Safer Banks for Greater Wellbeing

Geoff Bascand
Deputy Governor and General Manager Financial Stability
Reserve Bank of New Zealand

Institute for Governance and Policy Studies, Victoria University

26 February 2019
Contents

• Why the safety of banks matters?
• What is bank capital and why does it matter?
• What are we proposing?
• How do we achieve both soundness and efficiency?
• What are the expected impacts?
• How do our proposals compare internationally?
• What happens now?
Capital Review

• Started in March 2017

• Three consultation papers issued already
  ▪ Overall issues and framing of capital review
  ▪ Nature and quality of capital
  ▪ Measurement of assets and risk weighting

• Fourth – and current consultation - released on 14 December 2018 proposes a material increase to minimum capital requirements
NZ’s financial system

Size of financial sectors in NZ

- Banking system assets
- Bond market capitalisation
- Stock exchange capitalisation
- Insurance sector assets
- Assets of managed funds
- Non-bank sector assets
Why bank safety matters

• If a bank fails, then all of society suffers – not just the bank’s customers.

• Bank crises carry large social costs
  On average:
  o -23% of GDP, as deviation from trend
  o Public debt +12% of GDP
  o Higher unemployment
  o Negative impacts on health and quality of life

• Our tolerance of bank crises has reduced given evidence of enduring, wide-ranging crisis impacts.
Bank Capital – What is it?

- Banks get their money from two sources:
  1. owners (shareholders)
  2. borrowing (creditors, including depositors)
- Money provided by owners (equity injected or retained from earnings) = bank’s capital
- If a bank loses money, it is absorbed by its capital, and capital goes down
- Capital and debt are mixed together and lent to customers
- Banks, in NZ and elsewhere, generally have very little capital relative to debt compared to other businesses
Shareholder Equity to Asset Ratios

Source: Registered banks’ Disclosure Statements, Statistics New Zealand, company reports
Why does capital matter?

- More capital reduces the likelihood of a bank failure
- The more capital a bank has, the more money it can lose before it fails
- Protect depositors and potentially taxpayers from failing banks
- Maintain investor confidence in New Zealand’s banking system
- Higher capital means bank shareholders have more to lose from bank failure, and should constrain the bank’s risk taking
Minimum Capital Requirements

- The Reserve Bank, like other banking regulators, sets minimum capital requirements
- Current minimum requirement is 10.5% for total capital (8.5% of which is ‘high quality’ capital)
- Current Reserve Bank minimums are consistent with international minimums set by the Basel Committee
- NZ banks currently have around 12% of ‘high quality’ capital
Our proposals ...

- Minimum total capital requirement would be increased from 10.5% to 18% (for large banks) and 17% (for small banks)

- Minimum ‘high quality’ capital requirement would be increased from 8.5% to 16% (for large banks) and 15% (for small banks)

- Other more technical changes that would increase capital for large banks (for example, a capital ‘floor’)

- Five year transition period

- Total minimum capital requirement would be comparable internationally, but minimum requirement for ‘high quality’ capital would put us near the top of international peers
Clarity on regulator-regulated relationship

- More efficient model approval process
- Escalated Supervisory Response (ESR) – greater clarity about supervisory actions with a graduated buffer approach

<table>
<thead>
<tr>
<th>16% Tier 1 capital ratio of a bank</th>
<th>Potential supervisory actions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital below RBNZ buffer requirements</td>
<td>Subject to increased monitoring</td>
</tr>
<tr>
<td></td>
<td>Capital plan must be submitted</td>
</tr>
<tr>
<td></td>
<td>Approval may be required for new business lines</td>
</tr>
<tr>
<td></td>
<td>A bank’s activities may be restricted</td>
</tr>
<tr>
<td>6% Prudential response is increasingly restrictive on the bank</td>
<td>Additional capital must be raised</td>
</tr>
</tbody>
</table>

Bank likely to be in resolution
New Tier 1 Capital Needed

Source: RBNZ Balance Sheet Survey, RBNZ estimates
What will banks do?

• Banks will keep making their own commercial decisions about how they respond in terms of their funding, lending, pricing and margins

• They have a number of options to raise the capital they need

• They may also:
  • increase their margins between lending rates and deposit rates
  • accept lower return on equity, since their investors carry less risk
  • receive lower debt funding costs since they are lower risk
  • re-price and in some cases even reduce some unprofitable lending

• Competition amongst the banks and from other sectors will influence the outcomes
A more level playing field

- Current Tier 1 capital per $100 of mortgage lending, Tier 1 capital at proposed minimum ratios (estimate using publicly available data)
Higher soundness and expected output

- **Expected economic output (GDP)**
  - Stability and output combination implied by current minimum requirements
  - The expected-output maximising capital ratio (but the level of stability may still be too low)
  - Trading lower expected output for more stability (though expected output still higher than current settings)

- **Financial stability**
  - Less stable
  - More stable
Costs assessment

• Estimated impact of policy on lending margins 20 bps to 40 bps

• Net benefit of policy proposal =

\[ \text{Expected Costs of Crisis} \times \text{Reduction in probability of crisis} - \text{Lower steady state output due to higher lending margins} \]

• Overseas research suggests the present value (PV) impact of this change in lending rates on long run GDP is expected to be < -0.3% of GDP

• Final cost-benefit analysis will be included in a Regulatory Impact Statement (RIS)
### International comparison – Basel Committee

| Fully phased-in CET1, Tier 1 and total capital ratios under the final Basel III standards |
|---|---|---|---|---|---|---|---|---|---|
| In per cent | Group 1 banks | Of which: G-SIBs | Group 2 banks | CET1 | Tier 1 | Total | CET1 | Tier 1 | Total | CET1 | Tier 1 | Total |
| Max | 54.0 | 56.8 | 58.3 | 15.6 | 18.6 | 20.1 | 70.9 | 70.9 | 70.9 |
| 95th percentile | 21.8 | 22.4 | 24.0 | 15.4 | 17.8 | 19.9 | 27.1 | 30.1 | 33.1 |
| 75th percentile | 13.9 | 15.1 | 17.2 | 13.4 | 15.6 | 17.8 | 15.9 | 16.5 | 19.7 |
| Median | 12.3 | 13.4 | 15.1 | 12.0 | 13.6 | 15.5 | 13.4 | 13.6 | 15.4 |
| 25th percentile | 10.8 | 11.7 | 13.3 | 10.2 | 11.4 | 12.7 | 11.0 | 11.1 | 12.3 |
| 5th percentile | 8.7 | 9.8 | 11.0 | 8.3 | 9.6 | 10.9 | 9.4 | 9.4 | 11.0 |
| Min | 7.1 | 7.2 | 10.0 | 8.1 | 8.9 | 10.6 | 3.9 | 4.0 | 4.0 |
| Weighted average | 12.2 | 13.3 | 15.2 | 12.0 | 13.3 | 15.1 | 12.6 | 13.1 | 15.1 |

*Source: Basel Committee on Banking Supervision.*
International comparisons – S&P
Conclusion

The benefits…
• Safer banks and more resilient banking system
• Greater protection from banking crisis and recessions
• Greater wellbeing for New Zealanders

The costs…
• Lower investment returns for bank shareholders
• Modestly higher lending rates from banks are possible

Next steps…
• Submissions open until 3 May 2019
• Decisions expected in 3rd Quarter 2019
Questions?
Our proposals

- Total capital ratio of 18/17 percent of RWA
- Tier 1 capital of 16/15 percent of RWA
- Recalibrate internal models to around 90 percent of standardised
  - Enhanced role for capital buffers (including countercyclical, DSIB)
  - Leverage ratio – disclosure and minimum (4/3 percent of exposures)
  - 5 year transitional period
Four lenses on capital adequacy

Risk Appetite Framework:

- Soundness objective
  - Capital sufficient to retain the confidence of creditors when subject to an extreme (notional 1 in X) shock

- Efficiency objective
  - Subject to meeting soundness objective, does the capital requirement maximise expected economic output?