

10 January 2019

OIA s9(2)(a)

Via email:

Dear | OIA s9(2)(a)

Happy New Year and all the best for 2019.

Thanks for remaining interested and informed on Reserve Bank of New Zealand issues. In response to the article 7 January 2019 "Do our banks need as much gold-plating as the Reserve Bank thinks?" I would like to clarify some issues for you.

We emphasise in our public articles that stress testing results should not be read at face value. Both the significant modelling uncertainties, and the fact that the Banks know how/when the stress situation ends, limits the value of stress tests. Further, passing a stress test covering only dairy portfolios is not a meaningful indication of overall capital strength given it is only approximately 10 percent of banks' exposures.

You say the following in italics. My response follows.

"The Reserve Bank has suggested the big four banks should have to effectively double their tier 1 equity capital during the next five years".

The expected outcome of this consultation document is a 40-60% increase in tier 1 capital, given that current capital levels are above current regulatory requirements.

"...replace another \$6.2 billion of preference shares because they will no longer count as tier 1 capital".

The possible replacement is mainly contingent convertible instruments, not preference shares.

"Orr risks forcing New Zealand companies to seek alternative sources of capital outside the banking system, pushing people into the arms of less heavily regulated lenders. Boyd says New Zealand doesn't have a great record of protecting depositors in non-banks, pointing to the \$6 billion of finance company losses."

Given reasonable estimates of any increase in bank lending spreads (c. 25bps) it is hard to envision any dramatic change.

"Orr is clearly not satisfied with this oversight, even though APRA is well known for having capital requirements tougher than those in most Western countries and no depositor in Australia has lost money."

Group capital requirements are not relevant for New Zealand creditors and/or taxpayers. Only capital in the NZ subsidiary can be relied on. This is set by the RBNZ's requirements, not APRA.

No Australian bank depositor has lost money because a) the Financial Claims Scheme has been in place since 2008, and b) institutions that failed in the early 90s period of stress were rescued by state governments (e.g., SBSA, SBV, Pyramid Building Society).

“A paper put out by the Federal Reserve Bank of Philadelphia last year suggests that one outcome of requiring banks to hold more capital would be “a much more concentrated loan market.”

The effect of our proposals is mostly on the larger ‘internal ratings’ banks. Our proposal would better level the capital requirements across all banks.

“On the other hand, if the tier 1 capital requirement before 2007 had been 6 percent rather than its actual 4 percent minimum, “large US banks would have had enough capital to cover their losses at the peak of the 2008/09 crisis,” the paper says.”

It is hard to see where the 6 percent comes from. Figure 2 in the Philadelphia Fed paper shows large US banks were operating with ~9% capital ratios in 2007.

The paper refers to IMF research as the source of the 6 percent figure. The IMF study in the references is Dagher et al (2016) which states:

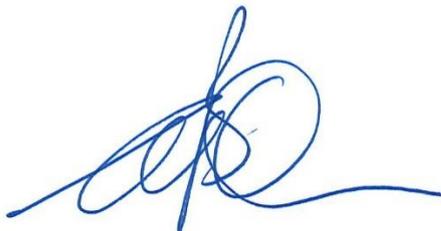
“a capital ratio of 15 percent in 2007 would have avoided the need for capital injection in almost 55 percent of cases in the United States and 75 percent of cases in Europe (based on sample of available data) while a capital ratio of 23 percent would have eliminated the need for injection in virtually all cases. While the 55 percent figure in the case of the United States might seem low, note that this is based on the lower bound of our range. Further, the Capital Purchase Program’s terms were relatively attractive to avoid stigmatizing participating banks as being weak (Swagel 2009).”

The article focuses on the “*radical*” word in the Fitch article title. The Fitch article also said the proposal “sets a *global standard*” and is “*positive for banks’ credit profiles, although we do not expect any immediate rating changes.*”

Finally, we are in constant dialogue with our Australian colleagues at APRA. On this particular topic we have shared many conversations, papers, and briefings over a period of many months. Our APRA colleagues are always pleased to be briefed and we jointly recognise each other’s sovereignty with respect to the issues.

I hope you find these points useful. Our consultation period is lengthy and I am eager it is well informed. We will soon release all of the background material that supports our consultation document.

All the best

A handwritten signature in blue ink, consisting of a series of loops and a long horizontal stroke at the end.

Adrian