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Ian Woolford
Manager, Financial Policy
Prudential Supervision Department
Reserve Bank of New Zealand
WELLINGTON

By email: capitalreview@rbnz.govt.nz

Dear Ian

SUBMISSION ON ISSUES PAPER:

Review of the Capital Adequacy Framework for locally incorporated banks

We welcome the opportunity to submit on the Issues Paper referred to above (dated May 2017). As the Issues Paper states that detailed consultation documents on the three key components will be released later in 2017, we have limited the submission to our views on its intended scope, and suggested other areas which should be considered in the review.

We have also restricted our submission to those areas in which we believe that we have particular experience. These largely relate to market-based considerations of the numerator in bank capital ratios, such as the role of bank regulatory capital in the public capital market in the context of the Government's wider business policy agenda. In addition, we have made several broad-based observations of the role of bank regulatory capital within the national economy and financial system. Accordingly, whilst our submission is general in nature, it predominantly relates to the numerator section in Questions 1 and 2 from the Issues Paper.

As background, Forsyth Barr has been an active participant in the additional tier 1 and tier 2 public market over recent years, both in relation to syndicate roles on primary offers and secondary market trading. As such, we believe that we are well positioned to provide feedback on the subjects at hand from a markets-based viewpoint.

In summary, we submit that any decisions regarding the capital adequacy framework should also have regard to the role of regulatory capital in the wider market and economy:

- As outlined below, the present tiered approach in the numerator of capital ratios allows banks to fund themselves in a relatively efficient manner globally, and this efficiency should flow through to end borrowers.
- Domestic banks have become more reliant on offshore funding, which is acknowledged as a key risk of the New Zealand financial system. Any changes to

the definition of regulatory capital that contributes to this increasing reliance should be considered in this context.

- In addition, the current framework allows locally incorporated subsidiary banks to fund themselves in a stand alone manner from Australian parents, whilst helping to “level the playing field” between offshore owned and domestic institutions.
- Finally, the development of the regulatory capital market has played an important role in the local capital market. The Government has a *Building Capital Markets* work stream in its *Business Growth Agenda*, and the progress of the regulatory capital market has assisted in improving our public capital market.

Wider financial stability considerations

As outlined in its statement of supervisory approach, the Reserve Bank carries out its functions for the purpose of promoting the maintenance of a sound and efficient financial system.

Financial stability is an important aspect of such a system, and a stable regulatory framework is critical to financial stability. Accordingly, any changes to the regulatory framework should be considered in this context. In particular, changes which represent a material departure from either the previous framework, or which are unprecedented on a global scale are unlikely to promote the desired stability.

In addition, given our banks’ dependence on offshore funding and the NZ market’s relative size in the global market, any developments which would result in our framework being out of step with the rest of the world should also be carefully considered in light of wider bank funding ramifications.

Specifically in relation to the three sections referenced in the Issues Paper (numerator, denominator, ratio), we note that there has been precedent in relation to changing the denominator (such as some standardisation/targets relating to risk weightings) and the level of the ratio itself. However, we understand that adjustments to the numerator are less material, and are largely related to adjustments/deductions, etc. Additional Tier 1 and Tier 2 instruments have been well established in offshore jurisdictions as sources of alternative capital. Accordingly, we believe the market would regard a change to the fundamental nature of regulatory capital in the numerator as being far more significant than adjustments to the denominator and ratios themselves.

Finally, a disruption to locally sourced capital is likely to further increase the dependence of our banking system on offshore funding sources. The Reserve Bank identified bank funding pressures as being one of the three key risks to New Zealand’s financial system in its most recent Financial Stability Report. It noted that banks have become more reliant on offshore funding, and that this has exposed them to international risks that could significantly increase the cost of funding or reduce its availability.

In addition, credit rating agencies highlight the risks associated with New Zealand banks’ reliance on offshore funding markets, and note this as being a weakness of our financial system. Greater reliance on offshore funding could reduce the credit ratings of domestic banks and, in turn, increase their funding costs. Any changes to the capital market framework which could result in lower domestic/higher offshore capital funding flows would further contribute to the current negative trend.

Hence, we submit that any changes to the framework should take into account wider financial stability considerations.

Stand alone considerations for local banks

It is generally accepted that New Zealand's financial system is less diversified relative to peer countries. We have a concentration of a few large institutions, all with Australian parents. As the Reserve Bank has indicated previously (including in the Deputy Governor's speech on 7 March 2017), whilst the implicit support of the parent banks is valuable for the New Zealand system, it is also a vulnerability, and it is important that our banks be seen as strong on a stand alone basis in order to maintain their international standing.

A move to diminish or eliminate the ability for our banks to raise regulatory capital in their own right will increase the dependence on their parents, and accordingly reduce their stand along international standing.

In addition, such a change will also create an uneven playing field for those banks who do not have the benefit of international parents, as offshore owned banks will be theoretically able to fund themselves more efficiently by utilising home jurisdictions which are more consistent with the Basel III framework. Depending on the form of instrument allowed, this may also extend to tax efficiency of the funding.

Accordingly, the review should also consider the wider impact on the funding of our local banks, their competitiveness relative to offshore owned entities, and their standing in the international markets.

Importance of bank regulatory capital to the local capital market

Bank regulatory capital issues have formed an important part of the local capital market for a number of years. In the past three years, regulatory capital issues have raised nearly $3 billion from the public markets. These instruments have allowed domestic investors to gain a quasi-equity exposure to the banking sector, with the commensurate risk and return profile. This exposure has been valuable to local investors, particularly given the general shortage of listed equity opportunities in locally incorporated banks (Heartland aside).

Further, these types of instruments have provided retail investors with a broader range of quality investment products. Note that lack of such range was considered to be one of the key weaknesses by the Capital Market Development Taskforce in its study of New Zealand's capital markets.

As evidenced by the *Building Capital Markets* work stream within the Government's *Business Growth Agenda*, well functioning capital markets are considered to be essential for strong economic growth. They are vital for ensuring that New Zealand businesses can respond to opportunities and grow the economy.

In addition, regulatory capital issues have allowed locally incorporated banks to maintain a more efficient capital structure. This is likely to have flowed through to a lower cost of capital, for both lenders and borrowers alike. A bank funded solely by Common Equity Tier 1 capital will have a much less efficient balance sheet and higher cost of capital, and this is likely to adversely affect borrowers and the wider economy.

The market and its participants have also invested significantly in understanding these instruments. This process has been assisted by the consistency in structure and terms demonstrated across these deals since the GFC. In addition, the Financial Markets Authority has also been active in overseeing the market, including the production of guidance notes to further assist understanding. We believe that a significant change to these terms will negative for the local capital market, and may increase retail investor scepticism as to investing in such instruments.

If you have any questions regarding the feedback provided in this letter, please feel free to contact either myself or Shaun Roberts.

Yours sincerely
Forsyth Barr Limited

Matt Sturmer
Senior Analyst, Fixed Interest

Cc
Shaun Roberts
Brent Stephen