

Capital Review 2019 – Qs & As

The Reserve Bank is increasing the capital requirements for NZ's banks. The aim is to improve the lives of all New Zealanders by making banks safer.

Q *Why have you made these changes?*

- Safe and efficient banks are important for New Zealand families, our communities and our businesses.
- We want to protect New Zealand from the significant harm that accompanies a banking crisis.
- We also want to maintain investor confidence in New Zealand's banking system.

Q *Why is capital so important?*

- Capital requirements are the most important component of our overall regulatory arrangements. In the absence of stronger capital requirements, other rules and monitoring of bank's activities would need to be much tougher.
- More and better-quality capital reduces the likelihood of a bank failure and makes our banks stronger.
- Capital in a bank demonstrates a commitment by the banks' owners and investors.

Q *Why is this important to the public?*

- Coming out of the Global Financial Crisis, we are learning that the costs of bank failures – both economic and well-being costs – are higher than previously understood.
- The changes are designed to make banks safer and better able to handle periods of financial stress by holding enough capital to reduce the probability of a banking crisis in New Zealand to a 1-in-200-year event.

Q *Who have you consulted?*

- We have run a detailed 2.5-year public consultation which has involved a submissions process plus in-person engagement with the public and industry groups. All feedback has been taken on board.
- We have sought the views of varied stakeholders through a range of ways, including focus groups with members of the public to understand the public's risk appetite, reports by international agencies (IMF, OECD), and engaged three external experts for an independent review of our proposals.
- All these inputs helped us to make robust and well-calibrated policies and decisions that best represent society's interests.

Q *What are the main changes?*

- The changes include requiring bank shareholders to increase their stake so that they absorb a greater share of losses, improving the quality of capital, and ensuring banks more accurately measure their risk.
- We are significantly increasing the capital buffer we require banks to have. The amount of high-quality capital in the banking system will increase by around 50 percent. In practice, actual changes to the amount they have will vary for each bank. The increase will depend on their current levels of capital, how much extra they choose to have above the required minimum, and whether they are large or small banks.

Q *How much might banks increase their lending rates by?*

- The impact of the changes was a key focus of many submissions, and of the external experts, and we undertook a detailed review of all of the information received. We think the changes could lead to around a 20 basis point (0.2%) increase in the average lending rates banks charge, once the changes are fully implemented.
- As an example, \$5 would be the fortnightly increase in a \$100,000 mortgage over 30 years at the current 3.45% 2-year rate, based on a 20 basis point increase.
- Banks make profits from lending. The competitive market will continue and if one bank pulls back in a particular segment of lending, we expect another will step up.
- 26 banks operate in New Zealand, with 14 in the retail market.

Q *How will banks raise this additional capital?*

- They have a number of options to raise the capital they need. They could retain more profits over several years (rather than paying out dividends to their owners) or they could raise more capital from shareholders. They can also raise capital through the new capital instruments allowed under the reforms.
- The four large New Zealand banks' average return on shareholders' equity is among the highest in the world.
- Given banks' historical performance, we expect banks to be able to meet the requirements within the transition period.

Q *What is the average total capital percentage held by banks now?*

- The average total capital ratios of banks is currently 14.1 percent.

Q *What are the current capital level requirements?*

All New Zealand banks must have:

- 7% owner equity
- 8.5% Tier 1 capital
- 10.5% Total capital

Q *What have you increased capital levels to?*

New Zealand's four large banks must have:

- 13.5% owner equity
- 16% Tier 1 capital
- 18% Total capital

All other New Zealand banks must have:

- 11.5% owner equity
- 14% Tier 1 capital
- 16% Total capital

Q *What are the capital tiers?*

- The highest quality capital is owner equity. This can be relied on to protect banks from failing. The next tier is equity provided by investors who don't have votes and in exchange have more certainty about the income they get from their shares. These investors hold 'preference shares'. Both of these types of capital add together to make "Tier 1" capital. Our changes will significantly increase the amount of Tier 1 capital.
- The lowest tier of capital is 'Tier 2'. This doesn't protect a bank from failure but it helps make sure depositors get their money back if a bank does fail.
- The Reserve Bank is increasing the amount owners contribute from \$8 for every \$100 of lending to \$12.

Q *Will the introduction of Deposit Insurance negate the need for banks to hold more capital?*

- Capital is the fence at the 'top of the cliff' – it reduces probability of failure. It will prevent deposit insurance being used in the first place.
- Deposit insurance is the 'ambulance at the bottom of the cliff' – it enables a more orderly process of closing the bank (giving depositors access to liquidity with certainty) once a bank has failed.
- For these reasons, capital and DI are not substitutes. They are complements at best (more capital means the size of any DI payout for a failed bank is smaller), and having DI does not imply less capital is needed.

Q *Have you done a cost-benefit analysis?*

- The Reserve Bank has completed a comprehensive analysis of the impacts of the changes on New Zealanders, to assess the economic and social costs and benefits of the changes. The benefits – that arise from an increase in financial stability – are estimated to exceed the costs, which arise from a small estimated increase in interest rates.
- In addition, the Reserve Bank considers that the unquantified benefits (including from the impacts of a more stable economic environment on the well-being of New Zealanders) are likely to exceed the unquantified costs (such as less access to credit for riskier customers).
- The inputs to the cost-benefit analysis were reviewed by three independent international experts. In addition, Dr John Yeabsley, Senior Fellow at the New Zealand Institute of Economic Research, acted as an external source to test ideas and concepts in the final stages of developing the cost-benefit material.

Q *When will these changes be implemented?*

- Implementation of the new rules will start from July 2020. There will be a transition period of seven years before banks are required to fully comply with any the rules.
- With seven years to transition to the new requirements, banks will be able to maintain their lending growth, reach higher capital ratios, and continue to pay dividends.
- The impacts across individual banks may vary, as some already hold high levels of capital and others have high returns from their profits. Where some banks may choose to limit their lending growth, it is likely that others will be able to grow their lending to fill any gap in the market.