RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Capital Review Paper 4: How much capital is enough?

Non-technical Summary

Bank Capital: What is it?
Banks get their money from two places – their owners (often referred to as 'shareholders') and people they borrow from, including depositors (often referred to as 'creditors'). The money that banks get from their owners is referred to as 'capital'.

Banks in New Zealand, like banks around the world, are required to have minimum levels of capital. This means that a minimum percentage of all a bank's money must come from its owners.

This minimum requirement exists to ensure that the owners of a bank have a meaningful stake in the business, because the more the owners have to lose, the more carefully they'll manage the bank. Another reason banks are required to have minimum levels of capital is in case the bank loses money. When a bank loses money, it is the owner's investment in the business (the bank's capital) that is lost first, not the money the bank borrowed.[1]

When the amount of a bank's capital gets too low, and it can't get any more capital, the bank is likely to fail. So the more capital a bank has, the more money it can stand to lose before going out of business. Higher levels of capital better protect depositors.

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.

The Capital Review
It is important that the Reserve Bank's banking regulations are up to date. There is also increasing evidence that the costs of bank failures – both economic and social (well-being) costs – are higher than previously understood. This is why we're reviewing the capital rules for banks.

The Reserve Bank has already consulted on how to measure the amount of a bank's capital.

The question we are asking now is:
What minimum level (percent) of a bank's money should come from its owners?

Our Proposals

[1] The Reserve Bank's 'Bank Financial Strength Dashboard' also provides some useful background information and relevant data on bank capital:
https://bankdashboard.rbnz.govt.nz/summary

Banks currently get the vast majority of their money by borrowing it (usually over 90 percent), with the rest coming from owners (usually less than 10 percent). The Reserve Bank is proposing to change this balance by requiring banks to use more of their own money. This proposal is consistent with steps taken by other banking regulators after the Global Financial Crisis.

The Reserve Bank is proposing this change to reduce the chances of banks failing in New Zealand. If banks in New Zealand fail, some of us might lose money and some of us might lose jobs. However, there would also be indirect costs on all of society that may be harder to see that would negatively impact the well-being of all New Zealanders. In the end, we would all bear the cost of bank failures, in one way or another.

This is why we want to make the chances of this happening very small – so small that a banking crisis in New Zealand shouldn't happen more than once every two hundred years. We are also making other proposals that would help ensure banks calculate how much capital they have more accurately.

Extent of changes
The proposal would see banks' capital levels increase materially. We are proposing to almost double the required amount of high quality capital that banks will have to hold.

In practice, actual changes to the amount that they hold will be less than double and will vary. The increase will depend on their current levels of capital, how much extra they choose to hold above the required minimum, and whether they are a large or small bank.

Generally, it will be an increase of between 20 and 60 percent. This represents about 70 percent of the banking sector's expected profits over the five-year transition period. We expect only a minor impact on borrowing rates for customers.

Possible Impacts
If banks increase their capital, they will be more resilient to economic shocks and downturns, which will strengthen New Zealand's banking system and economy.

What's the downside?

Because the level of a bank's capital can have an impact on the interest rate it charges on its loans, it is possible that higher capital requirements could make it more expensive for New Zealanders to borrow money from a bank. While we certainly take this into account, we think this impact should be minimal.

Another potential impact is that bank owners would earn less from their investment in the bank. While we agree that this is likely to be the case, we believe this cost would be more than offset by the benefits of a safer banking system for all.

What do you think?
Whether you agree or disagree with our proposals, or would like to contribute to the discussion, we'd like to hear from you.

A glossary of acronyms and terms used in this paper is available in Appendix 2.

Please send us your thoughts by 29 March 2019 to CapitalReview@rbnz.govt.nz