farm's productivity. Because farm incomes can be very volatile, depending on seasonal factors and commodity price movements, many farmers are also reliant on bank overdrafts and seasonal financing for day-to-day operations.
- 3.2 The soundness and efficiency of the financial system is therefore important for farmers, just as it is for the wider economy. Federated Farmers therefore supports the Reserve Bank's efforts to promote the maintenance of a sound and efficient financial system.
- 3.3 The capital adequacy framework for locally incorporated banks, which is intended to reduce the risk of the failure of a registered bank and the damage this would do to the financial system and the economy, is an important pillar of a sound and efficient financial system.
- 3.4 Federated Farmers' comments relate to all three components being reviewed:

- (a) Definition of eligible capital instruments.
 - (b) Measurement of risk.
 - (c) Minimum capital ratios and buffers.
- 3.5 Federated Farmers acknowledges the need to review the capital adequacy framework, especially in the light of international developments. We note the six high-level principles for the review:
1. Capital must readily absorb losses before losses are imposed on creditors and depositors.
 2. Capital requirements should be set in relation to the risk of bank exposures.
 3. Where there are multiple methods for determining capital requirements, outcomes should not vary unduly between methods.
 4. Capital requirements of New Zealand banks should be conservative relative to those of international peers, reflecting the risks inherent in the New Zealand financial system and the Reserve Bank's regulatory approach.
 5. The capital framework should be practical to administer, minimise unnecessary complexity and compliance costs, and take into consideration relationships with foreign-owned banks' home country regulators.
 6. The capital framework should be transparent to enable effective market discipline.
- 3.6 Federated Farmers agrees with these principles, but in relation to the fourth principle we consider that while there are risks to New Zealand's financial system, our financial system is sound compared to those in many other economies, both developed and developing. Indeed, the Reserve Bank's latest Financial Stability Report found that "New Zealand's financial system remains sound and the risks facing the system have reduced in the past six months"¹.
- 3.7 Taking a conservative approach to bank capital is appropriate, especially considering New Zealand-specific circumstances². However, we would be concerned if an overly conservative approach were to cause problems for financial stability by unduly restricting bank lending and/or increasing the cost of credit.
- 3.8 The issues paper notes that New Zealand is 'middle of the pack' and that other countries have been moving to tighten their requirements, with the implication that we need to follow suit. That may be so but Federated Farmers considers it critical for the review to carefully assess the degree to how conservative the requirements need to be relative to international peers. The review also needs to carefully consider the costs and benefits of any proposals to change the requirements to make them more conservative. This includes analysis of the impacts of any changes on banks, their customers, the financial system, and the economy.

¹ Reserve Bank of NZ May 2017 Financial Stability Report, published 31 May 2017

² Paragraph 85 on page 30 of the issues paper lists these circumstances: New Zealand's current reliance on bank-intermediated funding, New Zealand's exposure to international shocks, the concentration of our banking sector, the concentration of banks' portfolios, and a regulatory approach that puts less weight on active supervision and relatively more weight on high level safety buffers such as regulatory capital.

- 3.9 If there are changes to bank capital requirements to make them more conservative, we are concerned this could impact on bank lending policies to farmers and the cost of credit faced by farmers. Depending on how any changes are implemented (i.e., immediately versus gradually) this could in turn impact adversely on farmers, on rural economies, on the stability of the financial system, and on national economic growth.
- 3.10 Therefore, if this review finds that there should be tighter capital requirements then we submit that any changes should be carefully implemented to ease any adverse impacts on banks, their customers, the financial system, and the economy. A phase-in period is likely to be appropriate.

4. ABOUT FEDERATED FARMERS

- 4.1 Federated Farmers is a member based organisation that represents farmers and other rural businesses. Federated Farmers has a long and proud history of representing the needs and interests of New Zealand's farmers.
- 4.2 The Federation aims to add value to its members' business. Our key strategic outcomes include the need for New Zealand to provide an economic and social environment within which:
- Our members may operate their business in a fair and flexible commercial environment;
 - Our members' families and their staff have access to services essential to the needs of the rural community; and
 - Our members adopt responsible management and environmental practices.