

19 October 2017

## **Review of capital requirements for New Zealand incorporated banks: summary of submissions on first (overview) consultation paper**

The first consultation paper of the capital review was released on 1 May 2017. The paper was a broad overview of the issues encompassed by the review. Readers of the paper were asked to say whether the list of topics to be considered by the review was complete, and whether the Reserve Bank had identified the main issues to be addressed for each topic.

Despite the relatively narrow scope of our request for submissions, quite detailed submissions were made on a very broad range of issues. Most submissions anticipated the issues that were canvassed in more detail in the second (numerator) consultation paper or are yet to be discussed fully in the forthcoming denominator and capital ratio consultation papers.

We received twenty submissions on the paper:

- Eight from banks
- Two explicitly on behalf of banks (NZBA and Chapman Tripp)
- One from a law firm (Chapman Tripp)
- One from a non-banking lobby group (Federated Farmers)
- One from investment fund managers that have an interest in Kiwibank and also invest in bank capital instruments (ACC and NZSF)
- One from an investment firm that has been involved in the issuance of bank capital (Forsyth Barr)
- One from an academic specialising in banking (Martien Lubberink, Victoria University)
- Five from other individuals

We also received a brief letter from another bank indicating it did not wish to make a submission.

Four submitters (BNZ, Kiwibank, Westpac, and one member of the public) indicated that their submissions were confidential. A short summary of the issues raised in submissions follows, grouped by category.

This paper summarises the submissions. Interested readers can access the published submissions for a more detailed understanding of the submitters' point of view. As the overview paper laid out the topics the Reserve Bank intends to cover in the review, rather than being a consultation of the actual issues, this summary of submissions paper notes the points raised in submissions, rather than responds to the points. We will respond to submitters points as a part of the detailed consultations.

## Overall conduct of the review

### *Principles of the review*

One submitter asked that the principles of the review be more clearly articulated and ranked by priority, noting that there are trade-offs between them.

Two submitters asked that competitive neutrality be added as a guiding principle for the review, and implied that the current framework gives larger banks a competitive advantage.

One submitter also suggested that the principle focussing on relative conservatism has disadvantages, because cross-country comparisons are difficult and it is not desirable to have New Zealand requirements driven by overseas changes which may not reflect New Zealand circumstances.

### *Engagement process*

Two banks and the NZBA have requested that the Reserve Bank engage regularly with banks throughout the review, to promote mutual understanding and a smooth transition to any revised regulatory regime.

Three small-bank submitters have requested that the Reserve Bank engage separately with mutually- or trust-owned banks to find out how regulatory changes would affect them, because of their unique circumstances.

### *Timing of the review*

The largest bank submitters and the NZBA argued for the timetable for the review to be spelled out, and extended to allow more time to see how capital requirements change in Australia and in other Basel-following countries. They argue that misalignment of standards between New Zealand and other countries, should New Zealand move first and not anticipate final decisions elsewhere, will create uncertainty among bank investors and could push up funding costs.

Also arguing for more time, one bank noted that the capital review comes on top of a number of other significant regulatory changes and exercises being undertaken by the Reserve Bank and other agencies. ANZ and the NZBA argued for work on benchmarking of IRB models to be postponed until the review is complete.

One submitter argued that any major changes to capital requirements should be postponed until after March 2018, when a new permanent Governor will have had time to consider them properly.

### *Prioritisation of issues*

Several banks, the NZBA, and fund managers said that the treatment of supplementary capital instruments ("AT1" and "Tier 2" instruments) should be decided as a priority, to resolve uncertainty that is making it difficult for banks to do capital planning and unnerving investors. At the same time, three banks (including two who want capital instruments prioritised) have argued that decisions about capital should be made by carefully considering the numerator, denominator, and overall ratio *together*.

One bank (Rabobank) asked for the Reserve Bank to prioritise an assessment of the gap between standardised and IRB capital requirement outcomes.

### *Continuation of existing processes during the review*

Two banks submitted that while the review is in progress the Reserve Bank should continue to allow banks to issue AT1 and Tier 2 instruments under current rules. One suggested that any non-objection should remain valid for three months.

One bank (ANZ) said that the Reserve Bank should make it clear how it will approve applications to alter IRB models while the review is in progress (there is currently a moratorium on processing applications).

### *Requirement for careful analysis*

Several submitters said that proposals to make capital settings more conservative should be carefully analysed, with more empirical evidence sought and a careful cost-benefit analysis, to avoid the risk of adverse effects on financial stability and the economy. One submitter suggested that a Quantitative Impact Study (QIS) like those carried out by the Basel Committee would help to understand the economic effects of changes to regulation.

### *Alignment with international standards*

The major banks and two other submitters argued for alignment of New Zealand and international capital standards. They suggest this would make it easier for international investors and other stakeholders to gauge the relative financial strength of New Zealand banks, and would reduce compliance costs and complexity for banks that are part of international groups. It would also make it easier for foreign investors to understand and accept the capital instruments issued by New Zealand banks.

### *Transition arrangements*

Submitters also argued for a transitional (“phase in”) period for any changes. Martien Lubberink noted that banks tend to respond positively to changes which are phased on slowly and in practice strong banks seek to be fully compliant earlier than required.

### **Scope (Issues not considered sufficiently by the review)**

One submitter argued that the review should consider the government’s and the Reserve Bank’s roles. The submitter suggested that banks do not bear sole responsibility for mitigating risks to the financial system and an excessive reliance on capital requirements could be seen as privatising wider societal risks. The submitter also suggested that well-resourced regulators contribute to financial stability.

The NZBA and Martien Lubberink argued that the issues paper does not have enough discussion of stress testing and its role in determining capital adequacy. The NZBA argued more broadly that the Reserve Bank should take other regulatory tools, such as the counter-cyclical buffer, into account.

Several submitters argued that there should be more discussion of the interaction between the OBR and capital requirements, and that cost-benefit calculations will need to take the operation of the OBR into account. One submitter (Murray Jackson) argued that the existence of the OBR should not be used as an argument for lower capital requirements, since both policies would impose costs on depositors.

One submitter (Murray Jackson) argued that the issues paper does not pay enough attention to the negative effects of credit booms on productivity and economic growth.

## Numerator (definition of capital)

### *For or against supplementary capital instruments*

One submitter (Kevin Nicholl) argued that there should be a greater reliance on common equity (“CET1”) capital, because other forms of regulatory capital are merely another form of borrowing. The submitter anticipates that banks will argue it is difficult to raise CET1 in a crisis and states that the answer is to have more of it before a crisis.

The banks, a law firm, an investment bank, and one other submitter all strongly supported the continued recognition of convertible or write-off only financial instruments as regulatory capital.

This was argued on several grounds:

- These supplementary capital instruments reduce banks’ cost of capital, which promotes higher capital ratios and also leads to more investment (because it is suggested that lower costs are passed on to bank customers).
- These instruments promote the development of capital markets (e.g. by giving local investors the opportunity to get an equity-like exposure to locally incorporated banks).
- These instruments are not complex, or to the extent they are complex they are nevertheless well understood and their loss-absorbing effect in a crisis is supported by legal and tax opinions (two submissions gave detailed descriptions of the tax treatment).

Forsyth Barr also argued that the current supplementary instruments should continue to be recognised. This allows locally incorporated banks to raise capital independently of overseas parents or, if they have no overseas parent, allows for capital to be raised on a level playing field. Limitations on the use of such instruments would increase reliance on foreign funding, which would not improve financial stability. Forsyth Barr also argued that changes to policy in this area would increase investor uncertainty, which would work against stability.

Submitters argued that the Government would not be likely to bail out holders of supplementary capital instruments, because the contracts give the Reserve Bank the power to trigger conversion or write-off (though one non-bank submitter suggested that the triggers for conversion could be changed to be more objective and mechanical). Responding to the negative example of Monte dei Paschi bank in Italy, several submitters noted that in the more recent takeover of Banco Popular in Spain convertible instruments had worked as intended and losses were borne by investors rather than the State.

### *Tax treatment of supplementary capital instruments*

Some banks and the NZBA submitted that any tax haircut on supplementary capital instruments should depend on the tax liability that is likely to actually arise. They argued that there are tax rulings to support no haircut when instruments convert. It is highly unlikely that instruments will not convert, and if they do not convert then on write-off there will either be no tax (if within a wholly owned group) or there will be tax losses to offset any tax liability.

### *Banks with non-standard ownership structures*

The NZBA and small-bank submitters noted that issuing certain capital instruments (notably ordinary shares) can be more difficult for institutions with cooperative or trust ownership structures, and that for such institutions it is vital that there are other options available. The

small-bank submitters requested that the Reserve Bank consider alternative instruments designed for cooperatives and mutuals, such as instruments recognised in Canada.

#### *Transitional arrangements*

Some banks and a law firm submitted that any changes to the recognition of supplementary capital instruments should apply only to new instruments and not those already issued.

#### *Process for approval of capital instruments*

Two banks and fund managers called for a review of the non-objection process for capital instruments, suggesting that the purpose of the process be more clearly articulated, that the process be better resourced, and that there be mechanisms to deal with disputes. One submitter (Martien Lubberink) suggested that there should be a prescribed procedure for disqualifying a capital instrument that had earlier been recognised, and also suggested that it could be helpful to have an approval regime for recognition of CET1 instruments, to avoid any later misunderstandings (approval is currently only required for AT1 and Tier 2 instruments).

#### *Other issues relating to supplementary capital instruments*

Some submitters took issue with the position that write-off instruments do not create the same positive incentives as convertible instruments, or the suggestion that tax could arise on conversion or write-off of instruments in some circumstances.

#### *Issues relating to other components of capital*

One submitter (Martien Lubberink) provided comments about components of the numerator other than capital instruments. The regulatory measure of capital adjusts accounting (book) measures of equity. The submitter has done research which indicates that the market value of banks does not seem to be more closely related to the adjusted (regulatory) capital measure than the book value. This might suggest that the adjustments are not very meaningful. The submitter also notes that one of the adjustments gives banks an incentive to buy back debt in certain circumstances; this can increase CET1 capital but have negative effects on liquidity or total capital.

### **Denominator (calculation of risk-weighted assets)**

#### *Arguments for or against standardisation of risk measurement*

Three large banks made submissions in favour of retaining the Internal Ratings Based approach for calculating risk-weighted assets. This was argued to provide the most risk-sensitive estimates of capital and to be able to respond best to changes in market environments and risk practices. They also argued that it allows for easier comparisons of capital adequacy across banks in different countries.

These submitters argued that internal controls on modelling are robust and that it is unclear why the Reserve Bank considers the IRB approach is complex or makes comparisons between banks difficult.

With reference to recent Basel Committee proposals for standardisation of some portfolios or regulatory parameters, one bank has suggested that the Committee will accept industry arguments and allow the use of the Foundation IRB approach rather than pure standardisation for exposures to large corporates. More broadly, the submitter has

encouraged the Reserve Bank to reconsider its earlier decision to remove the Foundation IRB approach from BS2B.

One bank argued that where the Reserve Bank has had concerns about capital outcomes under the IRB approach it has been able to deal with these with specific interventions, such as prescribed model parameters.

Three small banks argued that risk weights should be standardised for all banks. This would put all banks on a level playing field, holding the same amount of capital for the same underlying risks. Another bank supported standardisation too, arguing that for the significant portfolios in New Zealand all banks face essentially similar risks. One other submitter supported the call for standardisation, stating that modelling is inconsistent across banks, hard to understand, and prone to errors. A growing body of research calls the accuracy of modelling into question, and it drives a negative focus on reducing regulatory capital requirements.

Another submitter (Murray Jackson) argued that it was not sensible to use risk-weighted measures of assets at all, citing comments by former Vice-Chairman of the FDIC Thomas Hoenig. If the Reserve Bank was to allow risk-weighting, he said it should be highly constrained and monitored with adequate floors.

Two large banks submitted that the Reserve Bank should retain an internal models approach to determine operational risk capital requirements. This provides the best incentives to improve processes and systems for managing operational risk (one of the banks and a non-bank submitter both argued that there should be such incentives). If it is not possible to have an internal models approach, then the standardised approach proposed by the Basel Committee would be the best option.

One submitter (ANZ) argued that the Reserve Bank should review the standards for market risk capital requirements, and should allow an internal models approach (currently only a standardised approach is permitted).

#### *Comparing standardised and internally modelled requirements*

One bank noted that care is required when comparing the capital requirements of IRB and standardised banks, and that not only differences in the capital standards but also differences in the underlying quality and diversification of portfolios should be taken into account. It also argued that the Reserve Bank should take into account the costs IRB banks have incurred to gain and keep IRB accreditations, and the need for incentives to help banks improve their risk management practices.

#### *Level of risk weights*

Three large banks submitted that risk weights should not overstate risk. ASB noted that regulatory risk estimates are already higher than banks' internal estimates of risk and that further increases could provide a misleading indication to external parties. Two banks commented that any floor on risk weights should be at an aggregate level (e.g. applying to *total* risk-weighted assets) and set at a level consistent with international norms.

One submitter (Murray Jackson) argued that risk weights for residential mortgages should be increased substantially, up to 400% for exposures with an LVR of more than 60%.

## Capital ratio

### *Conservatism of overall requirements*

One of the principles of the review is that New Zealand's capital requirements should be seen as relatively conservative.

The banks, investment funds, and Federated Farmers all argued that New Zealand's capital requirements are already conservative by international standards. Submitters point to the changes New Zealand has made to its capital standards to increase risk weights for residential mortgage and farm lending. They also note that New Zealand banks have simple business models and generally do not operate globally, with the implication that this reduces risk. They suggest that the Reserve Bank should take into account the other tools it uses to ensure financial stability, as well as the Reserve Bank's own assessment that the financial system is sound and that the risks facing the system have recently decreased.

In the context of "relative conservatism" some submitters noted the difficulties of comparing capital requirements across countries and recommended further research to enable a more informative comparison.

Two banks and one other submitter (Michael Reddell) argued that stress testing indicates New Zealand banks are adequately capitalised to cope with plausible stress events.

One submitter (Michael Reddell) argued that New Zealand's circumstances – e.g. our small, open economy status and a concentrated banking sector – do not necessarily justify higher capital ratios. He argues that we might not be much different from other small advanced countries, or even Australia and Canada. The submitter also argued that it is difficult to see the benefits of increasing capital in the New Zealand context, where historical bank failures have been rare, stress testing has not demonstrated that capital is insufficient, and the largest banks have overseas parents with the ability to provide capital support in a crisis.

### *Big equity*

Three submitters said that there was too much weight given to "big equity" arguments in the Issues Paper, and said that the Reserve Bank should do further analysis which takes into account the counter-arguments made in other literature.

### *Cost of capital*

Four submitters (two banks, fund managers, and Michael Reddell) said that capital is costly for banks and it is not automatic that the benefits of higher capital will outweigh the costs. The profitability of banks will be reduced if capital requirements are increased, unless higher costs are passed on to customers, which would have broader economic consequences. One submitter noted that higher capital requirements could also increase unregulated shadow-banking activity, which could increase risk.

### *Arguments for higher capital requirements*

One submitter (Positive Money) said that current capital ratios were inadequate and would not provide an adequate capital buffer in a major crisis. They favoured more fundamental changes to the capital framework.

Another submitter (Murray Jackson) said that higher capital requirements or a substantial Total Loss-Absorbing Capacity (TLAC) requirement would improve financial intermediation

by making a greater share of bank funding subject to market-determined pricing. He argued that depositors do not, and cannot, achieve an appropriate return for the risk they are taking on. In contrast, one bank encouraged the Reserve Bank to move slowly when considering a TLAC regime, carefully considering the practicality of the regime in the New Zealand environment.

### *Optimal capital ratio*

Two submitters commented on the “optimal capital” ratio. The issues paper suggested that a capital ratio of around 14%, within an uncertain range of 5-17%, seemed to balance costs and benefits. This was based on international studies and some Reserve Bank work from the time Basel III was introduced. Martien Lubberink and Murray Jackson noted recent work by the US Federal Reserve Board which suggests an optimal ratio of 13-26% in the US context, and recommendations for even higher ratios by some commentators.

### *Add-ons and other alternatives to the minimum capital ratio*

One submitter (Murray Jackson) argued that the Reserve Bank should use the existing counter-cyclical buffer – currently set to zero – in an automatic manner, increasing the buffer whenever private sector credit growth exceeds household income growth.

ANZ was opposed to any capital add-ons – e.g. an add-on for domestic systemically important banks (D-SIB) – because add-ons are inconsistent with optimal model design, and give rise to moral hazard.

One bank argued that a D-SIB add-on would be a double impost if the Reserve Bank also increased risk weights generally as part of the review, and this would reduce transparency (we presume this means that external parties would be misled about the true extent of underlying risk).

Several banks argued against an add-on for concentration risk and pointed out that concentration risk is already taken into account by banks in stress-testing and ICAAP processes.

One bank argued that a leverage ratio, if one is introduced, should be used as a backstop and should rarely be a binding constraint.

Heartland Bank submitted that a “solo” capital ratio requirement – i.e. a separate capital requirement for the registered bank and some very closely integrated related parties, as well as a capital requirement for the wider banking group – would affect some banks more than others, and this should be taken into account in any calibration.

### **Issues outside the scope of the review**

Some individual submitters indicated that capital requirements were not the solution to concerns about financial stability, and that the Reserve Bank should instead focus on policy changes in other areas, such as direct supervision, regulation of executive remuneration, fundamentally changing the nature of banking activities (e.g. introducing a “sovereign money” policy), developing wider measures of bank riskiness, or consumer protection.

We make no judgement on the merit of these submissions, but note that they are beyond the scope of the capital review.