Submission

By

THE NEW ZEALAND INITIATIVE

to the Reserve Bank of New Zealand

on

The Review of the Capital Adequacy Framework for locally incorporated banks: How much capital is enough?

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1. INTRODUCTION AND SUMMARY

1.1 This submission in response to the review by the Reserve Bank of New Zealand (**RBNZ**) of the capital adequacy framework for registered banks (the **Review**) is made by The New Zealand Initiative (the **Initiative**), a Wellington-based think tank supported primarily by chief executives of major New Zealand businesses. In combination, our members provide employment to more than 150,000 people.

1.2 The Initiative undertakes research that contributes to the development of sound public policies in New Zealand which help create a competitive, open and dynamic economy and a free, prosperous, fair, and cohesive society.

1.3 Our submission focuses on three issues:

(a) The relationship between the bank capital proposal and the RBNZ's statutory objectives as set out in section 1A of the Reserve Bank of New Zealand Act 1989 (**the Act**);

(b) The need for a full cost-benefit analysis to evaluate the proposal to almost double the required amount of high-quality capital that banks will have to hold to reduce the risk of bank failure to once in 200 years (**the bank capital proposal**); and

(c) The relationship between the RBNZ's consultation on the proposal and the separate Phase 2 review process being undertaken at the direction of the Minister of Finance, *Safeguarding the future of our financial system: The role of the Reserve Bank and how it should be governed* (**the Phase 2 review**).[1]

1.4 In summary, we consider:

(a) In advancing the bank capital proposal, the RBNZ has misdirected itself in relation to its statutory objectives. The "risk appetite framework" supporting the bank capital proposal proceeds on the mistaken assumption that the bank's statutory objective is soundness first, and efficiency second.[2] This is incorrect. The RBNZ is charged with "promoting the maintenance of a sound **and** efficient financial system" [emphasis added].[3] Like other forms of safety, soundness should only be pursued to the extent it is efficient to do so. That is, if the benefits exceed the costs. The RBNZ would be acting unlawfully if it implemented its bank capital proposals on the basis of the decision-making framework it has adopted.

(b) Borrowers, depositors and participants in the wider economy are all likely to be harmed if the bank capital proposal is implemented (not to mention the affected banks themselves). The RBNZ's estimates suggest the potential harm of the bank capital proposal could be significant (and the RBNZ's calculations may *underestimate* the potential adverse effects of the proposal). Given the potential costs, the RBNZ should not be proposing this change of regulatory policy without first undertaking a full cost-benefit analysis. The bank's omission to do this is inconsistent with good regulatory practice and is liable to judicial review.

(c) The RBNZ's proposals on bank capital requirements cut across the separate Phase 2 review the RBNZ is undertaking jointly with Treasury. The two consultation processes are inter-related. The RBNZ cannot fairly consult *separately* on whether to introduce deposit insurance *and* whether to double banks' capital requirements. The bank capital

[1] RBNZ and Treasury, "Safeguarding the Future of Our Financial System: The Role of the Reserve Bank and How It Should Be Governed," Consultation 1 Phase 2 of the Reserve Bank Act Review (Auckland: 2018).
[2] RBNZ, "Capital Review Paper 4: How Much Capital is Enough?" (Wellington: RBNZ, 2019), [13–28].
[3] Section 1A(b), Reserve Bank of New Zealand Act 1989.

proposal consultation process should therefore be suspended until after the Phase 2 review process has been completed and decisions made in response to it. Alternatively, the Bank should explicitly conduct these consultations jointly, so that the processes inform each other.

2. THE RBNZ HAS MISDIRECTED ITSELF IN RELATION TO ITS STATUTORY OBJECTIVES

2.1 The Initiative addressed the RBNZ's statutory objectives in its submission responding to the Phase 2 review process.[4] The RBNZ's existing, high-level financial policy objective is to "Promote the maintenance of a sound and efficient financial system".[5] The statutory objective is soundness *and* efficiency. It is not soundness *at any cost*.

2.2 "Soundness" is an important attribute of an efficient financial system. But it is important only to the extent it promotes efficiency. Expressed differently, soundness, like other forms of safety, is best only pursued to the extent that the benefits to the community exceed the costs.[6] It is not an over-riding objective.

2.3 The bank capital consultation proceeds on the mistaken assumption that the bank's objective is soundness first, and efficiency second. This is apparent from the RBNZ's assessment of its risk appetite framework in the RBNZ's *Capital Review Paper 4: How much capital is enough?* (**Paper 4**).[7] Paper 4 discloses that the RBNZ has proceeded as follows:

- First determine what "soundness" means (and the level of capital required to achieve it). This exercise is undertaken independently of any concept of efficiency. And in the RBNZ's working papers it involves the adoption of an (arbitrary) 1-in-200-year risk appetite for bank failure; and
- Then (and only then) consider how to deliver efficiency *having regard to the already selected criteria for soundness*.[8]

2.4 In Paper 4, the RBNZ describes the process as follows:[9]

> 23. Our risk appetite framework can be summarised as follows:
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> - Ensure the banking system can retain the confidence of creditors when subject to an extreme shock, which means being solvent in a regulatory sense (delivering 'soundness'); and
> - Having set bank capital to at least achieve the soundness objective, take advantage of opportunities to generate more stability if doing so is unlikely to impose any material loss of expected output (delivering 'efficiency').

2.5 This approach misconstrues the RBNZ's statutory obligation by relegating "efficiency" to a second-order criterion. As a consequence, we consider the RBNZ has misdirected itself in law as to its statutory purpose. The RBNZ would therefore be acting unlawfully if it implemented its

[4] Roger Partridge and Bryce Wilkinson, "Submission: Phase 2 of the Reserve Bank of New Zealand Act Review" (Wellington: New Zealand Initiative, 2019).
[5] Section 1A(b), Reserve Bank of New Zealand Act 1989.
[6] Roger Partridge and Bryce Wilkinson, "Submission: Phase 2 of the Reserve Bank of New Zealand Act Review," op. cit. [2.3].
[7] RBNZ, "Capital Review Paper 4: How Much Capital is Enough?" op. cit. [13–28].
[8] Ibid.
[9] Ibid. [23].

bank capital proposals on the basis of the risk appetite framework outlined in its Paper 4 supporting the proposal.

3. THE RBNZ SHOULD SUSPEND THE CONSULTATION PROCESS UNTIL AFTER IT HAS UNDERTAKEN A COST-BENEFIT ASSESSMENT

The bank capital proposal will have adverse impacts on borrowers and the wider economy

3.1 According to the RBNZ's assessments, implementing the bank capital proposal will have *some* adverse effects for borrowers and the wider economy. However, Paper 4 claims there will be "only minor impacts on borrowing rates for customers".[10]

3.2 Yet, the RBNZ's recently released Capital Review Paper (**the Capital Review Paper**) suggests that for every 1% rise in bank Tier 1 capital, lending rates will rise by 8.1-basis-points.[11] With the proposal involving a near doubling of banks' tier 1 capital from, the RBNZ's own estimates suggest the bank capital proposal could see lending rates increase by around 0.5% or more.

3.3 These estimates relate to *average* lending rates. It is likely some sectors – especially capital-intensive sectors – will face higher borrowing costs. Such sectors are likely to include high loan-to-value borrowers (including first-time borrowers), the rural sector, and small-to-medium sized enterprises.

3.4 The RBNZ also estimates that the bank capital proposals will have an adverse impact on the wider economy. According to evidence referred to in the Capital Review Paper, every 1% rise in bank Tier 1 capital could lead to an 8-basis-point decline in GDP.[12] On these numbers, the RBNZ's bank capital proposal could see a decline in steady-state GDP of 0.32% or more.[13]

3.5 As the RBNZ acknowledges, the estimated basis point effects on lending rates and GDP could be greater (or less) than these estimates depending on the assumptions made. We are aware that several market participants, including UBS, the investment bank,[14] and ASB, the trading bank,[15] have estimated more serious adverse effects. Adverse effects on savers through lower deposit rates have also been predicted.[16]

3.6 But even on the RBNZ's more optimistic numbers, the impacts on financial markets' participants and the wider economy are significant.

Need for a full cost-benefit analysis

3.7 We acknowledge the RBNZ has adopted a net-benefits framework for the analysis in its 3 April 2019 Capital Review Paper.[17] However, given the potential for adverse effects from the bank

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[10] RBNZ, "Capital Review Paper 4: How Much Capital is Enough?" op. cit. 5–6.
[11] RBNZ, "Capital Review Background Paper: An Outline of the Analysis Supporting the Risk Appetite Framework" (Wellington: RBNZ, 2019), 36. 'Tier 1' capital refers to the equity provided by shareholders and 'equity-like' debt funding.
[12] Ibid. 37.
[13] Ibid. 37.
[14] Jenny Ruth, "UBS doubles down on impact of RBNZ bank capital requirements," *Scoop Business* (27 February 2019).
[15] ASB, "Economic Note: What to Make of the Proposed Bank Capital Requirements" (Auckland: 2019).
[16] Ibid.
[17] RBNZ, "Capital Review Background Paper: An Outline of the Analysis Supporting the Risk Appetite Framework" op. cit. 20-44.

capital proposal, the RBNZ should have undertaken a full cost-benefit assessment. This was needed to inform the RBNZ's decision-making prior to making the proposal and to inform those participating in the RBNZ's consultation process in relation to the proposal and enable them to critique and respond to it.

3.8 Cost-benefit analysis is a fundamental requirement of good regulatory decision-making. Indeed, the *Government Expectations for Good Regulatory Practice* specifically provides that:[18]

> Before a substantive regulatory change is formally proposed, the government expects regulatory agencies to provide advice or assurance on the robustness of the proposed change, including by:
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> …
>
> - Making genuine effort to identify, understand, and estimate the various categories of cost and benefit associated with the options for change… [emphasis in original]

3.9 The RBNZ's decision to defer undertaking a full cost-benefit analysis is contrary to the legitimate expectations of the parties affected by the proposals, including all current and future borrowers and depositors.

3.10 The RBNZ said in its recently released Capital Review Paper that it will undertake a cost-benefit assessment to "inform and describe final decisions in the Review".[19] However, the RBNZ's approach to date suggests it has a preconceived notion of the "correct" level of capital the banks should hold. This is apparent from the initial failure to provide any meaningful justification of the 1-in-200-year threshold which drives the bank capital proposal, and from the RBNZ's vocal advocacy in favour of its proposal during the course of the public consultation process.[20]

3.11 Consequently, an *ex post* cost-benefit analysis is susceptible to challenge on the grounds of pre-determination. The assessment is needed as *part of the policy formulation process*, not to describe "final decisions". And an *ex post* assessment will not have the benefit of testing and challenge during the public consultation phase. Nor will it help inform discussion about the advantages and disadvantages of the RBNZ's proposal.

3.12 We consider the RBNZ should:

- suspend consultation on the bank capital proposal until it has completed a full cost-benefit assessment;
- reconsider whether it is appropriate to modify the banks' capital proposal having regard to the results of the full cost-benefit assessment; and
- submit any modified proposal, together with the cost-benefit assessment, for further public consultation.

3.13 Alternatively, the RBNZ should conduct a second round of consultation after it has completed its full cost-benefit analysis.

[18] Treasury, "Government Expectations for Good Regulatory Practice," op. cit. 4.
[19] RBNZ, "Capital Review Paper 4: How Much Capital is Enough?" op. cit. 4.
[20] See, for example, Jenny Ruth, "Orr notes limitations in bank stress tests," *The New Zealand Herald* (15 January 2019) and Hamish Rutherford, "Reserve Bank says bank profits may be out of proportion to risks they face, *Stuff* (13 February 2019).

4. THE BANK CAPITAL CONSULTATION PROCESS CONFLICTS WITH THE PHASE 2 CONSULTATION PROCESS AND SHOULD BE DEFERRED

4.1 Consultation on the RBNZ's bank capital proposals is occurring in tandem with the Phase 2 consultation process. Among other matters, the Phase 2 review process addresses the following issues:

- The RBNZ's high-level financial policy objectives (discussed in section 3 above);
- Whether we should have depositor protection in New Zealand; and
- How the RBNZ should be governed.

4.2 The bank capital proposal is *directly related* to the depositor protection question raised in the Phase 2 consultation process. The level of bank capital has a bearing on the need for depositor protection, and *vice versa* (the risk of a run-on-the-bank is reduced if deposits are subject to a statutory insurance scheme).

4.3 As a consequence, the RBNZ cannot fairly consult *separately* on whether to introduce deposit insurance *and* whether to double banks' capital requirements.

4.4 Apart from the other matters addressed in this submission, we consider the capital requirements consultation process should be suspended until after the Phase 2 process has been completed and decisions made in response to it. This would have the added advantage of enabling the bank capital proposal, or any other proposals the RBNZ wishes to put forward having regard to the matters addressed in this submission, to be subjected to any new governance and decision-making processes introduced as a consequence of the Phase 2 review process.

4.5 Alternatively, the Bank could explicitly conduct these consultations jointly, so that the processes inform each other.

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