It is essential the capital held by banks is increased. The current high valuations applied to NZ property is at historic levels. These will not and in fact can not be maintained. Banks must accept responsibility for the risk they take. Current levels of bank capital requirements are far too low and provide little comfort to NZ. When values fall the net effect of current capital requirements will place the banking industry in jeopardy and as has happened in previous crashes the public will be required to bail them out. No risk = no reward.
Dear Sirs

I'm an expat New Zealander who for the last 30 years has been working in one of the GSIFs in London and New York.

I have until recently been a Senior Manager under the UK FCA and PRA regulatory environment and have been running the leveraged finance and private equity related business in that bank son r 2010

I feel the proposed changes are important given the Basle 3 and 4 Global context but am also concerned that the impact on NZ with out high relative level of SMEs and self employed which might imply lower credit ratings and higher capital costs and thereby higher borrowing charges could be challenging.

As such I'm returning to NZ this year with a plan to start up a fund related alternative lending platform and would be keen to share some thoughts with you and am wondering who I would be best placed to liaise with in the first instance to understand RNBZs stance more clearly.

Wondering it despite this rather broad route into you if it would be possible to start a more specific dialogue?

Regards
Paul Carman
To Mr Grant Robertson,

Mid last year at a breakfast meeting held at the Classic Flyers in Tauranga I brought up the question of either Government back insure bank depositors cash of say $50-$75k or increase the capital of the key banks in NZ because of our small size and the impact upon NZ and its economy should another recession eventuate as in 2007.

There are many small countries where this is being done. Please see attached the actions taken by another small country exposed and sensitive to future economic shocks Denmark.

We can do the same and I support the actions of the Coalition to implement this initiative.

Thank you for reviewing my submission.

Sincerely
Paul Martin
Denmark toughens capital requirements for banks

Toke Jensen 3 MIN READ  f

COPENHAGEN (Reuters) - Denmark is to raise capital requirements over a five-year period for seven of the country's lenders, including the country's biggest bank Danske Bank (DANSKE.CO), joining global efforts to boost the sector's stability.

"It is pivotal that we strengthen the banks' robustness so we can resist future crises," Minister for Business and Growth Henrik Sass Larsen said in a statement.

Some analysts said the moves were in line with expectations and would not impose further capital-raising demands on lenders.

"The new requirements are roughly as expected. None of the banks have to change their business or get more capital," analyst Jesper Christensen at Alm. Brand Bank said.

Starting in 2014, the capital requirement for Danske Bank will gradually be increased by 3 percentage points to 15 percent of its risk-weighted assets, though the requirement could be changed in 2017, the ministry said in a statement.

Danske Bank, which in June was ordered by a Danish regulator to change how it calculates its solvency ratio and to set aside more risk capital, already exceeds the requirement. Last year the bank had a capital adequacy ratio of 21 percent of risk-weighted assets.

The new requirement is lower than the 15.5 percent suggested by a government-appointed expert group in March, but higher than the requirements for the other Danish systemically important financial institutions or SIFIs, reflecting Danske's significance in the Danish economy.

For Jyske Bank (JYSK.CO), the country's second-biggest lender, the capital requirement will be increased by 1.5 percentage points, and for Sydbank (SYDB.CO), BRFkredit BRFFOK.UL and DLR Kredit DLRKRX.UL it will be increased by 1 percentage point.

For Nykredit FRNYKH.UL and the Danish part of Stockholm-based Norden NDA.ST NDA.CO it will be raised by 2 percentage points.

The requirements will be reviewed in 2017 and compared with the requirements in seven other European countries. If Denmark's requirements diverges from the average in these countries, they can be raised or lowered, the ministry said.
I support the RBNZ's intent to increase the capital required to be held by Bank's in NZ.

Please pursue this to increase capital adequacy.

In the 2008 crisis it became clear overseas how vulnerable Banks were as a result of the low levels of shareholder capital. And as credit only ever seems to grow increasing capital adequacy is important in my opinion.

Depositors need to feel safe and needing the Government to guarantee deposits is not appropriate, especially when most years Banks are making very good profits i.e. I don't believe 'privatising profits but socialising risks' has integrity. Therefore Banks need to be stronger, and therefore I support the RBNZ's proposals to increase the amount of capital that Banks need.

The Banks levels of profitability and in particular ROE ratios are strong and so now in the better times I support the RBNZ to act to increase capital adequacy ratios to allow Banks to better weather the times of financial stress independently, without depositors needing to share in the risks.

Thanks, peter...
Peter Lomas

I support the Reserve Bank’s proposal to increase the trading banks Reserve Capital requirements to the maximum extent possible for the following reasons.

Shortly after the financial collapse in 2008 newly elected Prime Minister John Key went on television and said he had met with all four heads of the Australian banks and had been assured by them that they were all sound and none of them had required a bail out from the US Federal Reserve.

However a couple of years later US Senator Ron Paul succeeded in getting a partial audit of the US Federal Reserve and one of the results of this was that it was discovered that two of the Australian Banks did indeed receive bail-outs in 2008. Westpac received about 300 million and the BNZ about 1.2 billion.

Thus my reason for supporting the Reserve Banks requirement to increase the Capital Requirement for the four Australian banks in particular are

1) The four Australian banks have a history of lying and can’t be trusted
2) Our politicians are at best gullible and when push comes to shove are little more than pimps for these four banks.
3) We all know the next financial crises is on the horizon.
At this present time banks current capital requirements are well below other countries, it is of utter importance that an increase is required for the stability of New Zealand. Banks have the advantage of the Open Bank Resolution, out of 34 countries in the O.E.C.D New Zealand, along with Israel are the only countries without some form of deposit protection mechanism. insurance. Should there be an unlikely event such as a bank failure occur, the banks have the assurance of the O.B.R. debt levels are at present above the figures of 2007, I feel it is imperative capital requirements are increased to a level that projects confidence within the economy, along with the public sector.
Peter Stickings

OIA s9(2)(a)

Submission doc attached
Consultation Regarding RBNZs plans re increasing NZ Banks Capital Holding requirements

As a Kiwi I support the RBNZs view that New Zealand Banks need to hold significant capital to withstand potential future market shocks and possible banking failures. New Zealand is also well out of step with international situation where a deposit insurance scheme operates to protect retail investor’s deposits in banks. That said, I strongly object to the likely situation where deposit insurance costs and increased capital holdings requirements will be passed on to be paid for entirely by depositors. This will likely result in hard working Kiwis getting even lower return on savings than the current very low returns available. Key issues that these plans throw up include:

- Low deposit rates will provide little incentive to save in NZ banks, adding additional costs that result in even lower rates will be not well received by savers
- Capital from bank deposits will flow into the already significantly over-valued and stressed housing market via NZ’s favoured investment “property”
- Increased Capital holding requirements will be particularly hard on smaller local banks such as Heartland Bank and Coop Bank who will struggle to provide this capital, this will favour further mega profitable Aussie Banks who control most of the NZ banking market. There is the potential these small banks will be taken over by the Aussies or fail
- More capital will likely flow to Australia market and banks as NZ will be less attractive to local investors and savers
- Last week RBNZ Governor Orr cuts the OCR to 1.5% and is now telling Kiwis we should invest away from NZ banks; however there is little real opportunity for savers and investors in NZ beyond property. The NZ sharemarket (NZX) is a minnow and shrinking and offers little investment upside to small kiwi “ma and pa investors”. Just this week the planned Vodafone NZ IPO was cancelled as a private equity firms takeover removed this investor opportunities, other examples of the NZX investor issues include:
  o Restaurant Brands delisted from NZX after takeover by UK investment house
  o Trademe taken over by UK investors and delisted
  o Zero moved from NZX to ASX 12 months ago due to NZX viability
- No IPO or new listings on NZX in recent period
- NZX favours large investors and funds; the small investor has no access to live market data and is always on the unfavourable end of any market moves and negative news as we get the information too late!
- IRD and ATO need to sort out ASX imputation credits and Trans-Tasman cross market taxation issues need to be sorted out, to fairly treat the NZ saver and investor

My view is the RBNZ also needs to more favourably consider how fairly Kiwi Savers are being treated in an ever downward NZ interest rate environment. Encouraging spending is not the answer, many Kiwis are providing the capital that back the banks and the signals RBNZ is sending us is not incenting saving that is the bedrock of banking!

The NZ market dominant mega profit making Aussie banks are the most profitable in the world. The costs and decreased rate of return and profits from any increased capital holding requirements, and proposed depositor insurance scheme should be covered by their Australian parents Co’s through a small level of lower shareholders dividends, and not funded by decreased Kiwi depositor interest rates.
Bank, capital review

Hello

I am not sufficiently knowledgeable to offer a technical response to the proposed strengthening of Banks' capital requirements. However, as a superannuitant, dependent on relatively modest savings, I am totally supportive of the suggested changes.

Regards

Peter Thomson
Dear Ian,

Rabobank New Zealand appreciates the opportunity to provide feedback on the Reserve Bank’s Capital Review Paper 4: How much capital is enough?

We support the RBNZ’s objectives of enhancing the ‘soundness’ and ‘efficiency’ of the New Zealand banking system through a robust and internationally consistent regulatory capital framework.

Rabobank New Zealand is strongly capitalised and our existing capital ratio levels are well above current regulatory requirements. However, the RBNZ 15% Tier 1 proposal for non-systemic banks would require Rabobank to hold a higher level of Tier 1 capital than we currently consider necessary to protect the bank and our customers and to achieve our strategic growth ambitions.

While we strongly support measures to enhance the stability of the New Zealand banking system, we are concerned that the full costs of the Tier 1 proposals have been underestimated, particularly given the relatively short transition period. This will most likely have pricing implications for consumers, businesses and farmers. Our initial estimates are that the proposals could, at least in the short-term, result in approximately a 10% decrease in profit for the agriculture sector.

Our largest concern is around the indirect economic impacts of the proposals, including the potential withdrawal of credit to the agricultural sector and the impact on growth and rural asset values. We believe a full and independent cost/benefit analysis should be done on the direct and indirect impacts of the increase in Tier 1 capital to the sector. In addition, this should include consideration of other industry costs, such as environmental regulation and taxes, which will also need to be funded.

We support a level playing field between New Zealand banks and therefore support the RBNZ’s proposal to limit the difference between the Internal Ratings Based (IRB) and standardised approaches.
The 5-year transition period is short given the materiality of the changes and is likely to amplify the potential impacts and costs to banks and their customers. We think the transitional arrangements should not start until all the relevant policy proposals have been finalised.

Our responses to questions in the Consultation Paper are detailed in Appendix 1. If you have any questions or wish to discuss, please feel free to contact us.

Yours sincerely

Todd Charteris
Chief Executive Officer Rabobank New Zealand
APPENDIX 1: Response to questions in Capital Review Paper 4

1. **What would be the impact of this increase in capital requirements on borrowing costs?**
   - Given the size of the proposed increase in Tier 1 requirements and the 5-year implementation timeframe, we would expect an increase in borrowing costs. It will be difficult for banks to absorb this major increase in funding and maintain expected returns on equity without increasing borrowing costs. As such, we do not agree with the RBNZ assertion that the impact on lending rates for customers would be “minor”.
   - At a minimum, we estimate 50 basis points would have to be passed on to a customer to maintain the bank’s current return on equity. Even at that minimum, this could reduce a typical farm’s net profit after tax by at least 10%.

2. **What are the likely benefits and costs of higher capital requirements for New Zealand’s economy?**
   - We agree with the RBNZ’s objectives of enhancing the ‘soundness’ and ‘efficiency’ of the NZ banking system. The main benefit is to improve the banking system’s resilience to shocks, whether they occur in NZ or externally, and support market and public confidence in NZ banks.
   - Requiring banks to hold more Tier 1 capital will improve resilience, but this needs to be considered alongside the overall costs to the economy and, more specifically to Rabobank, the costs and availability of credit to the food and agricultural sector. We are concerned that if banks are unable or unwilling to absorb these costs, they will be largely passed on to consumers and farmers, which may impact their ability to service debt and increase financial stress. Increased costs may also drive banks to reduce lending or ration credit to certain industries or regions.

3. **We seek your views on the proposed additional capital requirement for banks that may be deemed ‘systemically important’ in New Zealand (D-SIBs):**
   a. **Should banks identified as D-SIBs be subject to higher capital requirements than other banks?**
      - In principle, D-SIBs should, arguably, hold more capital to reflect the risk they pose to the NZ system, and to reduce moral hazard and taxpayer exposure. This is consistent with international standards (e.g. FSB, etc).
      - We note the recent RBNZ consultation paper released on 10 April 2019, which while noting Rabobank’s relatively large exposure to agricultural loans, concluded it should not be classified as a D-SIB. We agree with this conclusion and will provide further comment on that paper in a separate response.
   b. **If so, what factors should a framework consider in identifying such banks, and what would be the appropriate size of any additional capital requirement?**
      - We consider that the factors should include: activities-based (i.e. the activities that present a risk to financial stability or transmit risk); substitutability of products;
complexity; inter-connectedness and cross-border activity; and the size of the bank (e.g. numbers of customers).

4. **We seek your view on the proposed Countercyclical Capital Buffer (CCyB) and in particular:**
   a. **Should there be an option to set the CCyB to zero in the exceptional circumstances following a crisis?**
      - We agree this is a sensible option for the RBNZ to have during a period of extreme stress.

   b. **Is 1.5 percent an appropriate calibration for the ‘early set’ component of the CCyB?**
      - It is unclear how the CCyB has been calibrated, but we think the RBNZ should increase the capital buffer it could release in times of stress.

      - We note the comments made in the paper on the ‘reciprocity’ principle, which may effectively result in a capital add-on at group level. This would result in double counting and suggest the RBNZ consider whether the CCyB could be held at group level. We would encourage the RBNZ to discuss this point with De Nederlandsche Bank (DNB).

5. **What are the advantages and disadvantages of having Tier 2 capital requirements?**
   - The main advantages of Tier 2 instruments is to allow alternative sources of capital other than equity. As a cooperative, the ability to issue instruments that count as regulatory capital is an important option to have available given we do not have external shareholders. The main disadvantage is the cost of the instruments (depending on market conditions) and their ability to absorb losses on a going concern basis.

6. **Is there continuing value in setting a specific requirement for Tier 2 capital, if the Tier 1 capital requirement is set to 15 or 16 percent?**
   - Rabobank’s view is the RBNZ should remove the current 2% requirement for Tier 2. As alluded to in the paper, this is unnecessary given the significant increase in the Tier 1 requirement. Under the current regime, the 2% must be met with a higher form of capital. Given Rabobank currently chooses not to use Tier 2, the proposed total capital ratio is 17%. We do not think this has been made clear enough in the paper, but would like to thank the RBNZ for clarifying this during the consultation period.

7. **Do you agree that minimum leverage ratio requirements should be part of the capital framework?**
   - We appreciate the need to be consistent with international best-practice, but in our view the RBNZ already has adequate policy tools to measure the build-up of leverage in the system and at individual bank level. The rationale for a leverage ratio is not well explained and we do not support additional metrics unless there is a clear need. The paper also notes the RBNZ does not expect a leverage ratio to be binding in “normal times”, but there is no explanation as to what constitutes “normal”.
8. Do you agree that leverage ratio disclosure requirements should be part of the capital framework?
   • If the proposal were to proceed, we think any disclosure should be included in the Bank Financial Strength Dashboard.

9. Do you agree with the proposed minimum leverage ratio calibration for Standardised and IRB banks?
   • This appears appropriate given its alignment with the APRA standard.

10. We seek your feedback on the proposed transition period provided to banks to meet the proposed capital requirements and the benefits and costs associated with a shorter or longer transition period.
   • The 5-year transition period is short given the materiality of the changes and likely to amplify the potential impacts and costs to banks and their customers. We think the transitional arrangements should not start until all the relevant policy proposals have been finalised.

11. We also seek your feedback on whether any banks not identified as ‘systemically important’ should be provided with a longer transition period to meet the new capital requirements.
   • No, we do not see an obvious need for this.

12. Do you agree with the Reserve Bank’s proposed method of narrowing the difference in capital outcomes between the IRB and Standardised approaches to credit risk?
   • We support the narrowing of the differences between the IRB and Standardised approaches. This will help promote a level playing field between IRB and non-IRB banks in NZ.
Tena korua,

I know I haven't been able to connect with you gents recently.

Could you send a personal message to Adrian to say KIA KAHA Stand Strong - I personally believe the Capital Review is very good and the stance taken with ANZ is a bloody good one.

_I don't have Adrian's phone number otherwise I would send him a personal message directly._

The banks' _social license to operate_ has been eroding with the public and the NAB and ANZ positions have been examples of untenable situations.
I am personally glad the RB has taken a proactive position with ANZ.

The RB action will give confidence to the public that seeks to ensure the likes of ANZ are operating in a sound, stable and efficient way. Kia Kaha koutou.

NB - I also believe the Chair and CEO of ANZ should be forced to resign - but that is another matter.

Renata Blair
Hi folks - my thoughts on new capital requirements........

I support the proposed stronger bank capital requirements by the RBNZ and congratulate them for addressing it - my views are based on my understanding as follows:

1. BIS rules say Tier 1 capital should be @8% - yet most NZ/Aust banks operate @10-12% (but that may include some dubious tier 2 debt?)

2. To jump to 16% tier 1 seems quiet a challenge - maybe if RBNZ required 12% tier 1 then banks may increase their buffer to @16…..- but to go to 16% means maybe they may buffer to 20% which is quite high??

3. To refute the avarice banks comments that 16% is excessive capital required - maybe point out to them that they want us as consumers to have 20% equity for a house loan and 35-50% equity for business/commercial loan ……so why should they operate at just 8%??

4. Also educate people that banks rely on confidence and continuity - that is because they fund @90% of their lending form 6 mths retail deposits (@75%) and 1 to 5yr wholesale funding (@20%) ……..and then they lend to complete strangers for 30yrs?/. That is a massive mismatch risk so higher capital requirements is sensible.

5. In response to fears of higher equity costs increasing the cost of funds to consumers/borrowers - I would suggest that higher equity levels should actually decrease the cost of funds as there is less risk to investors if there is more equity - to achieve this higher equity they can reduce dividends rather than necessary the need to raise more equity over a 5yr period

6. NZ banks take too much profit off the table as they are one of the highest ROE in the OECD (followed by Australia) as they have a strong oligopoly - increasing capital requirements should reduce their ROE which should be @10% over the risk rate

7. Please check product pricing between Australia and NZ and you will find NZ consumers pay higher prices in most products - Australia say NZ has a higher risk premium but thats just a way of stripping more dividend from NZ

8. I believe ask 3 questions of NZ banks - what's your ROE compare to OECD?, how much tax are you paying? and what are your service levels? - we are the worst at most - just try calling a call centre or try to speak to an ever decreasing number of bank personal

9. Risk weighted assets levels is a problem in NZ with housing at @35% and business/commercial/development loans at 100% - hence housing gets the most lending as it provides a greater ROE - if you don’t own property it is hard to get a loan

Just One Man’s Opinion!

Richard Trounson (34yrs in banking and financial markets in NZ)
Richard wilson

Would an investor not shift their capital to the highest return? Less return on a bank shareholding will result in less money available for NZ businesses. To be in business for the long term you have to last through the short term. As a dairy farmer I was afraid the government and its appointed people would make good on their ambition to bring New Zealand's dairy down. High interest rates, environmental taxes and the very real possibility of a CPT. I am not in favour of the large increase of the banks capital requirement.
I am rather concerned at what is looking far more like an over reaction, rather than prudence. Our banks are already at the top of the global list with regard to capital requirement. The proposal will put them in first place by a very large margin from what I understand.

It is right to be cautious, and strong capital requirement is a good thing. But this move will have a massive effect, particularly in the rural sector. Considering our economy is heavily reliant on agricultural exports we surely need to exercise caution. It would be my preference to not make any changes to the capital requirements.
Dear Governor,

We are trapped in a never ending quest for economic growth for the reason that the alternatives are untenable. That growth has been funded by debt which has increased the volatility particularly on the downside.

Most do not understand the risk attached to money in the bank nor can all be expected to have knowledge on such a specialist area.

For the above reasons the Reserve bank of NZ is prudent to increase the capital adequacy ratios of the main banks. I believe it is also important for NZ to have a deposit insurance scheme as the chaos ensuing from any rumours of difficulty or default may be catastrophic.

Thank you for the opportunity to submit my opinion.
Sincerely, Rob.
24 April 2019

Reserve Bank of New Zealand
CapitalReview@rbnz.govt.nz


My focus is on answering the question from the capital review paper as to ‘what minimum level (percent) of a bank’s money should come from its owners?’ As for considering a framework for identifying domestic systemically important banks, all registered banks are systemically important and so should be subject to the solution regarding the question as to owner capital percentage that is set out below – how to arrange registered banks in terms of size using different measures seems a comparatively unimportant exercise.

Banks and financial institutions that lend money are generally different to businesses that supply goods in terms of capital structure, but may be not so different to businesses supplying services (including insurers).

The concern: public sector bailouts of private sector banks.

The Capital Paper points out that usually over 90% of the money that banks use as assets comes from borrowing from unrelated 3rd parties, and that under 10% comes from owners (in terms of equity investment [6% to 8% as Tier 1 capital] and equity-like borrowing [2% as Tier 2 capital – subordinated debt]). I assume those percentages are factually accurate. In times of financial difficulty (when maturing obligations exceed available circulating cash in the economy), this level of capital is now being thought, perhaps, to be insufficient. The concern is that in times of stress, a bank, or a number of banks, find they cannot get deposits (or other loans) from third parties, and cannot raise new capital from existing or new investors, and so cannot meet their maturing liabilities. Government bailouts, based on central bank provided funding, are then necessary ‘to rescue the financial system’.

The Capital Paper’s suggestion

The Capital Paper suggests lifting the owner equity from 8% (Tiers 1 & 2) to 16% in terms of Tiers 1 & 2 for large banks, and to 15% for smaller banks and financial institutions.
The Capital Paper regards Tier 1 & 2 capital as being a bank's own money, and is proposing that the increase in bank capital from 8% to 16% should also come from the bank's own money. Presumably, this means from some combination of newly injected owner equity (Tiers 1 & 2) and increasing retained earnings (presumably underscored by the issue of new fully paid shares or subordinated debt, being fully paid from the retained earnings to lock such new retained earnings into permanent capital).

This suggested recipe, while in some ways heading in the right general direction, appears to be missing what is the key ingredient, to use a cooking analogy. Understanding the missing key ingredient, and adding it into the mix, will accordingly correct the recipe. That is my focus below. But first, two strands of historical experience must be mentioned.

First strand: circulating cash – the 'thing (chose) in possession' that meets a Government's fundamental obligation to provide a mechanism by which debt obligations within the Government's jurisdiction can be finally discharged.

Throughout human history it has been, perhaps, the most fundamental task of any government (however constituted) to provide a mechanism by which obligations arising from exchanges of goods and services by persons whose lives are subject to control by such government can be discharged in law. In NZ's own recent history, from 1840 to 1850 British currency was used in NZ, then the bank notes of the Colonial Bank of Issue (broadly 1850 – 1856), then bank notes issued by trading banks specified in legislation as being empowered to issue such currency (1856 to 1934), and then bank notes issued by the Reserve Bank of New Zealand. (Coins similarly have been issued in NZ under legislative direction.)

The Reserve Bank (established 1934) was NZ's second attempt at a central bank. The first attempt was the Colonial Bank of Issue (CBI) set up at the end of the 1840s. The CBI failed because its restricted constitution enabled it to be driven out of business by privately owned banks then operating in NZ who presented the CBI with its issued bank notes and demanded payment in gold. This depleted the CBI's gold reserves. The CBI was dissolved in 1856. The victory of the privately owned banks was limited, however, as while they were then permitted by law (in 1856) to issue NZ currency bank notes themselves, they were subject to NZ government oversight. Nevertheless, from 1856 the specified issuing banks had a state created monopoly over the issue of bank notes that comprised New Zealand's legal tender that they used in making profits for the following 68 years (until 1934).

So today, the currency that circulates as legal tender in NZ, is issued by the Reserve Bank of New Zealand, which is a state owned statutory corporation that is part of government. The cash (comprised mainly of bank notes, but also coins) is a largely paper evidenced liability of the Reserve Bank to the holder of the bank note (or coin). When the Reserve Bank creates a bank note, it holds the bank note created as an asset, and it has a corresponding liability in respect of the bank note (a liability against itself), so its currency ledger position is: Asset $1.00 = Liability $1.00. When it issues the currency into circulation, the Reserve Bank mainly does so by selling the asset on loan terms as a loan (usually to a registered bank or to the government (its owner)) – so the asset of 'cash' is replaced by an obligation-asset of 'loan to' or 'owing by' some authorized borrowing third party. The Reserve Bank can also spend its cash into

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1 The Colonial Bank of Issue (1847 to 1856) is not to be confused with the Colonial Bank of New Zealand, established later in 1874.
circulation — by paying wages to its staff and by paying its bills for assets and services it acquires, but this is trivial. The Reserve Bank will never run out of NZ currency because by law it can always create (by printing liabilities against itself) the bank notes it needs which bank notes are legal tender in NZ, and must by law be accepted as discharging a NZ$ liability in NZ. And if any holder of a bank note that it has issued ever presents the bank note to the Reserve Bank demanding payment of the liability expressed on the bank note (or coin), the Reserve Bank can discharge the liability by returning the same note to the former holder, or by giving the former holder a new bank note that it has issued.

The term ‘money’ encompasses more financial obligations than those obligations against self that are issued as currency by the Reserve Bank. Money includes all sorts of promises to pay that are issued by ‘borrowers’ to ‘lenders’ (normally in written instruments) that can be transferred by the lenders in satisfaction of their own obligations to creditors who are willing to accept such promises (evidenced in instruments) as discharging financial debt. The difference between currency and other money instruments is that a creditor must by law accept payment made in currency, whereas the creditor is not obliged to accept payment tendered in the form of another money instrument. So, while currency is an unrestricted ‘chose (thing) in possession’ (as well as being a chose in action), other ‘money instruments’ are restricted ‘chooses (things) in possession’ (as well as being choses in action). Currency paid to satisfy a financial obligation cannot be declined by a potential transferee within jurisdiction, whereas other ‘money instruments’ tendered in payment can be declined by the transferee who insists, instead, on payment in cash.

One of the many failings of imagined equilibrium economic thinking in academia (and in the commercial and political world) is the failure in that economic thinking to acknowledge the full significance of legal tender in the discharging of obligations of exchange (and, indeed, of the pivotal role of legal rules generally in the processes of exchange).

Registered banks in NZ buy and sell money (mainly NZ$ amounts) on terms that extend over various periods of time. They buy money from depositors and other lenders by giving promises to pay the depositors in future. They sell money to borrowers in return for promises by the borrowers to make payments over time. As mentioned earlier, over 90% of the money registered NZ banks sell comes from borrowing, and under 10% (indeed around 8%) comes from owner equity including subordinated debt (which is owner debt that is subordinated to third party (non-owner) debt). Registered banks use their own reserves of currency (from their earnings and from payments by their debtors and from equity obligations they have issued to their shareholders) and also borrow currency to meet their obligations from depositors and other lenders, including the Reserve Bank. Their ability to access cheap funding from the Reserve Bank is a statutory advantage that registered banks use and exploit in their businesses to make their profits.

In this regard it is useful to refer to the strategy, or rules for big business, detailed in 1906 by Frederick C Howe, and later elaborated by Economics Professor Antony C Sutton in 1974. In his book Confessions of a Monopolist (Chicago; Public Publishing; 1906), Howe said at p 157:

"These are the rules of big business. They have superseded the teachings of our parents and are reducible to a single maxim: get a monopoly; let Society work for you: and remember that the best of all business is politics, for a legislative grant, franchise, subsidy or tax exemption is worth more than a Kimberly or Comstock
lode, since it does not require any labor, either mental or physical for its exploitation.'

And in his work Wall Street and the Bolshevik Revolution [New York; Arlington House; 1974; republished Clairview Books], Sutton added at p 16:

'While monopoly control of industries was once the objective of J P Morgan and J D Rockefeller, by the late nineteenth century the inner sanctums of Wall Street understood that the most efficient way to gain an unchallenged monopoly was to 'go political' and make society go to work for the monopolists – under the name of the public good and the public interest. This strategy was detailed in 1906 by Frederick C Howe in his Confessions of a Monopolist. Howe, by the way, is also a figure in the story of the Bolshevik Revolution.'

Registered banks in NZ, along with privately owned banks around the world, make their profits by exploiting legislatively based advantages of access to state created low cost funding that is not available to other persons (corporate or individuals) seeking to borrow circulating cash.

Of course, in contrast to the Reserve Bank (or any other central bank), a registered bank or other financial institution (and any other business or individual), can run out of money because any notes (paper promises to pay) that it or they may issue are not legal tender – a creditor of the bank is not required by NZ law to accept such registered bank notes (paper promises to pay) as discharging the registered bank's liability.

If a registered bank for whatever reason does not have currency (or currency balances) to pay its liabilities as they mature, it needs to acquire such currency (by borrowing – ie selling promises to pay in future, or by selling assets), or it must cease trading. The lender of last resort in NZ to a registered bank is the Reserve Bank – because it can always fund its own liabilities, and so it can bail a NZ registered bank out of its liabilities to the extent those liabilities are in NZ$.

This leads, then, into the second strand of historical experience.

Second strand: history shows that financial crises are resolved by government bailouts where currency is injected into circulation in the economy to enable repayment of some maturing debts.

It is a fundamental fact that in any economy there are always more financial obligations in place than there is circulating currency to enable immediate repayment of all such obligations.

So long as debtors can obtain currency to pay their debts on maturity, there is no apparent problem arising from the mismatch. (This resembles the game of musical chairs where there are enough chairs for all the players who are standing to sit on in an orderly fashion if they wish to sit while the music is playing – not everyone wishes to sit at once – they are there for the dancing, so there are fewer chairs than there are standing players.) But when incomes drop or unexpected liabilities arise and financial obligations are not paid when they fall due or mature (the music stops), disruption arises as debtors who are relying on receiving payments to meet their maturing liabilities suddenly find themselves unable to pay their maturing debts in cash. There is a scramble for cash, and those with surplus cash hold onto it rather than lending it out.
Where an individual bank or financial institution cannot get cash to meet its maturing liabilities (including deposits), it will fail – and fail very fast. (In musical chairs failing to get a chair means you are ejected from the game.) Such a bank or financial institution will inevitably have additional maturing financial obligations to other banks and financial institutions that it cannot pay (in cash or by assigning its creditor interests in its financial assets). So the failure of one bank to meet its maturing liabilities can affect the ability of other banks to meet their maturing obligations, and so on.

The cascading effect can lead to financial crisis (such as in the GFC in 2008 when major financial institutions could not meet their obligations including under credit default swaps; in the 1987 stockmarket crash and ensuing financial crisis in NZ particularly; in the Wall Street crash in 1929 and the ensuing financial crisis called the Great Depression of the 1930s; and in the many preceding financial crises throughout human history: see HD MacLeod, The Theory of Credit, vol 2, part 2; chapter 17 ‘On Monetary Panics’ [1891; Longmans Green & Co; London]). Further, in terms of NZ banking history, contrast the government bailouts of the BNZ in 1894 and again in 1990, with the government decision not to bailout DFC in the 1989). Where new cash is injected into circulation in the financial system quickly, the effects of the financial crisis can be minimized – but where new cash is not injected or is not injected quickly enough the long-term effects of the financial crisis are more severe.

Banks and other financial institutions can borrow from various sources onshore and offshore, providing there are willing lenders. For NZ banks, the ability to borrow from the Reserve Bank is fundamentally important in managing their cash so as to be able to meet their maturing liabilities and remain solvent. Like most central banks, the Reserve Bank of New Zealand is owned by the state and governed by legislation. Government ownership of a central bank is not essential – a central bank can be owned privately, but controlled through legislation, as is the case in the USA with the US Federal Reserve Bank. Indeed the Reserve Bank of New Zealand itself was initially owned privately when it was first set up in 1934 until its shares were compulsorily acquired by the Crown, and cancelled, in 1935 as the Reserve Bank became a statutory corporation within Government.

These matters as to state bailout, too, along with favoured access to currency, are important when it comes to considering, objectively, the question – *in terms of substance (ie ignoring current legal form), who really 'owns' a registered bank?*

**The current free-ride and subsidized profits of registered bank shareholders and subordinated debt holders.**

It follows from these two strands just discussed that, in practice (being a practice that is permitted by law in the Reserve Bank Act), NZ registered banks and other partially protected financial institutions, have significant advantages arising from statute that are not enjoyed by other NZ borrowers in terms of being able to seek to obtain money from the Reserve Bank when in various shortfall situations. These advantages are means of capital support to a registered bank, and therefore to its owners (shareholders and holders of registered bank issued subordinated debt) that are provided by the state. In Howe’s terms those private businesses have what amount to legislative subsidies amounting to monopolies for their profit making ventures. The support or advantage is often colloquially summed up in phrases such as ‘too large to fail’, and ‘subsidized shareholder subordinated debt-holder profits’.

This means that registered banks enjoy a commercial advantage in the name of the public interest or public good over other businesses that do not have access to the lower
cost finding and potential government bailout. In NZ (as elsewhere around the world for other private sector banks) these are significant statutory advantages in running businesses and in making business profits.

These advantages of registered banks and their shareholders (and subordinated debt-holders), and the free carry they receive from the advantages, are currently not reflected in the capital structures and reward structures (profit distributions) of registered banks.

**Solution:** recognize the present unofficial capital contribution already being made by the Reserve Bank to each individual registered bank – subordinated uncalled guarantee bonds to be issued by Reserve Bank to each registered bank – with any calls of the guarantee bonds to be matched by pari passu cancelling of shares and subordinated debt.

A better analysis of the support provided by the Reserve Bank to registered banks at the behest of government is that it is a form of unofficial registered bank capital. And that in fact, the capital of any registered bank already includes the unofficial registered bank capital in the form of the systemic support given to the registered bank by the Reserve Bank, in the form of overnight ability to borrow and in the form of ability to borrow on terms longer than over-night from the Reserve Bank, and in the form of borrower opportunity for getting lender of last resort borrowing from the Reserve Bank.

These capital supports for registered banks, that are already being provided by the Reserve Bank, should be formally recognized in terms of the registered bank’s capital structure – along side the shareholder equity and shareholder equivalent subordinated debt.

As mentioned, experience suggest that registered banks can and do survive on private capital of shareholders and subordinated debt holders of around 8% of funds being lent by such registered banks when it is business as usual, but that when business as usual is disrupted and debtors are unable to secure NZ$ to repay maturing debt, extra capital support is required. On the Reserve Bank’s projections, additional capital of 8% (from the 4 large registered banks) and 7% from the other smaller registered banks is required to allow banks to survive up to 1 in 200 year levels of financial crises – lifting capital of the 4 large registered banks to 16% capital levels and smaller registered banks to 15% capital levels.

Experience also suggests that the extra capital is already being provided to registered banks, but in a somewhat different way, by the Reserve Bank. If that existing, presently unrecognized, capital contribution was to be formally recognized, in a legal form (say, as subordinated uncalled guarantee bonds issued by the Reserve Bank to the registered bank, ranking in security below third party lenders and above shareholders and subordinated debt-holders), the registered bank’s capital would be increased by the amount of the uncalled guarantee bonds.

The terms of the uncalled guarantee bonds would provide:

(a) That they are to rank equally with issued shares and with issued subordinated debt for distributions by way of dividend and interest payments (so the uncalled guarantee bonds would generate income for the Reserve Bank, and so split the earnings and increases in value of the registered bank between the providers of its capital, the shareholders, the subordinated debt holders and subordinated guaranteed bond guarantor); and
(b) That on all or part of the guarantee bonds being called by the registered bank (and paid by the Reserve bank guarantor), an equivalent percentage of each issued share and subordinated debt would be cancelled on a pari passu basis, so that in the event of a complete call of the guarantee bonds, the shareholding and subordinated debt would be fully cancelled; and

(c) That the registered bank would upon the calling of the guarantee bonds, increasingly be controlled by the guarantee bond issuer (the Reserve Bank as guarantor) and the Reserve Bank could then windup the registered bank or allow new shareholders to acquire new shares in the registered bank, or authorize a sale of the profitable financial assets of the business.

This would halve the current rate of return on capital owned by shareholders and subordinated debt holders in registered banks, making their rate of return reflect the limited real capital value being provided by such shareholders (and subordinated debt-holders). It would reward Government/Reserve bank (and so taxpayers) with their appropriate share of each registered bank's residual current earnings. And it would reflect in a 'concrete' legal form the real capital contribution that is in fact currently being made unofficially to each registered bank's capital by the Reserve Bank for the government and taxpayers of NZ.

Yours sincerely

R J Cullen
Barrister

Postscript

I mention in passing three further points that are also of importance, but in perhaps a broader context:

First, uncalled guarantee bonds could also be used in the property insurance sector – instead of permitting property insurers to daisy pick in terms of the NZ properties they are prepared to insure, and to exclude certain NZ properties from insurance or demand higher premiums in respect of such properties. The essence of insurance is the spreading of risk, and those wishing to insure property in NZ have to comply with NZ statutory requirements, and on doing so have a statutory advantage in being able to do business in NZ. One of the statutory requirements should be that the property insurer must take on all risks, and that uncalled guarantee bonds issued by, say, the statutory corporation EQC, is a way of capitalizing the insurer that includes the state in the insurer's capital structure, and spreads the insurer's annual profit between the private sector owners of the insurer and the state owner (say EQC).

Secondly, Howe and Sutton point to the use big business makes of monopolies and advantages created by the state in generating business profits. Howe used the expression, set out earlier, that 'the best of all business is politics for a legislative grant, franchise, subsidy or tax exemption is worth more than a Kimberly or Comstock lode'. As important, perhaps, is for big business to control academic economics, because it is from academic economics that civil servants who write and administer political policy are drawn. Big business has always controlled academic economics so it is taught in a way
that has sought to minimize and subordinate the proper and substantial role of
government in business, while at the same time privatizing (to the business and its
shareholders) the profits that are only able to be generated in the first place because of
the stability (including capital stability) provided by those domestic and foreign
governments. The power of policy-makers schooled in imagined equilibrium economics
(my term for neoclassical economics which is both a throw-back in methodology to
Plato’s world of imagined ideal forms and a rejection of evidence based scientific
methodology) over the past 150 years, from around 1870, for example, stands as
evidence for this proposition.

Thirdly, the role of taxation continues to be misrepresented as the source of funding for
government expenditure (and regarded as being part of ‘fiscal policy’). In fact, it is quite
the reverse. All government expenditure is funded by and from government borrowing,
and the creation of financial liabilities against itself undertaken in central banks (state
owned and/or controlled by legislation) is at the foundation of such borrowing. The
state’s liability to the Reserve Bank is matched by its asset (the Reserve Bank) –
combined, they cancel to zero. Government should, in fact, be earning and receiving its
share of the private sector business profits that it is helping to fund through providing
legislative subsidies and capital supports – these earnings should be direct earnings of
government’s share of the business profits based on investment instruments such as
uncalled guarantee bonds, as outlined above, not indirect claims on earnings of others
made through taxation of the incomes of businesses and individuals. Taxation is, in fact,
the state’s main method of taking currency that it has previously spent (into circulation)
out of circulation in the interests of making circulating currency somewhat scarce to
restrain inflation. Taxation is the primary tool of the state’s monetary policy. Taxation,
in fact, has nothing to do with funding government expenditure.
Robert Heywood

OIA s9(2)(a)

I fully support the proposal to increase the N.Z. Bank capital requirements to the level proposed in Reserve Bank's Consultation Paper on the amount of regulatory capital required of locally incorporated Banks. The proposals are particularly relevant in light of the fact that New Zealand does not have a Deposit Guarantee arrangement, as in other major Western economies, such as Australia, U.S.A., and the U.K.

Conservative investors use the major N.Z. Banks as their primary vehicle for savings and capital preservation. Further, many retirees depend on the interest earned on their Bank Deposits to supplement their Superannuation or Pension pay-outs to maintain a satisfactory standard of living.

The consequences of a major N.Z. Bank failure would be catastrophic for this vulnerable sector of society.

Turning to the bigger picture, there has been a disturbing increase in personal debt over recent years and whilst the present low interest rate setting has enabled this situation to be sustained, it leaves leveraged businesses and personal borrowers highly vulnerable to any economic downturn or credit event which would expose the Banks to an unacceptable level of risk with the present minimal capital settings.

We are experiencing an unprecedented global economic backdrop with many disturbing monetary and fiscal experiments yet to be normalised. These factors in a troubled global political & trade environment make a prudent capital setting for our major Banks imperative.

Implementation should be progressed in a prompt and timely manner.
In addition to the banks being required to raise their capital requirement the Government should guarantee Term Deposits in the event that a Bank fails and is unable to totally cover Term Deposit investments.

Term Deposits currently rank as unsecured yet form a substantial percentage of a bank’s loan portfolio. Term deposits should not be the last in the line as security rating and should be secured in the same way as any other Bank borrowing.

The failure of Banks to repay Term Deposits in the event of failure will have huge financial consequences particularly in the elderly group where their only or major source of income outside of Super is Term deposits.
17 May 2019

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BANK CAPITAL REVIEW - SUBMISSION

1. This is the submission of Russell McVeagh on the “Capital Review Paper 4: How much capital is enough?”.

2. Russell McVeagh has advised on all of the convertible instruments issued by New Zealand banks since the introduction of the Basel III standards. We also advise insurers on capital issuance.

3. Our submission does not address the issue of how much capital banks should hold. Our submission is that, if banks are required to hold additional capital, consideration should be given to part of that capital taking the form of contingent capital instruments (such as Additional Tier 1 and Tier 2 debt). Supporting comments on this are set out in the schedule to this letter.

4. Please contact Guy Lethbridge or Deempe Budhia if you have any questions regarding our submission.

Yours faithfully
RUSSELL McVEAGH

Guy Lethbridge | Deempe Budhia
Partners
SCHEDULE

1. **Legal effectiveness:** The Reserve Bank raised concerns regarding whether contractual conversion or write-off provisions will be legally effective, i.e., will they operate the way they are intended to absorb losses when a trigger event occurs. In our opinion, this concern is not well founded. While the legal effectiveness of contractual conversion and write-off provisions has not been tested in the courts in New Zealand, the contractual provisions are based on conventional legal principles and there is no compelling reason why they would not operate as intended. For previous contingent capital instruments issued in New Zealand, legal opinions have been obtained for the benefit of the Reserve Bank which confirm the legal effectiveness of the conversion and write-off provisions. If there are any residual concerns, which we believe are unjustified, another option may be for legislation to be introduced which provides legislative certainty that conversion or write-off will be effective. A similar approach has recently been taken in Australia where changes were made to the Banking Act 1959 (under the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018) to provide legal certainty regarding the conversion and write-off provisions under Additional Tier 1 and Tier 2 capital instruments.

2. **Fiscal risk:** Concerns have been raised by the Reserve Bank regarding the fiscal risk that contingent capital instruments carry, i.e., that the Government would be required to bail out investors who lose money if a contingent capital instrument converts or is written-off. Again, we do not think this concern is well founded. The Government has repeatedly said that it would not bail out a bank that was failing. In addition, the regulatory settings that apply to an offer of contingent debt instruments to retail investors in New Zealand significantly reduce the likelihood of a Government bail out. The disclosure requirements under the Financial Markets Conduct Act 2013 apply to bank hybrid products that are offered to retail investors. An offer document for contingent debt instruments to retail investors must include prescribed information explaining the nature of the instrument and the related risks. The offer documents must also include prominent warning statements (including on the front cover). If, notwithstanding these existing requirements, additional risk statements are required, this could be easily addressed in the offer documents. Finally, the distribution of bank hybrid products has also been tightly controlled by bank issuers: there has been no public pool and distribution has occurred via NZX firms and other approved intermediaries only. It has not been possible for instance, for retail investors to acquire convertible capital instruments at a branch of a bank.

3. **Going-concern trigger level:** The Reserve Bank raised also concerns that contingent capital instruments are not effective to absorb losses on a going-concern basis because the conversion or write-off occurs too late, i.e., when the bank is already non-viable. An option to address this concern could be to raise the trigger level, particularly if the overall capital requirement on banks increases as is proposed by the Reserve Bank.

4. **Contingent debt:** The Reserve Bank also asked whether there were advantages and disadvantages to retaining Tier 2 capital. We believe there are advantages in retaining contingent debt (both Additional Tier 1 and Tier 2). The first is that contingent debt has the ability to remove, through write-off or conversion, a class of creditors that would otherwise need to be dealt with in a bank resolution. The removal of a class of subordinated creditors means these claimants cease to have a voice during a resolution process (e.g., in a creditors’ compromise) and a recapitalisation is potentially easier by the removal of equal or higher ranking subordinated liabilities.
5. **Signalling effect**: The second benefit is the positive signalling effects of continuous disclosure that result from New Zealand banks issuing contingent capital instruments. An issuer of debt instruments that are quoted on NZX is subject to the continuous disclosure obligations of the NZX Listing Rules. Contingent debt instruments are more price sensitive than senior bonds, and so issuers of these instruments effectively are subject to enhanced disclosure obligations. Market analysts may also review and provide commentary on these instruments. This is likely to lead to a more informed market which would be a positive development.