Submission Review of the Capital Adequacy Framework for locally incorporated banks

This short submission to highlight a few key points (prefer to be anonymous but open to engagement with the RBNZ if it wishes)

- RBNZ LVR restrictions are good for providing a level of stability in the NZ financial system (especially given that a significant portion of NZ lending is secured by residential mortgages). Therefore, a downturn in house prices from 2008-2010 where values dropped around 20% could be absorbed/managed by the banks.

- Interest only loans are not good (I do not have a figure for interest only loans but I believe it is around 20%-25% in some banks). These are loans which can be put under significant pressure when rates rise. Interest only loans fuel speculation (the borrower is relying on a capital gain which is not taxable) this also pushes up house prices artificially and distorts the market. RBNZ should consider a stronger restriction on interest only loans (existing lending would have to continue otherwise there would be a shock to the market but new lending could be curtailed or phased out)

- Additional capital cannot prevent a financial crisis (it may only marginally reduce the impact and provides a false sense of security)

- President Obama ordered a Commission of Inquiry the causes were operational risks (not credit risks not capital). The conclusion of the report was that the crisis was avoidable (see links https://fcic.law.stanford.edu/report/conclusions https://fcic.law.stanford.edu/report and brief summary at end of submission)

The 2007/2008 Global Financial Crisis was not caused by sub-prime crisis (this was only the result, and it is necessary to take a further step back, what caused sub prime? what caused mass mortgage defaults? Poor lending standards, conflicts of interest, collusion, mis-selling products, weak regulatory oversight/self regulation etc.). The cause was primarily from Operational Risks in overseas markets (e.g. weak regulatory oversight, conflict of interests between mortgage brokers and banks, weak credit risk assessment processes, fraudulent loan application, collusion between banks and rating agencies (agencies paid by banks rated toxic assets as AAA products which investors (such as pension funds bought impacting millions of retail investors), Complex Products (Derivatives) CDOs (Collateralised Debt Obligations) and Credit Default Swaps (Credit Insurance) increased the operational risks as investors took even greater risks, Mis-selling and Misrepresentation Providing loans to people who could not afford it, Selling Products which were known to be toxic or poorly constructed, Failures of corporate governance and risk management, Senior Executives receiving large bonuses even when banks incurred huge losses.

Essentially, weak regulation, poor operational risk management and poor governance were prime causes of the GFC and the capital which banks had (even if it had been at 20% or 30% would not have saved them because of the exposure to toxic assets which resulted in huge losses and effectively wiped out the capital almost overnight. In the UK banks such as RBS (once one of the largest in the world) and Lloyds had to be taken over by the government tax payers as shareholders. (Acquisitions
which also falls into operational risk was a major cause for RBS troubles as in 2007 it made a cash bid for ABN Amro without proper due diligence being conducted only to find out a few months later that ABN Amro was riddled with toxic assets which now belonged to RBS. Weak regulatory oversight and controls allowed this type of acquisition to go ahead.

**RBNZ should consider on other controls not just more capital** because this will not prevent such events from occurring. Operational Risk is an area where most extraordinary events occur which can bring down banks and even countries (such as Iceland and Greece which also caused immense and ongoing social unrest). Operational risk covers a wide gambit from internal fraud, external fraud, breaches of AML laws and sanctions, poor product design, failure to complete proper due diligence on material acquisitions, mis-selling, weak regulatory environments, third party service provider failures, cyber security, IT process failures, model risk failures, human error etc.

There is a reason why **Air New Zealand** has such **good operational risk management** (from quality control, pre-flight checks, in flight checks, post flight checks, maintenance, training, a multitude of system performance monitoring, testing, segregation of duties, aviation authority oversight, safety controls etc). The airline’s interests are very closely aligned to good operational risk management, because poor operational risk management can end in disaster. In addition, unlike the senior executives in a bank, the airline pilots are closely aligned to the interests of the passengers (“stakeholders”) because everyone wants to land safely and the pilots do not have parachutes. If the same analogy is used for banks, the senior executives (pilots) interests are not so closely aligned to the passengers (stakeholders such as shareholders, employees, third party service providers etc). Furthermore the senior executives (pilots) generally have some form of “parachute” so that in the event of an “accident” they generally are still able to walk away with large bonuses/pensions and large salary payouts whilst stakeholders such a shareholders and employees may not be so fortunate. Generally when losses are incurred due to operational events the first thing to go is head count, this directly effects the economy and slows economic growth. Globally many banks have cut 10s of thousands of jobs, RBS (15,000), HSBC (over 50,000 globally), UBS (15,000).

**Conclusions/Suggestions:**

- Closer regulatory supervision on areas of weakness (Agri and commercial and residential real estate pre and post credit management drawdowns, monitoring and effectiveness of credit rating systems).
- In addition, multiple restructures within banks increase operational risk losses and errors because banks do not manage the change properly and often replace experienced staff with inexperienced staff) Some banks have been known to have annual restructures in departments which actually impacts efficiencies negatively, the restructure just been completed when the next restructure commences.
- The RBNZ should be asking banks to confirm how many restructures they have within the bank’s departments, the more restructures the increased change within the organisation and often the increased risk to the organisation (e.g. human errors/key in errors, process errors, product errors, inadvertent mis-selling/misrepresentation due to poorly trained or inexperienced staff).
- RBNZ review Director and Senior Executive suitability but at the level below this there is no visibility especially when shoulder tapping occurs appointing a person based on their network connections rather than their experience and good leadership. RBNZ may want to consider more visibility of the roles immediately under the execs because execs tend to rely strongly on their direct reports.
- Banks who are able to demonstrate on going Operational Risk Management (which includes recording of all operational risk losses including credit related operational risks (CROPs) such...
as inability to enforce security/documentary failure, near misses and actions taken to strengthen areas of detected weakness) should receive some form of incentive to reward good behaviour and allow large banks who manage operational risk effectively to be competitive in the market. Conversely banks who fail to demonstrate that they have systems in place (including records of events and near misses) should have additional restrictions placed on their business operations

- Strict oversight controls on derivatives
- Prohibition on creation or investment in exotic products
- Keep/evolve LVR restrictions to ensure that banks portfolios have some buffers
- Stop using IRB Modelling of credit (agree with RBNZ that this is not consistent between banks, is complex, difficult for others to understand and prone to errors. By the way model risk error is an operational risk, so is complexity of models). IRB drives the wrong behaviour there is a huge focus on banks to increase IRB efficiencies (minimise capital required to be held) with very little focus on the operational risks within their bank.
- RBNZ could look at Air New Zealand and see how they manage operational risk
- Bank’s should be encouraged to look at other industries which manage operational risk (this could be Air New Zealand, Fonterra, Petrochemical companies). This can increase understanding of operational risks in an operating environment and the types of controls which are put in place to mitigate the risks.
- Executive Pay, this is always a political football and the argument from banks is that if you do not pay the market rate then you cannot attract top talent. This can be true, however as in the GFC and since then there have been cases of huge executive pay despite poor management and huge losses. Many banks have a deferral system on exec pay which is good and probably does not need to be changed but claw backs should be given more consideration. e.g., the Execs can receive pay, bonuses, share options etc but if within a certain period after they have left the role/organisation and material operational issues are identified (e.g. widespread internal fraud, weak controls/oversight resulting in external fraud, serious failures in compliance with laws/deliberate circumvention of conditions of licence/AML/Sanctions) there should be the regulatory power to claw back a significant portion of an execs past remuneration if the material issues occurred under their watch. This is not about the bank incurring losses due to normal business operations or external events (e.g. downturn in economy), this is about where the regulators have investigated or uncovered material issues where there is deliberate or materially incompetent mis-management which has resulted in a material loss and/or threat to the New Zealand Financial system. Such a claw back provision will make senior executives think twice about cutting corners or closing their eyes to questionable sales practices by their business unit, or failing to manage material change within their business without effective due diligence being conducted). The Claw-back would remove the “parachute” and ensure that executives (whilst still entitled to their remuneration and benefits) have their interests aligned to their passengers (stakeholders shareholders, employees and New Zealand’s financial stabilities). Simply put people only care when there is something that can negatively impact their own money, this is human nature. The Claw back would increase the probability of good professional behaviour which will strengthen a bank and reduce the risk of poor management and weak governance. The argument that banks would not be able to attract good talent with a claw back provision would not hold true as there is effectively no new restriction on executive remuneration where they perform their duties responsibly, there will be no impact. It is only where incompetence or serious material mismanagement is identified that they would be impacted and this would be justifiable. Of course former execs would need an appeal process to ensure that they are treated fairly and impartially, but the fact that they know there is a claw back provision would help them to remain focussed when making decisions and running their banks effectively with good oversight and governance.
• Additional capital is not the answer, it leads to a false sense of security and when an extraordinary event occurs it is wiped out. Banks need to be proactively managing their operational risks (not reactively) and be able to demonstrate this to the Regulator. The Regulator will soon see which banks are managing operational risk well and which are managing it poorly by a simple comparison of peer groups (similar to what the regulator does for credit risk, market risk, regulatory disclosure, AML Compliance etc).
• OBR and Outsourcing Policy and proposed BCM policy by RBNZ are to be commended

Kind regards,
Additional Information:

Commission of Inquiry into the Causes of the Global Financial Crisis

We conclude this financial crisis was avoidable. The crisis was the result of human action and inaction.

The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks.

What else could one expect on a highway where there were neither speed limits nor neatly painted lines?

Commission of Inquiry into the Causes of the GFC Conclusions:

Regulatory Failure: Federal Reserve’s pivotal failure.
• Regulator was the only one who could take action but it did not
• Self Regulation

Collusion and Conflicts of Interest between:
• Rating Agencies and banks, Mortgage brokers – high commission based

Fraud:
• Fraudulent Credit Applications, fraudulent product valuation

Complex Products:
• CDOs (Collateralised Debt Obligations)
• Credit Default Swaps (Insurance) – increased the operational risks

Mis-selling and Misrepresentation:
• Providing loans to people who could not afford it
• Selling Products which were known to be toxic

Failures of corporate governance and risk management