Submission by

BusinessNZ

GROWING PROSPERITY AND POTENTIAL

to the

Reserve Bank

on the

Capital Review Paper 4: How much capital is enough?

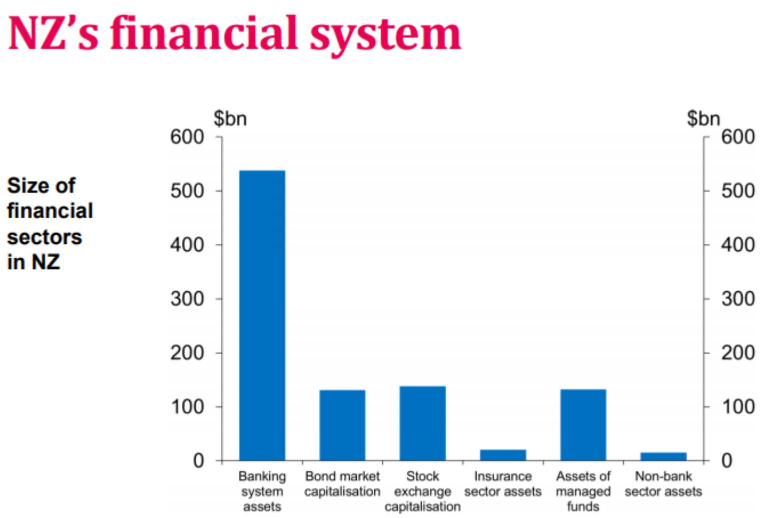
May 2019

CAPITAL REVIEW PAPER 4: HOW MUCH CAPITAL IS ENOUGH?
SUBMISSION BY BUSINESSNZ[1]

1.0 INTRODUCTION

1.1 BusinessNZ welcomes the opportunity to comment on the Capital Review Paper 4: How much capital is enough? ("the Review Paper").

1.2 BusinessNZ considers sound macro-prudential policy is important to the entire economy, with minimising risks to the banking system fundamental to the soundness of NZ's financial system.



Source: Reserve Bank of NZ

1.3 The NZ financial system came through the Global Financial Crisis (GFC) in reasonably good shape compared with many other countries, in no small part reflecting the quality of NZ's regulatory systems. Certainly, there was fall-out associated with the collapse of several finance companies but overall, the financial system managed reasonably well.

1.4 However a reasonable performance notwithstanding, it is entirely appropriate for the Reserve Bank to look seriously at the soundness of its current prudential management systems to see if anything more can be done to manage risk successfully. But in doing so it should keep in mind the optimal amount of resource available for reducing risk, given risk cannot be completely eliminated or if can, not without great cost. For example, imposing greater capital requirements on banks could boost financial stability but might well have the significant disadvantage of increasing the aggregate cost of capital.

[1] Background information on BusinessNZ is attached as Appendix 1.

1.5 The rationale for the changes is summarized on p.5 of the Review Paper: "*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 society that may be harder to see that would negatively impact the well-being of all New Zealanders. In the end, we would bear the cost of bank failures, in one way or another.*"

1.6 Given the Reserve Bank's recent discussion document on other significant issues, e.g. the proposal for mandatory depositors' insurance, care must be taken that in total, such actions do not lead to regulatory overkill. That could simply add to the cost of capital and/or reduce returns to depositors while potentially reducing the credit available both to smaller business and to particular sectors of the economy (outlined below).

1.7 From an economic perspective, risk involves two considerations:

1. The need for more resources, including time and money in order to reduce the amount of risk; and
2. How people will react – likely to indicate an acceptable level of risk well short of zero - in light of what must be given up in order to meet the increased cost of whatever is seen as desirable

1.8 BusinessNZ would welcome the opportunity to discuss the content of this submission, if the Reserve Bank felt this would be useful.

RECOMMENDATIONS

BusinessNZ **recommends** that:

Any moves towards the adoption of increased bank capital requirements should be made with caution, given the likely unintended consequences outlined in this submission. As a minimum, the Reserve Bank should undertake a comprehensive cost/benefit analysis of the proposals before any further steps are taken.

BusinessNZ **recommends** that:

Capital requirements are monitored and developed to ensure consistency with international capital standards, and that the analysis for this is provided by independent advisors. Given much of SME business capital funding is sourced through the banking sector we would not like to see NZ business borrowers having to pay unnecessary additional capital or borrowing costs where this is not commensurate with risk.

2.0 GENERAL DISCUSSION

2.1 Before coming to any decision as to the merits or otherwise of increasing bank capital requirements, it is crucial policymakers take a step back and ask some fundamental questions. These include – but are not limited to:

- Is there a problem *in New Zealand* with current capital requirements; (i.e. is there evidence of "market failure" which needs to be addressed)?
- If there is a problem, is the problem significant?
- What are the costs and benefits (including unintended costs) of increasing capital requirements?
- Will the proposal to adopt greater capital requirements effectively address the alleged problem of financial risk (and if so at what cost)?
- Are there potential options for improving outcomes which don't impose significant costs (e.g. by improving information to market participants)?

2.2 In order to justify government intervention, there must be a clear case of market failure and the market failure problem must be significant. Moreover, there is a need to be certain any regulatory action taken will address the alleged problem in a cost-effective manner.

2.3 Given markets are generally faster at self-correcting than are government intervention efforts, the onus must be on government to prove beyond reasonable doubt that the benefits of greater intervention (increased capital requirements) will exceed the cost, including any unintended cost, consequent upon regulation.

2.4 Regulators usually have strong incentives to minimise their own risk by imposing higher standards than might otherwise be justified. Because regulators do not bear the costs of their decisions (costs will ultimately be passed on to investors/consumers), they may over-regulate rather than take account of the cost/quality trade-offs investors/consumers are willing to make. Given each is unique, individuals will have different risk profiles - some will pay a considerable amount to minimise risk, others will want to invest little in reducing either real or perceived risk.

2.5 The Review Paper proposes the doubling of banks' minimum "high quality" capital requirements in order to reduce the risk of bank failure to once every 200 years. As most banks at present carry significantly more capital than the minimum level government currently requires, a doubling of existing capital held will not be needed. The Review Paper suggests overall capital requirements would have to increase between 20 percent and 60 percent; this would represent about 70 percent of the banking sector's expected profits over a five-year transition period.

2.6 Arguably, increasing capital requirements will potentially reduce the risk of bank failure and therefore the potential political pressure on the government (the taxpayer) of the day to fund bail-outs (however exceptional the circumstances might be). Nevertheless, an increase would come at a cost, both in respect to economic growth (as outlined in the Review Paper) and the potential impact of restrictions on lending (outlined below). The issue of moral hazard also has potential here – with less risk of bank failure reducing incentives on individuals and investors to monitor bank behaviour.

2.7 While the Review Paper indicates the proposal to increase capital requirements significantly is targeted at minimising the risk of bank failure to a 1 in 200-year event, nowhere in paper is there any detailed evaluation of the proposal's costs and benefits. Why 1-in-200 years? Why not 1-in-1000, or 1-in-10?

2.8 The Review Paper states that a 0.5 percent annual risk tolerance is embedded in insurance solvency standards across Europe but this has little, if any, relevance to NZ conditions.

2.9 It is acknowledged that the (overseas) studies cited suggest a strong relationship between capital requirements and lowering the risk of bank failure but as the Review Paper states in para 50 – p.22, *"…..it is important to also consider the New Zealand-specific context."*

2.10 Over the last 3 decades, New Zealand has been held up as having developed world class fiscal and monetary policy settings. These include the Reserve Bank Act's independent monetary policy and the country's fiscal policy, as espoused by the Fiscal Responsibility Act (now superseded by the Public Finance Act). Successive governments have, over the years, largely endorsed both these essential pillars of NZ's economic policy, with only minor tweaks here and there.

2.11 As mentioned earlier, the NZ financial system came through the Global Financial Crisis in reasonably good shape compared with many other countries, in no small part reflecting the soundness and quality of its regulatory systems. Certainly, there was fall-out associated with the collapse of several finance companies but overall, the financial system managed reasonably well. Areas of actual weakness have been largely dealt with by imposing greater transparency and reporting requirements on finance companies.

2.12 The Swiss investment bank UBS has published a research paper outlining the possible impact on consumers of what is proposed, particularly the increased cost of capital. According to UBS, the proposals could add between 80 and 125 basis points to mortgage costs as banks attempt to claw back the added capital costs.

2.13 Moreover, the UBS study estimates the proposals would see NZ overtake Norway in having the highest bank capital requirements in the developed world.

2.14 The Reserve Bank Governor has acknowledged increased capital requirements would add around 20 to 40 basis points additional premium between the costs at which banks borrow and lend. The increase would be passed on to borrowers as banks would have to raise equity, not just leverage debt. On the other hand, the Reserve Bank considers the increased capital requirement would reduce the risk of bank failure while lower risk would make it cheaper to attract equity since investors' expected rate of return would be lower as their institution would be safer. While this is possible, it still does not reduce the potential for simply passing the increase on to borrowers and small businesses as an added cost of borrowing or potentially, as a restriction on the ability to borrow through credit rationing (outlined below).

2.15 While the Reserve Bank has been keen to promote the argument that borrowing costs might actually be lower and returns on capital might not need to be so high if investors have confidence their investment is very secure, it is noteworthy that at least 2 credible international credit rating agencies have questioned whether in fact this would be the case if capital requirements were increased.

2.16 Standard & Poors has calculated that increased capital requirements by themselves will not impact on the four "big" banks' credit rating. And if their credit ratings are not lifted, it appears unlikely they will get the cheaper credit the Reserve Bank appears to suggest.

2.17 In December 2018, Fitch Ratings said the proposals were "radical" and "highly conservative relative to international peers" but that the result would ultimately be "significantly stronger buffers" against system shocks.

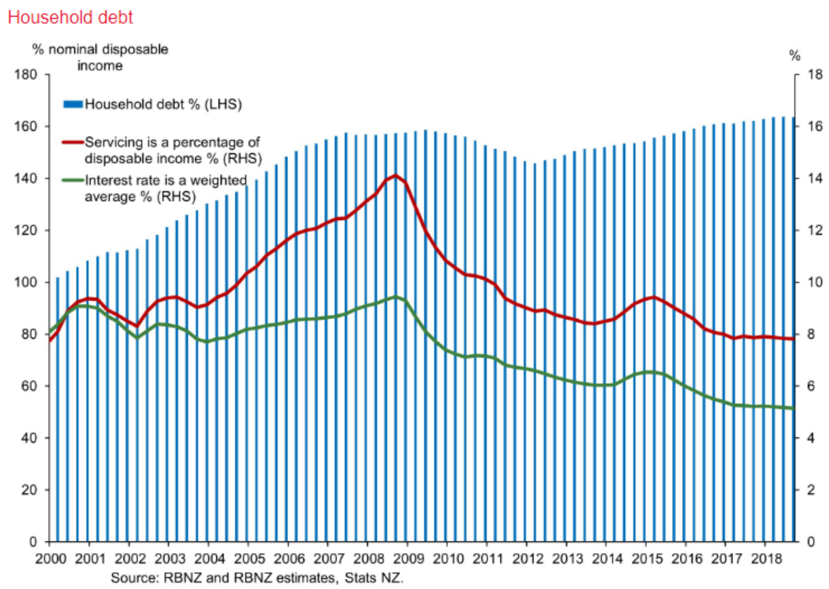
2.18 The potential impact on capital markets of raising the required capital could be significant when $15-$20 billion is likely involved. This amount of capital raising in not insignificant and as in reality New Zealand is not a capital rich country, the additional capital would likely have to come from offshore. Given economies of scale and the smallness of the NZ economy by international standards, it is also likely a risk premium would be involved. And while it is accepted the Reserve Bank proposes a phased-in approach over 5 years, the potential impact on capital raising should not be underestimated. To put this in context, the total capitalisation of the NZ sharemarket is only around $150 billion.

2.19 The proposed increase could potentially affect lending in two important ways. First, banks could lend less, thereby reducing the need for capital enhancement. Second, they could try and pass on some of the additional cost to borrowers making mortgage finance both increasingly difficult and expensive to obtain.

2.20 It is important that any changes to macro-prudential policy tools the Reserve Bank might make should reflect the above points, particularly where a proposed change could have an unintended impact, including on economic efficiency or equity.

2.21 While it almost goes without saying that the "benefits of regulation must outweigh the costs" if regulation is to be justified, it is also important to determine not only total costs and benefits (including potential unintended costs and/or benefits) but also where expected costs and benefits might fall. For example, in the case of higher bank capital requirements, the benefits (if any) might be widely dispersed but the costs fall on particular sectors. The distributional and equity effects of such a proposal on particular groups must be considered.

2.22 The distributional and equity effects would likely have an added impact on the NZ economy given households' relatively high net debt and particularly agricultural sector debt. Household debt levels are currently in excess 160 percent of disposable income (compared to around 100 percent in 2000 – see graph below).



2.23 Meanwhile. agricultural debt has continued to ratchet up and is currently sitting at around $63 billion (up from $12 billion in 2000), with around two-thirds of debt focused on the dairy sector.

2.24 Any significant change in interest rates could be enough to tip households and businesses over the edge with flow-on effects for creditors and the economy in general through reduced levels of activity.

2.25 While agricultural debt has increased five-fold over the period, other sectors have also shown significant increases but not to the same extent, with household debt having increased nearly four-fold and business debt increasing nearly three-fold over the same period (see table below)

Sector Lending (registered banks and non-bank lending institutions)

	Previous years:		*Monthly:*				
	Jan 2017	*Jan 2018*	*Sep 2018*	*Oct 2018*	*Nov 2018*	*Dec 2018*	*Jan 2019*
Housing ($m)							
Total	231,942	244,890	254,838	255,998	257,499	258,686	**259,870**
Registered banks [1]	230,227	242,712	252,319	253,460	254,928	255,979	**257,152**
Non-bank lending institutions [2]	1,715	2,177	2,519	2,538	2,571	2,708	**2,719**
Personal consumer ($m)							
Total	15,245	16,558	16,654	16,674	16,836	16,986	**16,927**
Registered banks	10,527	11,253	11,217	11,217	11,329	11,383	**11,315**
Non-bank lending institutions [2]	4,719	5,305	5,437	5,457	5,507	5,603	**5,612**
Housing and personal consumer ($m)							
Total	247,187	261,448	271,492	272,672	274,335	275,672	**276,797**
Registered banks	240,754	253,965	263,537	264,678	266,257	267,362	**268,466**
Non-bank lending institutions	6,434	7,483	7,955	7,995	8,079	8,310	**8,330**
Business ($m)							
Total	101,783	107,409	111,534	113,111	113,177	**113,021**	**113,557**
Registered banks	97,267	102,781	106,938	108,513	108,521	**108,321**	**108,828**
Non-bank lending institutions [2]	4,516	4,628	4,596	4,598	4,656	4,700	**4,729**
Agriculture ($m)							
Total	59,356	60,669	62,212	62,273	62,474	62,573	**62,882**
Annual growth rate (%)							
Housing [3]	9.2	5.8	6.0	6.0	6.2	6.1	**6.1**
Personal consumer [3]	4.8	8.6	4.7	3.6	3.7	**2.3**	**2.1**
Housing and personal consumer [3]	8.9	6.0	5.9	5.8	6.0	5.9	**5.9**
Business [3]	6.2	5.1	4.9	4.3	4.5	4.9	**5.7**
Agriculture [3]	3.7	2.2	2.6	2.8	3.0	3.4	**3.6**

Source: Reserve Banks of NZ

2.26 A 100 basis point increase in interest payments of household debt would add about $2.6 billion on annual interest rates cost facing households while a 50 basis points increase would add about $1.3 billion to interest costs. In respect to the agricultural sector, a 100 basis point increase in interest rates would add around $630 million in interest costs facing the agricultural sector while a 100 basis point increase in business debt would add in excess of $1 billion to interest costs.

2.27 Given the significance of the agricultural sector to the NZ economy (unique in the world compared with most developed countries), it is important restrictions on lending to that sector and/or increasing the cost of capital do not put added pressure on specific sectors, the more so in light of international trading arrangements' current uncertainty.

2.28 Home-ownership, generally speaking, has a number of benefits so that restricting the ability of certain groups to enter the market without adequate cause is problematic. It also acts against the current and previous government's promotion of mechanisms to increase the home ownership rates of, particularly, younger lower income people. As well, the impact on the availability and cost of small business finance could similarly be problematic.

2.29 Many small business owners use housing mortgage finance to partially fund business activities. They may do this for a variety of reasons including, but not limited to, the fact that housing mortgage finance is generally less costly than business finance. By in effect restricting this source of finance, the ability of many small business ventures to get off the ground could be unnecessarily restricted.

2.30 According to the Ministry of Business, Innovation and Employment, 97 percent of New Zealand businesses employ fewer than 20 people. Many small businesses have little in the way of assets to offer as collateral for loans, so often personal housing is used as security.

2.31 The UBS study states that: *"In effect, we estimate New Zealanders could end up paying between NZ$1.9 billion and $2.7 billion more on their home loans each year to fund the additional capital requirements proposed by the RBNZ to reduce the theoretical probability of a financial crisis from once-every 100 years to once-every-200 years."* (p.8)

2.32 While there would likely be some political pressure on banks not to pass on added costs, either through direct regulatory constraints or other political means, there is a risk of mechanisms to try and restrict consumer cost increases affecting consumers in other ways. Greater bank restrictions on loans to potentially marginal customers would be the most obvious.

2.33 It is possible the Reserve Bank could lower the Official Cash Rate (OCR) in an attempt to compensate for any impact a mandatory capital requirement increase might have on mortgage interest rates but this would not necessarily affect restrictions on lending requirements for specific sectors. It would also call into question the rationale for greater capital requirements if the immediate effect were to increase mortgage interest rates. Such matters would need to be considered as part of the cost-benefit analysis BusinessNZ recommends the Reserve Bank undertake before deciding to substantially raise banks' minimum capital requirements.

2.34 Further, with OCR currently sitting at 1.75 percent, there is little real room for any significant reduction as the Reserve Bank should recognise the need to leave a little in the tank (i.e. ability to reduce the OCR) should the NZ (or world economy), face a significant downturn. Reducing the OCR to compensate for placing greater capital requirements on banks would be like selling the family silver for a substantially discounted price.

2.35 That the proposed capital requirements are directed only to banks, with other financial institutions arguably not affected, could be considered inequitable and encourage greater lending in less regulated sectors of the economy - not necessarily desirable. However, it is accepted that as NZ's four "big" banks provide most of the country's mortgage finance, the failure of smaller lending institutions would be unlikely to cause the NZ economy much financial instability. More likely, the net effect would be an increase in the cost of capital for sectors considered to pose a risk to the financial system.

2.36 BusinessNZ strongly adheres to the idea of *travelling up the regulatory pyramid,* that is, considering non-regulatory options first, moving "up the pyramid" to generic light-handed options and introducing more stringent measures only if clearly warranted.

2.37 Since different banks will have different market shares and often specialise in lending to specific sectors, the implications for the banks themselves will need to be examined carefully to avoid any undue impact both on particular banks and on the sectors they lend to.

2.38 Arguably, a reasonable amount of time will be needed if undue disruption to banks, individuals and businesses is to be avoided, allowing for planning ahead with some certainty knowing the rules are not going to change abruptly.

2.39 BusinessNZ accepts that at this stage of the policy development process, a proper understanding of the proposal's costs and/or benefits might be lacking but considers it crucial to obtain reasonably accurate information before proceeding further. The process should not continue on the basis of a "perceived" problem without first establishing both actual and to the extent possible, unintended costs.

2.40 Given the points raised above, BusinessNZ does not support any increase in bank capital requirements. This conclusion notwithstanding, Business NZ considers there could be merit in providing individuals and businesses with greater information about the risks of investing, potential returns and the need to ensure the use of adequate risk management techniques to minimise the possibility of significant failure. The information campaign should not be directed only to bank depositor risk but also to risk generally, particularly as it appears many are not fully informed of the benefits and costs associated with property or health insurance or the many other risks individuals and businesses face daily.

BusinessNZ **<u>recommends</u>** that:

Any moves towards the adoption of increased bank capital requirements should be made with caution, given the likely unintended consequences outlined in this submission. At minimum, the Reserve Bank should undertake a comprehensive cost/benefit analysis of the proposals before any further steps are taken.

BusinessNZ **<u>recommends</u>** that:

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Appendix One - Background information on BusinessNZ

BusinessNZ is New Zealand's largest business advocacy body, representing:

- Regional business groups EMA, Business Central, Canterbury Employers' Chamber of Commerce, and Employers Otago Southland
- Major Companies Group of New Zealand's largest businesses
- Gold Group of medium sized businesses
- Affiliated Industries Group of national industry associations
- ExportNZ representing New Zealand exporting enterprises
- ManufacturingNZ representing New Zealand manufacturing enterprises
- Sustainable Business Council of enterprises leading sustainable business practice
- BusinessNZ Energy Council of enterprises leading sustainable energy production and use
- Buy NZ Made representing producers, retailers and consumers of New Zealand-made goods

BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy and services for enterprise, BusinessNZ contributes to Government, tripartite working parties and international bodies including the International Labour Organisation (ILO), the International Organisation of Employers (IOE) and the Business and Industry Advisory Council (BIAC) to the Organisation for Economic Cooperation and Development (OECD).