CHAPMAN TRIPP

To: Reserve Bank of New Zealand

On: Capital Review Paper 4: How much capital is enough?

17 May 2019

INTRODUCTION

This submission is from Chapman Tripp, PO Box 993, Wellington 6140.

We would be happy to meet with the Reserve Bank to discuss our submission. Our contacts are:

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ABOUT CHAPMAN TRIPP

Chapman Tripp is a leading law firm with a strong practice in banking and finance law. We welcome the opportunity to make a submission on the "Capital Review Paper 4: How much capital is enough?" (the *Consultation Paper*).

The Reserve Bank's proposal to increase the regulatory capital requirements of New Zealand banks is relevant to us and important to our clients, some of whom we are advising on the Reserve Bank's proposals.

PUBLICATION OF SUBMISSION

We do not have any objection to our submission or parts of it being published.

SUBMISSION

We do not state a view on what is an appropriate level of capital for banks or the increases proposed in the Consultation Paper. These are economic questions which are outside our area of expertise.

Rather, our submission looks at the context within which the Reserve Bank is carrying out the review and, in particular, the timing of the review.

Time needs to be spent getting the right outcome

We believe that the matters raised in the Consultation Paper, are of critical importance, not just to the New Zealand banking industry but to the broader economy.

It is therefore vital that sufficient time and resources are devoted to getting the right outcome and that decisions are made only after all the relevant issues have been thoroughly analysed. We note that the most recent Reserve Bank Statement of Intent includes among the "success measures" for the Bank's prudential supervision objectives "*…demonstrat[ing] a consultative and transparent approach to its policy development, supported by robust analysis that is understood by regulated institutions and stakeholders*"[1].

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1 Reserve Bank of New Zealand Statement of Intent 2018 – 2021, pg 26, published June 2018.

However we sense, from the tone of the Consultation Paper and the timeframes for responses, that the Reserve Bank is focused on concluding this process quickly.

We question the Reserve Bank's apparent urgency. New Zealand banks (in particular the four major banks) have consistently passed stress tests by the Reserve Bank (most recently in 2017[2]), and no issues have been raised in relation to the ability of New Zealand's banks to weather economic downturns by credit rating agencies or the IMF[3].

Costs/benefits need to be fully analysed

We do not consider that it is sufficient for the Reserve Bank to conduct the cost/benefit analysis after it has received all submissions and immediately before any final decisions are made, as contemplated in the Reserve Bank's 3 April 2019 background paper (the *Background Paper*)[4]. This will not give stakeholders any meaningful opportunity to comment on the factors the Reserve Bank has taken into account when making its assessment.

The proposed changes to bank regulatory capital requirements are significant – by reference not only to the impact on New Zealand banks, their customers and the New Zealand economy but also when compared with the corresponding prudential requirements in other jurisdictions. For this reason we think it is necessary that a cost/benefit analysis is carried out as part of the consultation process.

There have been historic concerns about how the Reserve Bank conducts and tests the cost/benefit analysis in respect of its preferred policy option and whether this is exposed to the same rigour as the cost/benefit analyses provided by stakeholders in support of alternative options. An example is the approach the Reserve Bank took to costing the outsourcing review[5]. In regards to the capital review, we note that market participants have commented that the Reserve Bank is overly optimistic about the benefits of its proposal and may have underestimated the potential costs.

While there may be a self-serving element to some of these criticisms and there is rarely agreement among economists, we think that, for proposals of this significance, it is important that the Reserve Bank is transparent and has an open mind to feedback. Without this, we question whether stakeholders will have confidence in the Reserve Bank's final decisions on the matter.

[2] In its conclusions to the 2017 stress test of major banks the Reserve Bank stated "*Outcomes from the test suggest that the four banks would be able to maintain capital levels above their minimum requirements during these scenarios*".

[3] IMF described the major New Zealand banks as "resilient to a severe global economic downturn" – see "New Zealand: Financial System Stability Assessment" (IMF Country Report 17/110, May 2017), pgs 22 to 24.

[4] Capital Review Background Paper: An outline of the analysis supporting the risk appetite framework – Page 1 Paragraph 5.

[5] See, for example, the Cost of Proposals section in the Reserve Bank's Regulatory Impact Statement – Revised Outsourcing Policy - February 2017.

We note that a "success measure" for the Reserve Bank is to provide "*....sound regulatory impact analyses of policies that the Reserve Bank intends to adopt…*".[6]

The level of capital should not be looked at in isolation

The Reserve Bank appears to be looking at the level of capital banks need to hold in isolation rather than in conjunction with other relevant factors and levers. The financial crises which lead to bank failures often result from a range of underlying issues in financial markets. Resolving these, and limiting the potential impact of them, requires the use of a range of prudential tools.

There is nothing in the information that the Reserve Bank has published to suggest that it has given any material consideration to the other tools in the prudential "toolkit" - such as open bank resolution (*OBR*), the core funding ratio and the liquidity coverage ratio.

This is in contrast to other jurisdictions when central banks have considered adjustments to the capital adequacy framework, based on our review.

In determining the capital levels under the European Capital Requirements Directive (CRD IV) and the Capital Requirements Regulations (CRR), for example, the European Commission also considered the management of liquidity risk, the definition of capital, counterparty credit risk and leverage ratios[7]. Likewise in respect of CRD V/CRR II, the proposed amendments provided a wide array of risk-reducing measures, including net stable funding requirements, total loss absorbing capacity (*TLAC*) requirements and a new market risk framework[8].

Separately, and notably, there is no indication in the Consultation Paper that the Reserve Bank has taken into account the impact that the outcome of the Reserve Bank Act Phase 2 review could have on the capital proposals. This seems strange to us, especially as the Consultation Paper was released within weeks of the Phase 2 discussion document.

The Phase 2 review is considering a range of issues that will directly affect core elements of the Reserve Bank's prudential "toolkit", especially in areas where New Zealand has been out of step with international norms. These could have an

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6 Reserve Bank of New Zealand Statement of Intent 2018 – 2021, pg 26, published June 2018.

7 See European Commission - Proposal for a Regulation of the European Parliament and of the Council on Prudential requirements for credit institutions and investment firms - 2011/0202 (COD) – see for example "2.2 Impact Assessment" page 5.

8 See European Commission - Adoption of the banking package: revised rules on capital requirements (CRR II/CRD V) and resolution (BRRD/SRM) – 16 April 2019.

Note also that in relation to the Swiss "too big to fail" legislation, the proposal included strengthening the amount (and type) of capital (which was subsequently reviewed and amended, including by introducing a TLAC requirement), stricter liquidity requirements, better risk diversification and organisational measures to ensure the continuance of systemically important functions if a bank should fail.

important bearing on considerations as to the optimal levels of capital for banks.

The Phase 2 review will look at the effectiveness of the crisis management powers of the Reserve Bank. This may result in an overhaul of the OBR regime, and the introduction of alternative resolution regimes[9].

The outcomes of the Phase 2 review may also have a bearing on other prudential "toolkit" decisions that the Reserve Bank still needs to make (for instance, whether New Zealand introduces a leverage ratio, further policy developments in relation to the countercyclical buffer and the possible introduction of TLAC as an additional capital requirement).

The Consultation Paper and the Background Paper considers in some detail the policy goals of the capital review, including weighing up the relative importance of the Reserve Bank's current objectives of soundness and efficiency. However, the Phase 2 review may change the meanings assigned to, and the relative weightings of, the soundness and efficiency objectives, and may add new objectives, such as consumer protection or public confidence.

Potentially even more significant are the questions in the Phase 2 review around depositor protection and the possible implementation of a depositor guarantee scheme.

We consider that such a scheme would directly influence the level of risk depositors were prepared to be exposed to at a personal account level, and that it might lead the New Zealand public to consider that a one in 200 year risk profile for banks is too conservative.

Further consideration of appropriate forms of capital instruments

While we understand the Reserve Bank's desire to ensure that any additional capital buffers should be of an appropriate quality, and that there are questions around the relative merits of going-concern and gone concern capital, we question the proposal to limit the form of the additional capital that is being proposed to Common Equity Tier 1 capital (*CET1*) only.

In this context we consider that the decisions made by the Reserve Bank in earlier consultations on what types of financial instruments should qualify as bank capital should be reconsidered.

CET1 capital may be simpler for the Reserve Bank to monitor and administer and, all other things being equal, we agree that simplicity should be preferred over complexity. But simplicity should not be the main determinant of what types of financial instruments qualify as bank capital.

[9] See for example Bank of England (Martin Brooks et al) "Measuring the Macroeconomic Costs and Benefits of Higher UK Bank Capital Requirements" (Financial Stability Paper No. 35, December 2015). This noted that, inter alia, the beneficial effects of improvements in the UK's resolution regime resulted in the authors arriving at a lower optimum capital ratio for UK banks than may otherwise be the case.

In determining the regulatory requirements, the Reserve Bank should focus on what is the most optimal capital composition from the perspective of the efficiency of the financial system. Alternative capital instruments can also contribute to soundness by creating another group of stakeholders with a vested interest in a bank's stability. Because they do not receive any upside return on their investment, they can be expected to be risk averse, with strong incentives to assert market discipline on the bank.

We note that the Reserve Bank is out of step with the methodology being adopted in other major jurisdictions, including Australia, where considerable thought is being given to the optimal capital composition[10]. We are concerned that the Reserve Bank's approach may be driven, at least in part, by constraints on its supervisory resources[11].

This seems a questionable justification, given that the cost of any increased resourcing by the Reserve Bank is likely to be significantly outweighed by the benefit of a more optimal capital position. Moreover, the resourcing and funding of the Reserve Bank is another of the key topics that the Phase 2 review is to consider – which, again, raises issues around the timing of the two reviews.

[10] See APRA Discussion Paper - Increasing the loss-absorbing capacity of ADIs to support orderly resolution 8 November 2018 (especially Chapters 2 and 3) and the KangaNews article in March 2019 "APRA's "door open" to ALAC developments" - http://www.kanganews.com/news/9803-apra-s-door-open-to-alac-developments.

[11] See for example the memorandum to the FSO from Financial Policy (Ian Woolford) dated 14 March 2016 entitled "A monkey on our back?" released by the Reserve Bank on 25 January 2019 as part of the background papers in relation to the review of capital.

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