TE TAI ŌHANGA
THE TREASURY

Reference: 20190546

8 October 2019

[redacted]

Thank you for your Official Information Act request, received on 14 August 2019. You requested the following:

> *any reports, papers, submissions and advice prepared by Treasury relating to the RBNZ's review of capital requirements for locally incorporated banks.*
> *I would like the request to incorporate any correspondence with ministerial advisers and/or the RBNZ on the topic.*

In a subsequent conversation with the Treasury, you clarified that "correspondence with ministerial advisers and/or RBNZ on the topic" refers to correspondence with substantial advice or debate on the Reserve Bank of New Zealand's review of capital requirements for locally incorporated banks.

A response to your request was originally due on 13 September 2019, but the Treasury extended the response time for this request.

Information being released

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	28 November 2017	Aide Memoire: Briefing for meeting with Westpac on 30 November 2017	Release in part
2.	15 January 2018	Aide Memoire: RBNZ Capital Review	Release in part
3.	28 February 2019	Aide Memoire: Meeting with NZBA	Release in part
4.	19 March 2019	Treasury Report: Meeting with OECD delegation to discuss their 2019 Draft Survey of New Zealand	Release in part
5.	4 April 2019	Aide Memoire: Meeting with BNZ	Release in part
6.	5 April 2019	Aide Memoire: Meeting with ANZ Group Chief Economist	Release in part

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https://treasury.govt.nz

7.	30 April 2019	Aide Memoire: Meeting with ASB	Release in part
8.	9 May 2019	Treasury Report: OECD Economic Survey Update	Release in part
9.	9 May 2019	New Zealand Economic Survey – New Zealand 1 pager	Release in part
10.	6 June 2019	Aide Memoire: Meeting with SBS Bank	Release in part
11.	11 June 2019	Aide Memoire: Meeting with Oliver Hartwich, The New Zealand Initiative: RBNZ reforms and bank governance	Release in part
12.	19 June 2019	Aide Memoire: Meeting with Westpac on 25 June 2019	Release in part
13.	19 June 2019	Treasury Report: Launch of OECD Survey of New Zealand 2019	Release in part
14.	11 July 2019	Aide Memoire: Talking points for the NZ Initiative lunch	Release in part
15.	23 July 2019	Aide Memoire: Meetings with Citi on 25 July 2019	Release in part
16.	19 June 2019	Banking matters – FEC June 19	Release in part
17.	18 December 2017	Bullet points for the PM's attendance of the NZBA dinner on 18 December 2017	Release in part
18.	30 April 2019	Draft RBNZ's Bank Regulatory Capital Proposals: Key topics Treasury internal discussion	Release in part
19.	21 May 2019	Briefing – Secretary and Deputy Secretary Meeting with Banks	Release in part
20.	28 May 2019	Internal Working Document: Comparison of RBNZ and Sapere Capital Adequacy Analyses	Release in full
21.	26 July 2019	Treasury Report: Reserve Bank review of capital requirements for locally incorporated banks	Release in part
22.	26 March 2019	Email: Input for aide-memoire for meeting with BNZ	Release in full
23.	26 March 2019	Attachment: Reserve Bank Aide memoire: Meeting with the National Australia Bank Acting CEO and Chair Designate, and Bank of New Zealand Chairman on 8 April 2019 (attachment to item 22 – Email: Input for aide-memoire for meeting with BNZ)	Release in part
24.	21 May 2019	Email: Re: Background and talking points on Capital Review	Release in full
25.	21 May 2019	Email: Re: Background and talking points on Capital Review	Release in full
26.	22 May 2019	Email: TSY-RBNZ discussion on Capital Review	Release in full

27.	23 May 2019	Email: Re: TSY-RBNZ discussion on Capital Review	Release in full
28.	23 May 2019	Attachment: Agenda for meeting (attachment to item 27 – Email: Re: TSY-RBNZ discussion on Capital Review)	Release in full
29.	23 May 2019	Attachment: Email: sectoral impacts of capital review (attachment to item 27 – Email: Re: TSY-RBNZ discussion on Capital Review)	Release in full
30.	23 May 2019	Attachment: Stylised example of RWA (attachment to item 27 – Email: Re: TSY-RBNZ discussion on Capital Review)	Release in full
31.	24 May 2019	Email: Re: Follow-up from May 23 meeting	Release in full
32.	27 May 2019	Email: Follow-up from 23 May meeting	Release in full
33.	27 May 2019	Attachment: Copy of RBNZ Q&A – The Capital Review (attachment to item 32: Email: Follow-up from 23 May meeting)	Release in full
34.	28 May 2019	Email: Re: Follow up from 23 May meeting	Release in full
35.	5 June 2019	Email: Re: Minister’s meeting with SBS bank- content on capital review	Release in full
36.	16 July 2019	Email: Re Treasury advice on capital framework proposal	Release in part
37.	5 August 2019	Email: Additional Info	Release in full
38.	11 September 2019	Email: Re: Capital and bank failure	Release in part

I have decided to release the relevant parts of the documents listed above, subject to information being withheld under one or more of the following sections of the Official Information Act, as applicable:

- information provided by the Government of any other country or any agency of such a Government under section 6(b)(i),
- to protect information where the making available of the information would be likely unreasonably to prejudice the commercial position of the person who supplied or who is the subject of the information under section 9(2)(b)(ii),
- personal contact details of officials, under section 9(2)(a) – to protect the privacy of natural persons, including that of deceased natural persons,
- advice still under consideration, section 9(2)(f)(iv) – to maintain the current constitutional conventions protecting the confidentiality of advice tendered by Ministers and officials,
- advice, under section 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions, and
- direct dial phone numbers of officials, under section 9(2)(k) – to prevent the disclosure of information for improper gain or improper advantage.

In addition, a paragraph in Item 23: *Reserve Bank Aide memoire: Meeting with the National Australia Bank Acting CEO and Chair Designate, and Bank of New Zealand Chairman on 8 April 2019* has been withheld under section 105 of the Reserve Bank of New Zealand Act 1989.

Some information has been redacted because it is not covered by the scope of your request. This is because the documents include matters outside your specific request.

Direct dial phone numbers of officials have been redacted under section 9(2)(k) in order to reduce the possibility of staff being exposed to phishing and other scams. This is because information released under the Official Information Act may end up in the public domain, for example, on websites including the Treasury's website.

Information publicly available

The following information is also covered by your request and is, or will soon be, publicly available on the Reserve Bank of New Zealand and New Zealand Bankers' Association websites:

Item	Date	Document Description	Website Address
39.	3 April 2019	Capital Review Background Paper: An outline of the analysis supporting the risk appetite framework	https://www.rbnz.govt.nz/regulation-and-supervision/banks/capital-review-proposals-information-release
40.	7 May 2019	How much capital is enough – a review of Reserve Bank Tier 1 capital proposals	https://www.nzba.org.nz/wp-content/uploads/2019/05/Appendix-One-Dr-Graham-Scott-report.pdf
41.	May 2019	Terms of Reference: Capital Review: External Experts' Reports	https://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/banks/capital-review/Terms-of-Reference-Capital-Review-External-Experts.pdf
42.	16 July 2019	Attachment: Consolidated RBNZ comments on Treasury Report (in Email: Re: Treasury advice on capital proposal framework)	Forthcoming
43.	31 July 2019	Attachment: Slides for MoF – Potential impact of higher bank capital on agri.pptx (in Email: Re: Treasury advice on capital framework proposal)	Forthcoming
44.	9 June 2010	Failing prompt corrective action	https://link.springer.com/article/10.1057/jbr.2010.11

Accordingly, I have refused your request for the documents listed in the above table under section 18(d) of the Official Information Act:

- the information requested is or will soon be publicly available.

Some relevant information has been removed from documents listed in the above table and should continue to be withheld under the Official Information Act, on the grounds described in the documents.

Information to be withheld

There are additional documents covered by your request that I have decided to withhold in full under the following sections of the Official Information Act, as applicable:

- advice, under section 9(2)(g)(i) – to maintain the effective conduct of public affairs through the free and frank expression of opinions by or between officers and employees of any department or organisation in the course of their duty.

In making my decision, I have considered the public interest considerations in section 9(1) of the Official Information Act.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.
This reply addresses the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Robbie Taylor
Team Leader, Financial Markets

OIA 20190546
Table of Contents

Reference:	T2017/2575	SH-11-4-3-1
Date:	28 November 2017	
To:	Minister of Finance Hon Grant Robertson	
Deadline: (if any)	29 November 2017	

THE TREASURY
Kaitohutohu Kaupapa Rawa

Aide Memoire: Briefing for meeting with Westpac on 30 November 2017

You are meeting with Westpac on Thursday, 30 November 2017 at 4pm.

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Pages 2 and 3 of this document have been Deleted - Not Relevant to Request

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RBNZ banking capital review

The RBNZ is currently undertaking a review of the capital adequacy framework for registered banks. The consultation will cover three main areas: (1) what should qualify as 'capital'; (2) the calculation of risk weighted assets; and (3) minimum capital ratios and buffers. The RBNZ has released papers on introductory issues and what should qualify as 'capital', and the paper on the calculation of risk weighted assets is to be released by the end of this year.

Westpac has submitted on the two currently released consultation papers and this is a good opportunity for you to seek their views on the review. Westpac has indicated its support for the review, but has raised some concerns. In general terms Westpac believes that there are benefits in allowing contingent debt[1] to be used as part of banks' tier one capital and that the RBNZ's proposals are likely to require greater supervision by the RBNZ. Westpac has also submitted that international harmonisation is important and a full cost/benefit analysis should be undertaken once the RBNZ has completed its review (taking into account macroeconomic impact of the proposed changes).

You could respond by noting that the RBNZ intends to release a further paper, and will take into account submitters' views. The RBNZ also plans to conduct both a full Quantitative Impact Survey and a Regulatory Impact Assessment.

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Daniel Jury, Senior Analyst, Financial Markets, s9(2)(k)
Craig Fookes, Team Leader, Financial Markets, s9(2)(k)

[1] Contingent debt in this context are instruments that write-off or convert into equity when certain triggers are met.

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Reference: T2018/35 BM-1-7-78

Date: 15 January 2018

To: Minister of Finance
(Hon Grant Robertson)

Deadline: 17 January 2018
(if any)

Aide Memoire: RBNZ Capital Review

You are meeting with the Reserve Bank on Wednesday 17 January to discuss the Bank's capital review. We understand the purpose of the meeting is for you to obtain an overview of the key issues of the review. This Aide Memoire provides some high-level comments as background. It highlights the issues that you are most likely to hear about in discussions with the banking sector and the areas that we are looking to explore further with the Reserve Bank.

Background: Role of capital and relevance of this work to the Minister of Finance

Through conditions of registration, the Reserve Bank imposes minimum capital requirements on locally incorporated registered banks. Capital in this context means funding that is similar to (and includes) equity. The function of regulatory bank capital is to absorb losses and prevent a bank's default on obligations to creditors (including depositors) or costs to taxpayers from a bailout. It is appropriate that the Reserve Bank reviews the capital requirements for registered banks from time to time.

Setting capital requirements is a function of the Reserve Bank for which it has operational independence. These requirements can, however, have wider economic implications (weak requirements can undermine economic stability and excessively tough requirements may impose undue costs on banks, investors, and consumers). It is therefore appropriate that the Bank keeps you appraised of the issues covered by the review and the direction the Bank is taking. It is appropriate for you to be comfortable that financial stability interests are being served by the capital regime without undue costs being imposed on participants in the economy.

Review takes a three-stage approach

Capital requirements are generally expressed as a ratio of types of capital to a bank's risk-weighted exposure. The review's approach is to consult separately on:

i. What should count as regulatory capital (ie, the type of capital)

ii. How banks should measure risk-weighted exposures

iii. The levels to be set for minimum capital ratios

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Item (i) has been completed and the Reserve Bank has published a response to submissions received. Item (ii) is currently being consulted on. Item (iii) will be consulted on later this year.

The RBNZ proposes to move away from recognising contingent debt as regulatory capital

Contingent debt (also known as ‘hybrid’ capital and ‘co-cos’) is debt that writes off or converts to ordinary shares when a pre-specified event relating to a bank’s financial condition occurs. According to the Reserve Bank’s response to submissions, a common theme in submissions was opposition to the proposal to cease recognising contingent debt as capital.

Opposition focussed on several arguments including:

- a reduction in funding options for banks
- the impact on local financial market development
- the impact on banks’ cost of capital
- a loss of foreign lender confidence, and
- challenging the Reserve Bank’s scepticism about the loss-absorbing effectiveness of contingent debt.

s9(2)(g)(i)

[redacted]

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The outstanding question is how banks would respond to the loss of having contingent debt recognised and what the cost implications will be. Will they seek to increase their actual levels of regulatory capital and pass on any additional costs of doing so, or will they seek to restrict new lending, particularly to sectors of the economy that attract the greatest risk weighting (such as business and agriculture) and sell risk-weighted assets? It will not likely be possible to reasonably speculate on this question until the Bank’s proposals on minimum capital ratios are known later this year.

The Reserve Bank proposes to disallow some internal credit risk models

Among its proposals on measuring risk-weighted exposures, the Reserve Bank is proposing to disallow the use of internal credit risk models for any exposure that is also externally rated and to require the use of standardised models instead.

The Basel Committee on Banking Supervision has also recently moved to limit the use of internal models in credit risk assessment. The Reserve Bank's proposals go further and take a more simplified approach. Submissions on this have not yet been received but we await them with interest in light of the Basel decisions.

Based on feedback to the Bank's initial issues paper last year, banks can be expected to oppose the proposal on the grounds that their internal models:

- are robust
- provide the most risk-sensitive estimates of capital, and
- enable them to respond best to changes in market environments and risk practices.

s9(2)(g)(i) Both in New Zealand and overseas, internal models have been found to consistently estimate lower capital requirements than would be the case using the standardised models, for the same portfolios. Banks may not have the right incentives to model credit risk robustly; a key incentive for banks would be to minimise their capital costs. Failure to assess credit risk appropriately increases the likelihood of unanticipated losses.

The justification for internal models is stronger where a bank's portfolio is uncommon rather than for commonly-held portfolios.

A number of higher-level questions emerge from the exercise

We see a number of higher-level questions emerging from the review which we are interested in exploring and which you may wish to raise to ensure you have an understanding of the underlying issues:

1. ***Are there other, intermediate policy objectives that should be taken into account, such as capital market development?***

   Loss-absorption capacity is the primary rationale behind regulatory capital requirements. But other financial stability-related objectives could also be served by maintaining diversity in recognised capital instruments.

   Would the non-recognition of contingent debt instruments as capital adversely affect the development of New Zealand's financial markets? If so, would it mean that no such market for these instruments would actually exist at the point when such sources of financing might be desired?

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The Reserve Bank usefully notes that the amount of contingent debt issued by New Zealand banks represents approximately only 19% of total New Zealand (NZDX listed) debt market capitalisation, so the banks' contingent debt is not necessarily a major player. The question is whether we should be looking for regulatory capital settings to play a wider role in developing local financial market depth and liquidity, particularly so that the depth is there to be tapped when it is needed.

The flipside of encouraging diversity in capital instruments is ensuring that the investors – particularly 'mum and dad' retail investors – actually understand the risks associated with them. This potential lack of understanding is one of the reasons why contingent debt instruments are seen as being vulnerable to taxpayer bail-out rather than being used for absorption of bank losses. There is evidence internationally of governments being reluctant to see retail investors bear bank losses through investment in instruments that they may not have fully understood. Any decision to promote market depth in such instruments may therefore also require improving risk disclosure by issuers and risk awareness among retail investors.

2. *Might the model of supervision unduly bias regulatory settings?*

A key argument of the Reserve Bank is that contingent debt is contractually complex, requiring an approach to oversight and enforcement that is at odds with the Bank's supervisory framework. The counter-argument to the complexity of contingent debt is that such instruments are not unduly complex; they just require the regulator to apply the supervisory resources necessary to understand them.

The Bank's supervisory framework is light-touch; the Bank's regulatory philosophy emphasises bank self-discipline and market discipline over supervision. This approach is not common internationally and the IMF has recommended the Bank consider a more involved approach to supervision.

Is there a risk of the Bank's supervisory model unduly driving the Bank's regulatory settings (such as capital requirements) to manage risk, rather than the supervisory model being a response to the nature of the risk?

3. *What work will be done on estimating the impact on the cost of capital?*

The Reserve Bank has some robust responses to the claims that its proposals will see an increase in banks' cost of capital. This is perhaps another area where academic consensus is likely to be elusive. In their assessments of the proposals, the banks will undoubtedly model their version of the direct costs to them, and possibly estimate the wider costs to the economy. However, they may fail to consider all of the social costs associated with the increased risk that may result from less stringent capital requirements.

What cost estimates will the Reserve Bank be undertaking in the development of its final proposals?

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4. Should New Zealand and Australia be looking at greater harmonisation?

The Reserve Bank usefully notes the relevance of the Australian Prudential Regulation Authority (APRA) assessment of what constitutes ‘unquestionably strong’ capital ratios. APRA will in fact be carrying out its own capital adequacy requirements review this year. Given that New Zealand’s ‘big four’ banks are wholly owned subsidiaries of Australian banks, the question arises at what point might it be in both countries’ interests to pursue a more harmonised approach to bank regulation.

Harmonisation could be wider than just on capital requirements, though. The changing technological landscape (eg, international trends towards ‘open banking’ and the as-yet unknown implications of blockchain technology for access to financial services across borders) and the increasingly international reach of foreign regulatory regimes (eg, OTC derivatives trading and anti-money laundering and counter-terrorism financing rules) may see increasing pressure for harmonisation in the regulatory frameworks governing parent and subsidiary institutions, if not between the two jurisdictions generally.

NZBA has commissioned an international comparison of New Zealand banks’ capitalisation

The New Zealand Bankers’ Association has recently commissioned a PriceWaterhouse Coopers study on how New Zealand banks’ existing capitalisation compares internationally. You may wish to ask the Reserve Bank for their views on the NZBA study.

Victor Kuipers, Senior Analyst, Financial Markets, s9(2)(k)
Dasha Leonova, Manager, Financial Markets and International, s9(2)(k)

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Reference: T2019/432 SH-11-4-3

Date: 28 February 2019

To: Minister of Finance (Hon Grant Robertson)

Deadline: 5 March 2019
(if any)

Aide Memoire: Meeting with New Zealand Bankers' Association on Tuesday 5 March

1. You are meeting with Roger Beaumont, Chief Executive of the New Zealand Bankers' Association (NZBA), and Miles Erwin, Associate Director of Government Relations, on Tuesday 5 March 2019.

2. This meeting is a meet-and-greet with Mr Beaumont and Mr Erwin. You met with the chair of the NZBA, David McLean, in his capacity as the Chief Executive of Westpac New Zealand in November 2018. You also met with the NZBA Council, the chief executives of all the member banks, in December 2018 with the Prime Minister and the Minister of Commerce and Consumer Affairs.

3. You requested a briefing on any issues which the NZBA may wish to discuss and matters which you may wish to raise with the NZBA.

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7. The NZBA may also ask about or raise the following other matters

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- The Reserve Bank's capital review.

Pages 2 - 3 of this document have been deleted as they are not relevant to the request.

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Reserve Bank's capital review

29. The Reserve Bank released its fourth and final consultation paper for the review of capital requirements in December 2018, and is receiving submissions until 3 May 2019. This final consultation seeks feedback on how much capital banks should have to deliver on the Reserve Bank's financial stability objectives.

30. The NZBA may raise concerns that the proposed capital that banks should have is too high, which would lower the return on equity and may increase the cost of lending for consumers. The NZBA met with the Minister of Commerce and Consumer Affairs late February and raised these concerns.

31. The Reserve Bank acknowledges that the cost of lending may rise in response to the proposals. However the Reserve Bank advised that this cost should be balanced against the benefits of a more resilient banking system, such as credit being more likely to flow and support the economy during stress, depositors having greater confidence in their investment, and fiscal risk decreasing with shareholders bearing more of their own risks

32. In a report to you by the Reserve Bank on the 13 February 2019 [Reserve Bank report 5243 refers], the Reserve Bank estimated that the increase in the cost of lending will be around 20 to 40 basis points. This increase will depend on a

number of factors, including the level of competitive pressures across banks and across other sources of finance.

33. Setting capital requirements for banks is an independent function of the Reserve Bank. You should encourage the NZBA to engage with the Reserve Bank on the final phase of the review and inform the NZBA that the Reserve Bank is keeping you informed on the review.

Max Lin, Analyst, Financial Markets, s9(2)(k)
Robbie Taylor, Team Leader, Financial Markets, s9(2)(k)

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Pages 6 of this document has been deleted as they are not relevant to the request.

Heading: Suggested Talking Points

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Reserve Bank's capital review

- The Reserve Bank is keeping me informed on the capital review and I encourage you to submit on the final stage of the consultation.
- It is important that any increased cost of lending should be balanced against the benefits of a more resilient banking system.

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THE TREASURY

Treasury Report: Treasury Report: Meeting with OECD delegation to discuss their 2019 Draft Survey of New Zealand

Date:	Tuesday 19 March 2019	**Report No:**	T2019/762
		File Number:	SH-11-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** you have a meeting with a delegation from the OECD to discuss the findings of their draft Survey of New Zealand 2019. **Note** that in addition to macroeconomic performance the OECD has analysed and made recommendations on wellbeing, housing policy and migration policy. **Note** this is the first time the OECD have attempted to comprehensively integrate wellbeing themes across a whole survey. **Refer** this report to Ministers Twyford, Parker and Lees-Galloway who are also meeting with the OECD delegation.	10.30am, Thursday 21 March 2019

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Blake Shepherd	Senior Analyst	s9(2)(k)	N/A (mob)	✓
Simon McLoughlin	Manager		s9(2)(a)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Forward the signed report to the other Ministers that will meet with the OECD delegation – Minister Twyford, Minister Parker, and Minister Lees-Galloway.

Note any feedback on the quality of the report	

Enclosure: Annex One: Draft meeting schedule for the OECD 2019 Survey
Annex Two: OECD's summary of key findings and recommendations

Pages 2 and 7 of this document have been Deleted - Not Relevant to Request

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Bank capital requirements

29. The RBNZ is publicly consulting on its review of the capital adequacy framework for registered banks. A key proposal in the review is to materially increase the

amount of capital banks are required to hold in order to reduce the chances of banks failing in New Zealand.

30. The OECD note the proposed increases would take capital requirements well beyond those applying in major OECD countries. The OECD's main findings are that the proposed increases are bigger than those called for in comprehensive analysis previously undertaken by the RBNZ in 2012 and potentially impose greater costs on the public than the benefits of reduced financial crisis risk. In light of this, the OECD has recommended that bank capital requirements are gradually increased, consistent with the analysis undertaken by the Reserve Bank in 2012, and that further evaluation of the welfare trade-offs of going beyond these increases is undertaken.

31. The Treasury has not formed a view on the macroeconomic impacts of raising the capital requirements on banks, as there is uncertainty regarding the final capital requirements. Public submissions on the proposals are due by 3 May 2019 and the RBNZ expects to release its final decisions on the capital requirements in Q3 2019. Following release of the RBNZ's final decisions on capital requirements, the Treasury can model the macroeconomic impacts and form a view. The RBNZ expects to release a technical analysis paper in the next month and this will support the Treasury in forming a view.

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Pages 10 and 13 of this document have been Deleted - Not Relevant to Request

TE TAI ŌHANGA
THE TREASURY

Reference: T2019/958 SH-11-4-3-1

Date: 4 April 2019

To: Minister of Finance
(Hon Grant Robertson)

Deadline: None
(if any)

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Aide Memoire: Meeting with BNZ

Meeting overview

You are meeting with Philip Chronican, the interim Chief Executive Officer of National Australia Bank Limited (NAB), and Doug McKay, the Chair of Bank of New Zealand (BNZ) on Monday, 8 April 2019 at 8.00am–8.30am. BNZ is a subsidiary of the NAB Group.

The NAB Board of Directors announced in March that Mr Chronican will become the next Chair of NAB later in 2019.

Mr Chronican and Mr McKay have indicated that they wish to discuss:

- the Reserve Bank of New Zealand's (the Reserve Bank) review of the capital adequacy framework for registered banks
- the Reserve Bank and Financial Markets Authority's (FMA) report on the culture and conduct of the banking and life insurance sectors.

Other topics that could be raised include:

- the Reserve Bank Act Review
- the provision of regional banking services.

This briefing provides background and talking points on these topics.

BNZ is generally supportive of the Reserve Bank's Capital Review

The Reserve Bank is currently consulting on the capital adequacy framework for banks (the Capital Review). It is proposing to increase the minimum level of regulatory capital for domestic systemically important banks (such as BNZ) from 8.5 per cent to 16 per cent of risk-weighted assets, over a five-year transition period.

In December 2018, NAB estimated this would require a potential capital increase of about NZ$4 billion to NZ$5 billion for BNZ.

BNZ is broadly supportive of the Capital Review. However, Mr McKay may raise the following concerns, based on BNZ's engagement with the Capital Review:

- Higher capital requirements have the potential to reduce economic growth, competition in banking, and unduly restrict the availability of credit (i.e. it may impact the ability to lend to every sector)
- There are an existing range of prudential risk management tools that need to be considered in the context of the Capital Review.

Setting capital requirements for banks is an independent function of the Reserve Bank. Consultation on the proposal ends on 3 May 2019 and the Reserve Bank intends to publish its final decisions in mid-2019.

BNZ has provided a response to the Reserve Bank and FMA on their review of bank conduct and culture

The Reserve Bank and FMA jointly reviewed the conduct and culture of 11 New Zealand banks and 16 New Zealand life insurers (including BNZ Life Insurance Limited) in the second half of 2018.

The Reserve Bank and FMA provided feedback to BNZ on the findings of the review so that BNZ could develop a plan to address the issues. BNZ provided a response on bank conduct and culture at the end of March; a response on life insurer conduct and culture is due by the end of June.

The Reserve Bank and FMA are reviewing the responses received from the 11 banks and will likely make a substantive public comment in several weeks. Following the conduct and culture review, banks are removing sales incentives for frontline customer service staff and their managers.

Phase two of the Reserve Bank Act Review

The review team is preparing the second consultation document to be released in mid-June 2019. This consultation document will cover:

- your in-principle decisions on topics from the first consultation, including the Reserve Bank's objectives, governance, and regulatory perimeter

- the remaining review topics, including prudential regulation and supervision, crisis management, macro-prudential policy, the role of the Reserve Bank in climate change, funding and resourcing, and coordination arrangements.

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The review team expects to complete policy work on the review towards the end of 2019 (including a third round of consultation), with legislative drafting taking place over 2020.

In its submission on the first consultation document, BNZ:

- supported widening the RBNZ's regulatory perimeter to include all deposit-taking institutions (like Australia's approach) to level the playing field between bank and non-bank deposit takers
- considered that depositor protection would be unnecessary if the Reserve Bank's proposed higher capital requirements are implemented (the Treasury notes that increasing capital requirements can reduce the risk of a bank failing. However, increasing capital requirements does not eliminate the risk of a bank failing and therefore does not negate the desirability of implementing depositor protection)
- supported prudential regulation remaining with the Reserve Bank, providing that enhancements are made to the Reserve Bank's governance and resourcing
- supported moving to a traditional board governance model, but did not consider a Financial Policy Committee necessary.

s9(2)(f)(iv) [redacted]

Amir Mehta, Analyst, Financial Markets, s9(2)(k) [redacted]
Sam Thornton, Acting Team Leader, Financial Markets, s9(2)(k) [redacted]

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Philip Chronican, Acting Group Chief Executive Officer, National Australia Bank

Mr Chronican is Acting Group Chief Executive Officer, National Australia Bank as of 1 March 2019 and Chairman-elect. He is fulfilling the Group CEO role in an interim capacity until a permanent appointment is made.

Mr Chronican was previously a non-executive director of BNZ from October 2016 to 28 February 2019.

He has more than 35 years of experience in banking and finance in Australia and New Zealand.

Doug McKay, Chair, Bank of New Zealand

Mr McKay is Chair of the Bank of New Zealand and a non-executive director of National Australia Bank.

He has held CEO and managing director positions within major trans-Tasman companies and organisations including Auckland Council, Lion Nathan, Carter Holt Harvey, Goodman Fielder, Sealord, and Independent Liquor.

Suggested talking points

The Reserve Bank's Capital Review

- The Reserve Bank is keeping me informed on the Capital Review. I encourage you to submit on its proposals.

- It is important that any increased cost of lending is balanced against the benefits of a more resilient banking system.

s9(2)(f)(iv)

[redacted]

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TE TAI ŌHANGA
THE TREASURY

Reference: T2019/1019 SH-11-4-3

Date: 5 April 2019

To: Minister of Finance (Hon Grant Robertson)

Deadline: None
(if any)

Aide Memoire: Meeting with ANZ Group Chief Economist

You are meeting with Richard Yetsenga, the Chief Economist and Head of Research at Australia and New Zealand Banking Group (ANZ) on Monday, 8 April 2019, at 6.15pm.

Mr Yetsenga would like to present ANZ's research on the global economic outlook. He may also raise the following issues:

- the Reserve Bank of New Zealand's (the Reserve Bank) review of the capital adequacy framework for registered banks;

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[redacted]

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Capital review

The Reserve Bank is currently consulting on the capital adequacy framework for banks (the Capital Review). It is proposing to increase the minimum level of regulatory capital for domestic systemically important banks (such as ANZ) from 8.5 percent to 16 percent of risk-weighted assets, over a five-year transition period.

ANZ's view is that regulatory capital requirements for New Zealand incorporated banks should align with those in Australia. The Australian Prudential Regulation Authority is currently reviewing the capital framework for Australian authorised deposit-taking institutions. ANZ noted in December 2018 that the Reserve Bank's proposal could require a capital increase for the New Zealand subsidiary of $6 billion to $8 billion. The Reserve Bank will provide you with a separate briefing on matters related to ANZ and the Capital Review.

Setting capital requirements for banks is an independent function of the Reserve Bank. Consultation on the proposal ends on 3 May 2019 and the Reserve Bank intends to publish its final decisions in mid-2019.

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ANZ also noted that the outcome of the Capital Review should be factored into any decision on depositor insurance. The Treasury notes that increasing capital requirements can reduce the risk of a bank failing. However, increasing capital requirements does not eliminate the risk of a bank failing, and therefore does not negate the desirability of implementing depositor protection.

Max Lin, Analyst, Financial Markets, s9(2)(k)
Sam Thornton, Acting Team Leader, Financial Markets, s9(2)(k)

Deleted - Not Relevant to Request

Suggested talking points

Deleted - Not Relevant to Request

The Reserve Bank's Capital Review

- The Reserve Bank is keeping me informed on the Capital Review. I encourage ANZ to submit on its proposals.

- It is important that any increased cost of lending is balanced against the benefits of a more resilient banking system.

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TE TAI ŌHANGA
THE TREASURY

Reference: T2019/1248 SH-11-4-3

Date: 30 April 2019

To: Minister of Finance (Hon Grant Robertson)

Deadline: None
(if any)

Aide Memoire: Meeting with ASB

You are meeting with Vittoria Shortt (ASB Chief Executive), Nick Tuffley (Chief Economist), and James Watson (Head of Government Relations) on Wednesday 1 May 2019 at 5pm.

ASB is likely to raise the following matters:

- Deleted - Not Relevant to Request
-
- the Reserve Bank of New Zealand's (the Reserve Bank) review of the capital adequacy framework for registered banks;

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Capital review

The Reserve Bank is currently consulting on the capital adequacy framework for banks (the Capital Review). It is proposing to increase the minimum level of regulatory capital for domestic systemically important banks (such as ASB) from 8.5 percent to 16 percent of risk-weighted assets over a five-year transition period.

ASB has not yet made a submission on the Capital Review. ASB representatives will be meeting with Deputy Governor Geoff Bascand for a more technical conversation on 3 May 2019. There have been several interim conversations with Vittoria Shortt and the ASB Board Chair (Gavin Walker). The Reserve Bank advises that ASB appear to accept that there will be some uplift in capital requirements, but are expected to debate the appropriate level and capital composition of the future requirements and to emphasise their view of the potential unintended consequences.

Setting capital requirements for banks is an independent function of the Reserve Bank. Consultation on the proposal ends on 17 May 2019, and the Reserve Bank intends to publish its final decisions in the third quarter of 2019.

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Suggested talking points

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The Reserve Bank's Capital Review

- The Reserve Bank is keeping me informed on the Capital Review. I encourage ASB to submit on its proposals.

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: OECD Economic Survey Update

Date:	9 May 2019	**Report No:**	T2019/1313
		File Number:	TY-1-0-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the OECD's Economic Survey of New Zealand will be launched in Wellington on 25 June 2019 **Note** that the Treasury will raise suggested changes to the draft Survey to the OECD's Economic and Development Review Committee on 13 May 2019 **Refer** this report to the Minister of Housing and Urban Development; the Minister for Economic Development; and the Minister of Immigration	None

Contact for Telephone Discussion

Name	Position	Telephone		1st Contact
John Janssen	Principal Advisor, Economic Strategy and Productivity	s9(2)(k) [redacted]	N/A (mob)	✓
Simon McLoughlin	Manager, Economic Strategy and Productivity		s9(2)(a) [redacted]	

Actions for the Minister's Office Staff

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: Annex 1 Draft comments of the New Zealand delegation on the OECD Economic Survey of New Zealand 2019

OECD NZ Draft Survey

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Annex A: Draft comments of the New Zealand delegation on the OECD Economic Survey of New Zealand 2019

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New Zealand Economic Survey – New Zealand 1 pager

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We have two specific comments on the macro policy recommendations. We consider that the data presented in the report overstates the difference between the proposed changes in New Zealand's capital requirements and current levels in relevant comparator countries. Deleted - Not Relevant to Request

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TE TAI ŌHANGA
THE TREASURY

Reference: T2019/1575 SH-11-4-3-1

Date: 6 June 2019

To: Minister of Finance (Hon Grant Robertson)

Deadline: None
(if any)

Aide Memoire: Meeting with SBS Bank

Meeting overview

You are meeting with the chief executive of the SBS Group, Shaun Drylie, on 10 June 2019 at 5.30pm. SBS Bank is the main division of the SBS Group.

This aide memoire contains background information and suggested talking points for your meeting with Mr Drylie. We understand that Mr Drylie would like to discuss:

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- "regulation requirements", which will likely include:
    - the Capital Review for registered banks undertaken by the Reserve Bank of New Zealand (the Reserve Bank)

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Capital Review: SBS Bank argues that the Reserve Bank's proposals to increase capital requirements will undermine small banks' ability to compete with the main banks

The Reserve Bank is reviewing the regulatory capital requirements for locally incorporated banks (the Capital Review).

The Reserve Bank's key proposals include:

- increasing 'tier 1' capital requirements from 8.5 per cent to:
  - 15 per cent of risk-weighted assets (RWA) for smaller banks, such as SBS Bank and Kiwibank
  - 16 per cent of RWA for the 'systemically important' four main banks.
- requiring the increase in tier 1 capital requirements to be met *only* by 'common equity tier 1' (CET1) capital, the highest quality (and most expensive) form of capital. Banks would not be able to use cheaper contingent convertible debt (known as 'CoCos') to meet tier 1 (or tier 2) capital requirements.[2]

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[2] Contingent convertible debt is convertible into equity if a pre-specified trigger event occurs (e.g. when a bank's financial position falls below certain prescribed limits).

SBS Bank jointly submitted on the Capital Review with Kiwibank, TSB Bank, and the Co-operative Bank, from the perspective of New Zealand-owned banks.

The joint submission points to particular implications for smaller banks of both: (i) significantly increasing regulatory capital requirements *and* (ii) limiting the type of capital that can be used to meet these new requirements (to higher cost CET1 capital).

The joint submission argues that the proposed capital requirements will undermine the growth of small, New Zealand-owned banks, and create a "risk that small banks are ultimately absorbed by the large banks" which would "increase concentration on the existing systemically important banks and lessen competition."

Specific key issues and proposed remedies raised in the joint submission are as follows:

Issue raised by New Zealand-owned banks	*Proposed remedy by New Zealand-owned banks*
Proposals to restrict the type of eligible non-CET1 capital (i.e. disallowing the use of contingent convertible debt) will place New Zealand-owned banks at a competitive disadvantage and limit growth opportunities. It is already difficult to access CET1 capital due to: • scale and illiquidity (New Zealand-owned banks are not listed) • investors favouring larger banks because they offer higher returns.	Allowing "reasonably practical access to capital" – small banks should be able to use cheaper AT1 and tier 2 capital (i.e. contingent convertible debt) to meet new capital requirements.
Transition period of five years is too short if small banks need to rely on retained earnings to meet proposed requirements.	Transition period of eight years.
The four main banks gain a competitive advantage by using their own internal models to calculate lower RWA, compared with the small banks' use of a standardised model prescribed by the Reserve Bank.	Greater alignment between the calculation of RWA for large and small banks.

Public submissions have now closed. The Reserve Bank received a large number of submissions – 164 in total. It will publish a summary of submissions later in June 2019 and will continue to engage with stakeholders. The Reserve Bank has also appointed three experts to independently review its analysis and advice underpinning its proposals.

The Reserve Bank intends to release the final decisions on the Capital Review by the end of November 2019, with implementation of any new rules starting from April 2020.

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Suggested talking points

Capital Review

- The Reserve Bank is operationally independent in setting bank capital levels.
- The Reserve Bank is considering all submissions on the Capital Review before making its final decision.
- The Reserve Bank expects to release a final decision by the end of November 2019.

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TE TAI ŌHANGA
THE TREASURY

Reference: T2019/1717 SH-11-4-3-1-2 (Capital review)

Date: 11 June 2019

To: Minister of Finance (Hon Grant Robertson)

Deadline: 13 June 2019
(if any)

Aide Memoire: Meeting with Oliver Hartwich, The New Zealand Initiative: RBNZ reforms and bank governance

Meeting overview

You are meeting with meeting with Dr Oliver Hartwich, Executive Director of the NZ Initiative (NZI), on Monday 17 June from 9:15-9:45am.

This aide memoire contains background information and suggested talking points for your meeting. We understand that Dr Hartwich would like to discuss the RBNZ reforms and governance. Dr Hartwich may also be interested in discussing bank capital and conduct and culture issues.

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Bank capital

The RBNZ is reviewing the regulatory capital requirements for locally incorporated banks (the Capital Review). Its proposals include:

- Increasing the minimum level of regulatory capital for domestic systemically important banks from 8.5 percent to 16 percent of risk-weighted assets over a five-year transition period.

- Requiring the increase in tier 1 capital requirements to be met *only* by 'common equity tier 1' (CET1) capital, the highest quality (and most expensive) form of capital. Banks would not be able to use cheaper contingent convertible debt (known as 'CoCos') to meet tier 1 (or tier 2) capital requirements.[1]

Public submissions have now closed. The RBNZ will publish a summary of submissions later in June 2019 and will continue to engage with stakeholders. The RBNZ has also appointed three experts to independently review its analysis and advice underpinning its proposals. It intends to release the final decisions on the Capital Review by the end of November 2019, with implementation of any new rules starting from April 2020.

NZI made the following submissions on the Capital Review:

- 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 proposals proceeds on the mistaken assumption that the bank's statutory objective is soundness first, and efficiency second. The RBNZ would be acting unlawfully if it implemented its bank capital proposals on the basis of the decision-making framework it has adopted.

- Borrowers, depositors and participants in the wider economy are likely to be harmed if the bank capital proposal is implemented. Given the potential costs,

[1] Contingent convertible debt is convertible into equity if a pre-specified trigger event occurs (e.g. when a bank's financial position falls below certain prescribed limits).

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the RBNZ should not be proposing this change of regulatory policy without first undertaking a full cost-benefit analysis. Its omission to do this is inconsistent with good regulatory practice and liable to judicial review.

- The RBNZ's proposals on bank capital requirements cut across Phase 2 of the Reserve Bank Act Review. The Capital Review consultation process should be suspended until after Phase 2 has been completed and decisions made in response to it.

Dr Hartwich is likely to take the opportunity to repeat the Initiative's recent public suggestion that you request the RBNZ Governor to defer any decision on the capital proposals until after Phase 2 of the Reserve Bank Act Review has concluded.

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Susan Ivory, Senior Analyst, Financial Markets, s9(2)(k)
Robbie Taylor, Team Leader, Financial Markets, s9(2)(k)

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Suggested talking points

Capital Review

- The RBNZ is operationally independent in setting bank capital levels.
- The RBNZ is considering all submissions on the Capital Review before making its final decision.
- The RBNZ expects to release a final decision by the end of November 2019.

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TE TAI ŌHANGA
THE TREASURY

Reference: T2019/1586 SH-11-4-3-1

Date: 19 June 2019

To: Minister of Finance (Hon Grant Robertson)

Deadline: 25 June 2019

Aide Memoire: Meeting with Westpac on 25 June 2019

You are meeting with David McLean, in his capacity as Chief Executive of Westpac New Zealand, on 25 June 2019. Mr McLean is also the chair of the New Zealand Bankers' Association. Deleted - Not Relevant to Request

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Other topical issues

Regulatory capital requirements

The Reserve Bank is reviewing the regulatory capital requirements for locally incorporated banks. Key proposals by the Reserve Bank include increasing tier 1 capital requirements from 8.5% to 16 per cent of risk weighted assets for the 'systemically important' four main banks (including Westpac), and not allowing the use of cheaper contingent convertible debt (known as 'CoCos') to meet tier 1 (or tier 2) capital requirements. Public submissions have now closed. The Reserve Bank received a large number of submissions – 164 in total.

Westpac submitted on the capital review consultation paper. Westpac's submission states that:

- the cumulative impact of the Reserve Bank's proposals would be to increase tier 1 capital requirements of banks from 9.5% to 18%
- the Reserve Bank's proposals are unnecessarily conservative, go well beyond international norms, would significantly impact the cost and quantity of credit available to New Zealand borrowers, and could create a productivity drag on New Zealand's economy amounting to 1.3% of GDP annually.
- the imposition of such high levels of regulatory capital on New Zealand banks will increase the cost to borrowers in New Zealand by more than 100 basis points, which would equate to an increase of approximately $6,000 to the annual borrowing cost for an average home loan in Auckland.
- there are concerns about whether the Reserve Bank's consultation process meets the commitments outlined in the Reserve Bank "Relationship Charter" and note that a balanced consideration of the capital options and comprehensive independent cost benefit analysis is a necessary component of the consultation process.

The Reserve Bank has appointed three experts to independently review the analysis and advice underpinning its proposals. Final decisions on the Capital Review are expected to be released by the end of November 2019, with implementation of any new rules starting from April 2020.

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THE TREASURY

Suggested talking points

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Capital Review

- The Reserve Bank is operationally independent in setting bank capital levels.
- The Reserve Bank is considering all submissions on the Capital Review before making its final decision.
- The Reserve Bank expects to release a final decision by the end of November 2019.

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Launch of OECD Survey of New Zealand 2019

Date:	19 June 2019	Report No:	T2019/1623
		File Number:	TY-1-0-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the contents of this report **Refer** this report to Prime Minister Jacinda Ardern and Minister Hipkins	Thursday 20 June 2019
Minister of Housing and Urban Development (Hon Phil Twyford)	**Note** the contents of this report	None
Associate Minister of Finance (Hon Dr David Clark)	**Note** the contents of this report	None
Associate Minister of Finance (Hon David Parker)	**Note** the contents of this report	None
Minister of Immigration (Hon Iain Lees-Galloway)	**Note** the contents of this report	None
Associate Minister of Finance (Hon Shane Jones)	**Note** the contents of this report	None
Associate Minister of Finance (Hon James Shaw)	**Note** the contents of this report	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
John Janssen	Principal Advisor, Economic Strategy and Productivity	s9(2)(k)	s9(2)(a)	✓
Simon McLoughlin	Manager, Economic Strategy and Productivity			

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Refer a copy of the report to Prime Minister Jacinda Ardern and Minister Hipkins.

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Note any feedback on the quality of the report	

Enclosure: Yes (attached)

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17. In terms of increases to bank capital, the OECD note that local contextual factors have been incorporated in the Reserve Bank's quantitative analysis. The Bank's choice of a 1 in 200 year threshold is viewed as driving its specific proposal for capital requirements, which is well above that previously advocated by the Bank.

18. While international comparability is complicated by differences in asset risk weightings used and different economic context, the OECD suggests that the proposed changes would take Tier 1 capital requirements beyond those applying in other OECD countries.

19. The Survey concludes that higher bank capital requirements would reduce the costs from financial crises, but might also dampen economic activity through higher lending rates. On balance and notwithstanding considerable uncertainty, a modest rise in bank capital is likely to have net benefits, but the impacts should be carefully monitored.

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TE TAI ŌHANGA
THE TREASURY

Reference: T2019/2053

Date: 11 July 2019

To: Minister of Finance (Hon Grant Robertson)

Deadline: 15 July 2019

Aide Memoire: Talking points for the NZ Initiative lunch

You will be attending a NZ Initiative members' lunch on 15 July, where you will be presenting on the Government's policy agenda. Following your presentation there will be a Q&A session chaired by the NZ Initiative Executive Director, Oliver Hartwich.

The 30 NZ Initiative members attending the lunch come from a diverse range of sectors such as banking, law, telecoms and tobacco.

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The Reserve Bank's capital review

- The Reserve Bank is responsible for the prudential supervision of banks including setting their capital requirements. It is consulting on increasing banks' capital requirements and expects to finalise its decision at the end of November 2019.
- The Reserve Bank is operationally independent in setting these capital requirements.
- Roger Partridge wrote an opinion piece where he posed three "unanswered questions on the RBNZ's capital proposals". These are set out below with proposed responses.

Do the benefits of the capital requirement proposals exceed the costs?

- Our expectation is that the Reserve Bank will publish a robust cost-benefit analysis around any modified proposals before making final policy decisions (which take into account feedback received as part of the consultation).

- The Reserve Bank has commissioned three external experts to independently review its analysis and advice underpinning the capital review proposals.

Has the Reserve Bank been consulting with an open mind?

- The Reserve Bank is continuing its stakeholder outreach programme. This includes conducting focus groups to understand the public's risk appetite, engaging with iwi, the social sector, industry groups, financial institutions, and investors.
- I have urged all interested participants to listen to, and work with, each other constructively as this work is carried out.

Does the Reserve Bank properly understand its statutory objectives (i.e. is there too much focus on soundness and not enough on efficiency)?

- The aim of the capital review is to strike the right balance between achieving a safe and efficient banking system that New Zealanders need and deserve.
- I expect that the Reserve Bank's cost-benefit analysis will adequately justify its decisions taking safety and efficiency into consideration.

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Tamiko Bayliss, Prinicpal Advisor, Macroeconomic and Fiscal Policy, s9(2)(k)
Renee Philip, Manager, Macroeconomic and Fiscal Policy, s9(2)(k)

TE TAI ŌHANGA
THE TREASURY

Reference: T2019/2192 SH-11-4-3-1 (Banks)

Date: 23 July 2019

To: Minister of Finance (Hon Grant Robertson)
Associate Minister of Finance (Hon James Shaw)

Deadline: 25 July 2019
(if any)

Aide Memoire: Meetings with Citi on 25 July 2019

The Minister of Finance (Hon Grant Robertson) and the Associate Minister of Finance (Hon James Shaw) are meeting with representatives from Citi in two separate meetings on 25 July 2019. Citi is meeting with Hon Grant Robertson at 4:00pm and then Hon James Shaw at 4:30pm.

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Regulatory capital requirements

The Reserve Bank is reviewing the regulatory capital requirements for locally incorporated banks. However, as Citi operates as a branch of an overseas-incorporated bank, and is not incorporated in New Zealand, the requirements under review do not apply to Citi.

Daniel Jury, Senior Analyst, Financial Markets, s9(2)(k)
Robbie Taylor, Team Leader, Financial Markets, s9(2)(k)

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Banking matters (Deleted - Not Relevant to Request bank capital)

Key points

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s9(2)(f)(iv)

- The RBNZ is currently reviewing bank capital levels. A key proposal is a significant increase in the capital banks must hold. **[Not public:** The Treasury is preparing advice for the Minister of Finance on the capital review, which will provide background and discuss aspects of the review. The Treasury will *not* peer review the proposals. Key trade-off that will be involved will be discussed]

Q and A

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s9(2)(f)(iv)

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Question: Does the Government agree with the RBNZ's bank capital proposals?

Answer: The RBNZ as an independent regulator is responsible for setting bank capital requirements. Government delegated the responsibility to the RBNZ.

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Bullet points for the PM's attendance of the NZBA dinner on 18 December 2017

RBNZ review of capital requirements for banks

Background

- The Reserve Bank imposes minimum capital requirements on locally incorporated banks as a condition of registration.
- The capital requirements refer to how much of a bank's funding must be sourced from equity-like sources (such as shareholder funds) compared to funds that are sourced from depositors and other financial institutions and investors.
- In March 2017 the Reserve Bank announced a review of the capital requirements for banks incorporated in New Zealand. The review comprises a number of consultation papers issued over the course of 2017 and 2018 and is expected to conclude in mid-2018.

Issue

- The Reserve Bank's consultation papers released so far have proposed ceasing recognition of contingent debt as capital in order to improve the quality and availability of regulatory capital. Bank submissions have opposed this proposal, citing, among other things, the potential impact on local financial markets and increased bank costs of raising funds.
- The NZBA commissioned PriceWaterhouseCoopers to compare the capitalisation of New Zealand banks against international peers. The study concluded that New Zealand's major banks are well capitalised relative to banks in many other jurisdictions. The major banks may point to the study to support an argument that additional capital requirements are not necessary.

Suggested response

- The PM could note that the Reserve Bank is only part-way through its capital review. Additional consultation papers have yet to be published and final proposals have yet to be developed and consulted on. The Reserve Bank also plans to conduct both a full quantitative impact survey and a regulatory impact assessment.

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RBNZ's Bank Regulatory Capital Proposals

Key topics for Treasury internal discussion

Dr Brian McCulloch
brian.mcculloch@outlook.co.nz

30 April 2019 -- DRAFT

RBNZ's Bank Regulatory Capital Proposals

This slidepack outlines key topics to inform Treasury's views on the RBNZ proposal to increase the minimum level of regulatory capital in the banking system, as discussed in the RBNZ consultation paper, "Capital Review Paper 4: How much capital is enough?" (January 2019).

Contents:

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Background to the RBNZ review

This background section covers the following topics:

- the overall regulatory framework within which bank capital requirements sit,
- the origins of the RBNZ review and the process that has been undertaken by the RBNZ to date,
- the process to completion of the review and expected outcomes, and
- the roles (if any) of Treasury and Ministers in the completion and implementation of the review.

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The overall regulatory framework within which bank capital requirements sit

Part 5 of the Reserve Bank of New Zealand Act 1989 gives the RBNZ powers to register and supervise banks for the purposes of:

- promoting the maintenance of a sound and efficient financial system; and
- avoiding significant damage to the financial system that could result from the failure of a registered bank.

There are two key elements to the RBNZ role:

- undertaking bank registration and supervision; and
- maintaining a capacity to respond to financial distress or bank failure, where a bank's financial condition poses a serious threat to the financial system.

The RBNZ's powers include to:

- set conditions of registration for registered banks;
- authorise a change in ownership of a registered bank;
- recommend public disclosure requirements to the Minister;
- give directions to banks under certain circumstances;
- recommend that a bank in financial distress be placed into statutory management.

Qualitative and quantitative conditions are set by the RBNZ. These include capital adequacy requirements.

In addition, the Reserve Bank monitors each registered bank's financial condition and compliance with its conditions of registration.

Other agencies also have regulatory roles in relation to banks, principally the Financial Markets Authority.

The origins of the RBNZ review

The RBNZ announced a review of the capital regulations applying to locally incorporated banks in March 2017.

The aim of the capital review is to identify the most appropriate capital regulations for New Zealand, taking into account the lessons learned from applying the current regime; the policies and experiences of other countries; and evolving ideas internationally about what constitutes best-practice bank capital regulation.

The RBNZ noted six high-level principles for the review:

- *Capital must readily absorb losses before losses are imposed on creditors and depositors.*
- *Capital requirements should be set in relation to the risk of bank exposures.*
- *Where there are multiple methods for determining capital requirements, outcomes should not vary unduly between methods.*
- *Capital requirements of New Zealand banks should be conservative relative to those of international peers, reflecting the risks inherent in the New Zealand financial system and the Reserve Bank's regulatory approach.*
- *The capital framework should be practical to administer, minimise unnecessary complexity and compliance costs, and take into consideration relationships with foreign-owned banks' home country regulators.*
- *The capital framework should be transparent to enable effective market discipline.*

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The process that has been undertaken by the RBNZ to date

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Issues Paper

The RBNZ commenced the review with the publication of an Issues Paper in May 2017. The issues paper provided a broad overview of the issues to be covered by the review:

- Numerator: the definition of eligible capital
- Denominator: the measurement of risk-weighted exposures
- Ratios: minimum requirements and capital buffers
- Efficiency and stability

Submissions on the issues paper were published and summarised by the RBNZ in October 2017.

Capital Review Paper 2: “What should qualify as bank capital?”

A paper on issues and options on what should qualify as bank capital was published by the RBNZ in July 2017. The paper set out set out a range of dimensions relevant to the determination of the regulatory definition of capital and presented five options for consultation. Submissions in response to this paper were published on 7 November 2017, and a summary of responses was published by the RBNZ on 19 December 2017.

Following this paper, the RBNZ made in-principle decisions to:

- remove contingent debt and contingent preference shares from the definition of capital;
- accept non-redeemable, non-contingent, perpetual preference shares as AT1 capital;
- accept redeemable, non-contingent preference shares and long-term subordinated debt as Tier 2 capital; and
- keep open the option of including in the regime a Tier 1 instrument able to be issued by banks structured as mutual societies.

The process so far … (2)

<u>Capital Review Paper 3: “Calculation of risk-weighted assets”</u>

A consultation paper on the calculation of risk-weighted assets was published on 19 December 2017. This paper addressed issues with the denominator of the capital ratio calculation: risk-weighted assets. Submissions and a response to the submissions were published on 6 July 2018.

Following this paper, the RBNZ made in-principle decisions that:

- the capital framework will continue to permit qualifying banks to use internal models to estimate credit-risk related RWA (the ‘IRB’ approach), although there will be more restrictions on modelling;
- the IRB approach will not be permitted for any credit exposure with an external rating (for example, sovereigns, banks, some large corporates);
- there will be a RWA floor imposed on IRB models. This floor will be a proportion of the equivalent standardised calculation RWA value;
- all banks will calculate the RWA arising from operational risk in the same way, using the Basel Standardised Measurement Approach; and
- IRB banks will be required to report RWA (and associated credit ratios) calculated using the standardised approach alongside those arising from the IRB approach (‘dual reporting’).

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The process so far … (3)

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

The RBNZ published a consultation paper with a proposal to increase the minimum level of regulatory capital in the banking system on 14 December 2018, with an updated version on 25 January 2019.

A suite of background papers that were used as inputs to the consultation paper were also released on 25 January 2019.

An industry forum was presented on 21 February 2019, and a media briefing was provided on 22 February 2019, with slides and a "non-technical summary" paper.

A further background paper published on 3 April 2019 outlined the RBNZ's analysis supporting the risk appetite framework that informed the proposals in the consultation paper.

Submissions on the proposals were to be due on 29 March 2019, but this deadline was progressively extended to 17 May 2019.

Consultation Paper: "A framework for identifying domestic systemically important banks"

On 8 April 2019, the RBNZ published a consultation paper on an indicator-based framework for identifying domestic systemically important banks (D-SIBs). Submissions close on 31 May 2019.

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The process to completion of the review and expected outcomes

The expected process to completion of the review is set out on the RBNZ website:

<u>May – June 2019</u>

- Round four of public consultation closes
- Publish submissions and summary of what they say
- Presentation at IMF / World Bank conference

<u>September quarter 2019</u>

- Publish a response to submissions
- Publish a Regulatory Impact Statement
- Decisions on appropriate risk appetite for banking crises and level of capital required
- Decisions on which financial instruments qualify as 'high quality' (Tier 1), and which financial instruments will remain eligible as capital
- Decisions on changes to the risk-weighted assets framework
- Decisions on transition – i.e. how much time banks have to comply with decisions

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The roles (if any) of Treasury and Ministers in the completion and implementation of the review

Capital requirements for banks are set by the RBNZ as part of its bank regulatory role (see slide 4).

Ministers and Treasury do not have any formal role in this process …

… unless changes are proposed to the banks' public disclosure requirements: requires an Order in Council made on the advice of the Minister that is given in accordance with a recommendation from the RBNZ (s 81, RBNZ Act).

The key issues

- Higher regulatory capital requirements [slides 12-22]
- Treatment of "Tier 2" capital [slide 23]
- Leverage ratio requirement [slide 24]

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Higher regulatory capital requirements

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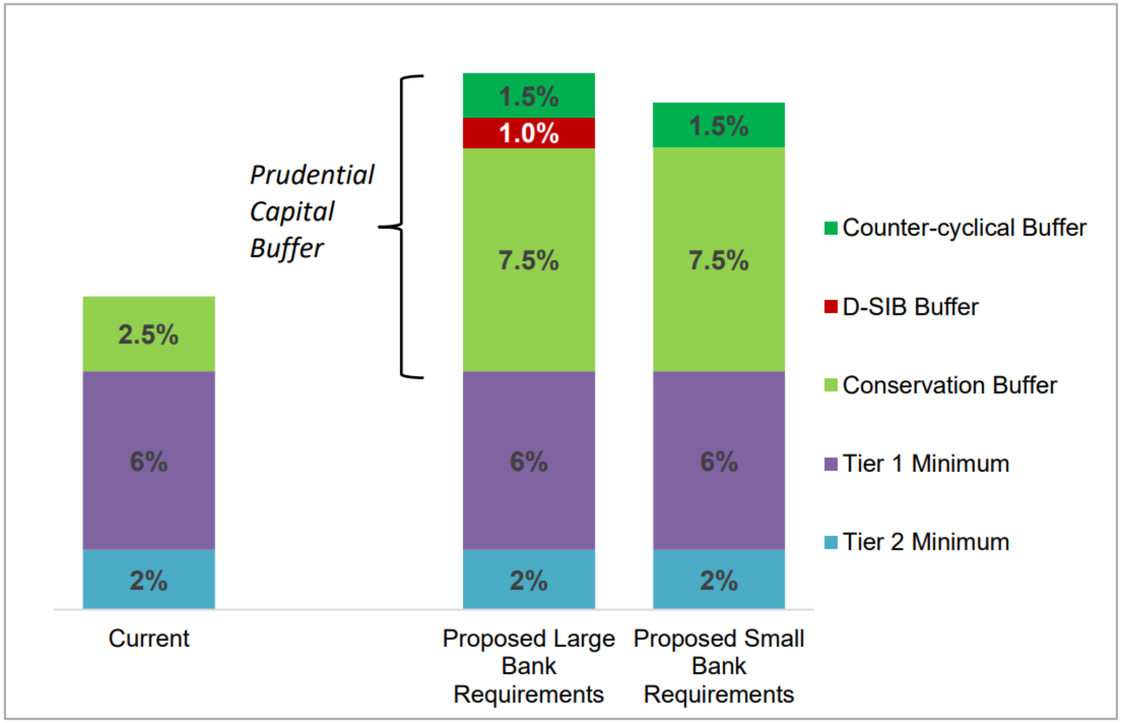
The headline proposal of the review is to require banks to hold levels of capital that are substantially higher than the current regulatory requirements:

- A Tier 1 capital ratio requirement of up to 16 percent, which includes a conservation buffer of 7.5 percent, countercyclical capital buffer of 1.5 percent, and an additional 1 percent for domestic systemically important banks.
- Consultation of whether "Tier 2" requirements should be retained (see page 23).

Figure 8: Proposed Capital Requirements



Higher regulatory capital requirements – Key topics

The following main assumptions and judgements under this proposal are discussed in the next slides:

- Crisis cost: *"When considering the level of capital to invest, shareholders do not take the societal impacts of bank failure into account and thus banks have insufficient capital from a societal perspective. … A broader view of the cost of crisis and society's risk appetite may be warranted, … [and not just] the impact of crisis in terms of the contraction in lending and flow-on effects to output."*
- Crisis risk appetite and likelihood of crisis: *"We want enough capital in the system as a whole to cover losses that are so large they might only occur very infrequently (for example once every 200 years)."*
- Required capital levels: *"We are proposing to double the amount of high quality capital that banks will be required to hold." "[The international evidence] suggests that Tier 1 capital equal to or exceeding 16 percent of RWA is needed to limit the probability of a crisis to 1 in 200 years or thereabouts.", and "[Risk modelling analysis indicates] a Tier 1 capital ratio of 16 percent of RWA is needed to ensure our banking sector retains creditor confidence after enduring an extreme shock."*
- Lending rates: *"We expect only a minor impact on borrowing rates for customers. … Lending margins above borrowing costs are likely to expand by 20-40 points."*
- Competitiveness: *"The competitive market will continue and if one bank pulls back in a particular segment of lending, we expect another will step up."*
- GDP: *"We consider a one percentage point increase in the Tier 1 capital ratio could lead to a 3 basis point decline in the steady-state level of GDP."*
- Domestic systemically important banks: *"D-SIBs should have an additional capital requirement [of 1%]."*
- Standardised vs internal methods of calculation: *"… to reduce the undue differences in capital requirement outcomes produced by the IRB and Standardised approaches."*
- Transitional effects: *"The expected effect on banks' capital is 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."*

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Crisis cost: *"When considering the level of capital to invest, shareholders do not take the societal impacts of bank failure into account and thus banks have insufficient capital from a societal perspective. … A broader view of the cost of crisis and society's risk appetite may be warranted, … [and not just] the impact of crisis in terms of the contraction in lending and flow-on effects to output."*

The RBNZ April paper reviews a considerable amount of international literature on the social implications of severe financial crises, including impacts on physical health, mental health, family cohesion, wellbeing of children and youth, community connectedness, and vulnerable people.

The RBNZ concluded that the potential for "these impacts are likely to lead [New Zealand] society to be relatively intolerant of banking crises."

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Crisis risk appetite and likelihood of crisis: *"We want enough capital in the system as a whole to cover losses that are so large they might only occur very infrequently (for example once every 200 years)."*

For the purpose of setting bank capital requirements, the RBNZ expressed its "soundness" objective in terms of the probability of a banking crisis, and considered "efficiency" as a secondary objective.

The consulted proposals are based on modelling using 1/200 probability of a banking crisis.

- The April paper notes that 1/200 is a "starting assumption", not based on any evidence about New Zealanders' intolerance for banking crises.
  - 1/100 was also used earlier in the process, and gave results similar to the existing capital requirements (FSOC paper, November 2018, footnote 2).
  - An even less risk tolerant (1/333) probability was also used as the baseline in some of the RBNZ's sensitivity analysis to support the proposed requirements (January paper, Table 4).

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Required capital levels: *"We are proposing to double the amount of high quality capital that banks will be required to hold." "[The international evidence] suggests that Tier 1 capital equal to or exceeding 16 percent of RWA is needed to limit the probability of a crisis to 1 in 200 years or thereabouts.", and "[Risk modelling analysis indicates] a Tier 1 capital ratio of 16 percent of RWA is needed to ensure our banking sector retains creditor confidence after enduring an extreme shock."*

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<u>Lending rates</u>: *"We expect only a minor impact on borrowing rates for customers. … Lending margins above borrowing costs are likely to expand by 20-40 basis points."*

- The theoretical motivation for estimation of the effect on lending rates of changing the level of equity capital should not change overall funding cost - the "Modigliani-Miller effect" (MM). MM is not expected to hold in full in practice. RBNZ assumes a 50% MM effect (that is, half of the increase in the banks' average funding costs that would be implied by the increased equity funding would be offset by lower required return on equity, with the other half affecting lending (and deposit) rates).

- The April paper noted that, if all of the adjustment was in lending rates, the increase would likely be at the 40 basis points end of the range, but if the change was shared between lending and borrowing (deposits), the impact just on lending rates would be more like 20 basis points.

- With total bank lending of $440 billion (RBNZ, February 2019), a 20 to 40 basis point increase amounts to increased lending costs (or lower deposit interest) of $880 million to $1.8 billion per year.

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[redacted]

Competitiveness: *"The competitive market will continue and if one bank pulls back in a particular segment of lending, we expect another will step up."*

- The banking market as whole may be regarded as competitive, with:
  - the four major banks,
  - a swarm of various sizes of smaller banks,
  - various other types of non-bank financial entities and intermediaries offering services in competition with the registered banks, and
  - direct access to international financial markets for larger businesses.

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<u>GDP</u>: *"We consider a one percentage point increase in the Tier 1 capital ratio could lead to a 3 basis point decline in the steady-state level of GDP."*

- The impact of capital on output is assumed to arise through interest changes, so there are two components:
  - the impact of increased capital on lending rates (see slide 17); and
  - the impact of lending rate changes in equilibrium output (logic: ↑ lending rates → ↓ investment → ↓ output).
- The proposal is to increase required Tier 1 capital by 7.5 percentage points (for D-SIBs, which hold the bulk of the market), so the 3 basis point conclusion above implies a 24.5 basis point (¼%) decline in steady state GDP.

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Domestic systemically important banks: *"D-SIBs should have an additional capital requirement [of 1%]."*

- While a failure of any of the main retail banks would be regarded in "crisis" terms, the four largest banks dominate the market (88%) and it is reasonable to expect that they would cause more of a systemic effect.
- RBNZ published a consultation paper in April on a framework for identifying domestic systemically important banks based on:
  - Size
  - Interconnectedness
  - Substitutability
  - Complexity

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[redacted]

Table 7: Systemic importance scores for all locally incorporated banks

Bank (in order of total assets)	Total score (equal weight)	Total score (size*100)
ANZ	35.53	31.63
BNZ	20.99	19.89
ASB	18.94	19.05
Westpac	14.44	17.88
Kiwibank	3.40	4.16
Rabobank	1.52	2.34
TSB	1.73	1.50
SBS	0.99	0.91
Heartland	0.66	0.91
Co-op	0.47	0.53
BOC	0.41	0.44
ICBC	0.47	0.42
CCB	0.37	0.29
BOB	0.03	0.02
BOI	0.02	0.02

<u>Standardised vs internal methods of calculation</u>: *"… to reduce the undue differences in capital requirement outcomes produced by the IRB and Standardised approaches."*

- RBNZ had earlier consulted on this issue in the context of the calculation of risk-weighted assets, and decided to continue to permit qualifying banks (currently the main 4 banks) to continue to use their internal models (the "IRB approach"), but to close the gap between calculations using the IRB and standardised methods.

- It is proposed to be achieved by:
  - adjusting a parameter in the IRB framework to reduce the average difference between the IRB and standardised approaches, and
  - introducing an output floor that limits the aggregate reduction the IRB approach allows over the standardised approach.

- RBNZ expects the effect of this to be an increase in the measure of risk-weighted assets (the denominator in the capital adequacy ratio) across the four banks of 16 percent. This would reduce their existing capital ratios from about 13.4% to 11.6% (see graph on next slide).

- This compounds with the proposed increased capital ratio requirements to require a larger total increase in the Tier 1 capital holdings the big 4 banks.

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Transitional effects: *"The expected effect on banks' capital is 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."*

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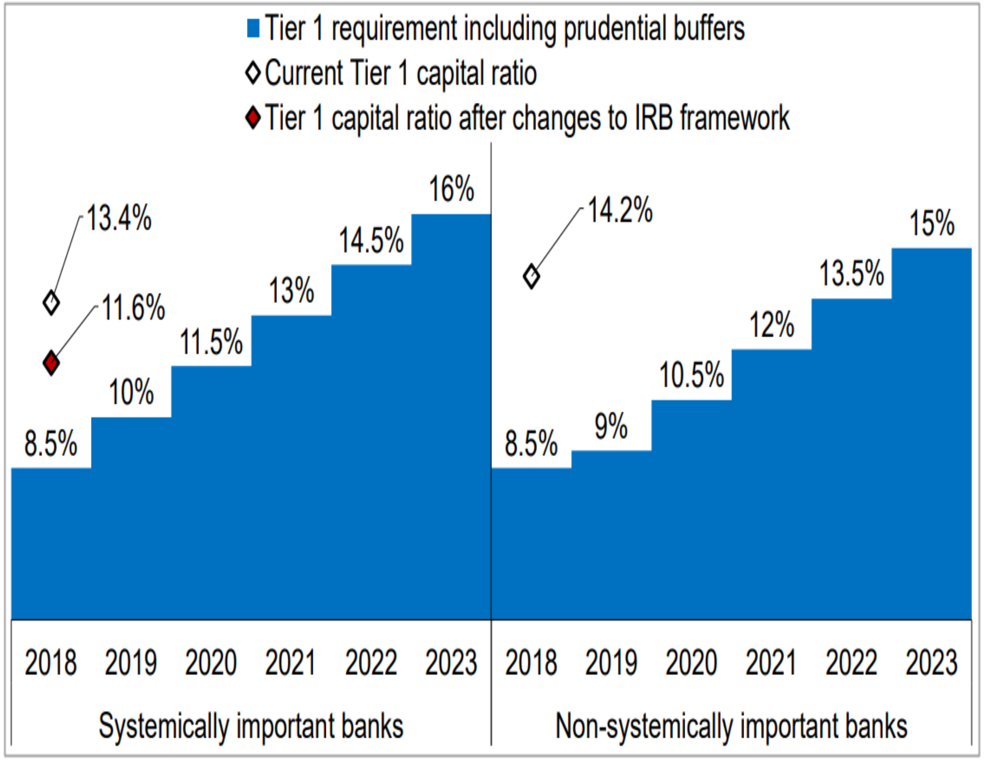
RBNZ is proposing a five-year transition.

Figure 9: Proposed transitional arrangements to meet higher capital ratio requirements



Treatment of “Tier 2” capital

The second main proposal of the review relates to the treatment of “Tier 2” capital (currently required to hold 2%).

- *“In this [proposed] environment [with Tier 1 capital at 15%-16%], there may be less justification for setting regulations for the required level of Tier 2 capital.”*

The main differences between Tier 2 and Tier 1 capital are:

- Tier 2 capital has only “gone concern” absorbency. That is, it generally only absorbs losses when the bank is being wound up or liquidated, not in ongoing operation, so it provides resolution support only. However, this is arguably just what the proposed 6% “Tier 1 minimum” would be used for anyway.
- Tier 2 capital is generally a cheaper form of financing than Tier 1 capital.
- What constitutes Tier 2 capital can be harder to define and measure, so it requires more regulatory effort.

APRA’s current proposal to increase capital requirements would allow it to be met with Tier 2 capital.

The RBNZ consultation paper does not contemplate being able to meet some of the proposed capital requirement with Tier 2 capital, and only poses the question as to whether or not there should continue to be an <u>additional</u> Tier 2 requirement.

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Leverage ratio requirement

The RBNZ preferred approach is to set both disclosure and minimum leverage ratio requirements.

- Provides a non-risk-based capital adequacy measure, but it is not clear what additional information it provides.
- Leverage ratio requirements would align with Basel standards and proposed APRA standards.
- However, a leverage ratio is unlikely to be binding ahead of the capital ratio so it is not clear what it would actually add in practice.

The RBNZ consultation paper seeks views, but further consultation is expected before decisions are made.

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Public commentary (1)

- ANZ: Should the RBNZ proceed with its proposal to increase bank's capital requirements by such a large amount, difficulty obtaining credit (particularly for the relatively risky agricultural and business sectors) could become a significant headwind. [23 April – interest.co.nz]
- UBS: [NZ banks will] need to reprice their NZ mortgage book by [about] 80 basis points to about 125 basis points to achieve the same return on equity. Credit rationing is also likely following the introduction of the rules, which could put pressure on the Kiwi Dollar and Official Cash Rate, as well as leading to the repricing of dairy and SME books. [10 April, 1 March – interest.co.nz]
- Standard & Poors: The proposed changes would improve banks' stand-alone credit profiles but issuer credit ratings unlikely to change. A five-year transition is sufficient, given banks current profitability and capital levels, but note that it could also affect APRA's requirements on the Australian parents. [26 February – interest.co.nz]
- Resimac and Squirrel Group: The changes will provide opportunities for non-banks in the home loan market, particularly for a structured product like RMBS. [23 April – interest.co.nz]
- Deutsche Bank: The proposals are sensible given NZ's unique market structure (highly concentrated in four banks with oligopoly returns. Estimate that banks would need to increase their margins by 50 basis points to maintain equity returns, they will "more sharply manage" the size and shape of their NZ balance sheets, and cut their "unsustainably high" dividend payout ratios. [13 March – interest.co.nz]
- Heartland Bank: Proposed capital increase would be able to be met from retained earnings over a 5 year period.
- Kiwibank: RBNZ proposal to level capital playing field between the big 4 banks and the rest makes a lot of sense.

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Public commentary (2)

- Ian Harrison: Main points of a detailed analysis:
  - The 'risk tolerance' approach ignores a consideration of both the costs and benefits of the policy.
  - Bank decision based on evidence that is not credible. A 1:200 target can be met with a capital ratio of around 8 percent using more credible inputs.
  - The policy will be costly -- ~$1.5-2 billion a year -- present value in excess of $30 billion.
  - The Bank's assessment that the banking system is currently unsound is at odds with rating agency assessments
  - The Bank's analysis ignores the fact that the banking system is mostly foreign owned
  - The Australian option of increasing tier two capital has been ignored
  - The benefits of higher capital are modest
  - New Zealand banks already well capitalised compared to international norms (ref PwC).
  - The Bank has forgotten about the OBR
- Goef Mortlock:
  - These are extremely high proposed tier 1 ratios by international standards.
  - The RBNZ's own earlier stress tests indicated that the banks come nowhere near the point of failure, even under severe stress scenarios.
  - Reducing the gap between IRB and standardised frameworks is arbitrary and penal relative to international (e.g. Basel) norms.
  - The D-SIB 1% premium does not reflect reality or international practice - a small bank failure would cause barely a ripple to the financial system or the economy, yet it is required to hold almost as much capital as a D-SIB.
  - Takes no account at all of the means by which bank failure resolution planning can reduce the economic and financial impact of bank failure and reduce the amount of taxpayer funding that might be needed as part of the resolution process. Contrary to international practice.
  - Fails to take into account other mechanisms that help reduce risk of crisis – risk appetite settings, risk management and governance arrangements, etc.

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Public commentary (3)

- Michael Reddell:
  - Concerns about quality of the process and lack of analysis on issues, such as:
    - comparison with the current and proposed rules in Australia,
    - a cost-benefit analysis ahead of making decisions,
  - Highlights and reviews other commentators’ views.
- Business NZ (Kirk Hope): Significant unanswered concerns about how the proposals would affect various groups of bank customers (farms, small business, young lower income people, households, marginal customers). [26 April – interest.co.nz]

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Briefing for Gabriel Makhlouf and Bryan Chapple for meetings with ANZ, ASB & BNZ

You have meetings with ANZ, ASB and BNZ in Auckland on Friday, 24 May. The attendees from the banks are:

- **ANZ:** David Hisco, Chief Executive Officer ANZ New Zealand and Group Executive
- **ASB:** Vittoria Shortt, Chief Executive Officer; Chandu Bhindi, General Manager Treasury; and Nick Tuffley, Chief Economist
- **BNZ:** Dean Schmidt, Executive General Manager Corporate Affairs

Purpose

This briefing provides background on the Reserve Bank's Capital Review,

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Bank capital requirements

Reserve Bank's Capital Review

Consultation closed on Friday, 17 May 2019 on the Reserve Bank's proposal to increase regulatory capital requirements for New Zealand incorporated banks.

The Reserve Bank expects to publish the submissions on the consultation paper in June. It will continue its stakeholder outreach programme, which includes conducting focus groups to understand how New Zealanders feel about risks in our financial system. It is also in the process of appointing external experts to independently review the analysis and advice underpinning the proposals. An announcement is planned by the end of November 2019, with implementation of any new rules starting from April 2020. There will be a transition period of a number of years before banks are required to fully comply with any new rules.

The Treasury is preparing advice for the Minister of Finance on the Capital Review. This advice will provide background and discuss aspects of the review. Some of the main banks have requested an independent review of the Reserve Bank's proposals. The Treasury's advice will *not* peer review the proposals.

The four big banks have generally noted that increased capital requirements are likely to lead to larger downside impacts on economic activity than estimated by the Reserve Bank, and that the proposals are likely to reduce banks' returns on equity. The four main banks and the NZBA have made the following key statements related to the proposal to increase regulatory capital requirements:

Bank	Statement
ANZ	- ANZ noted in December 2018 that the Reserve Bank's proposal could require a capital increase for the New Zealand subsidiary of \$6 billion to \$8 billion - ANZ's view is that regulatory capital requirements for New Zealand incorporated banks should align with those in Australia.

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ASB	- ASB estimates a 50–75 basis point increase in borrowing costs. On a $500,000 mortgage, this would increase annual interest payments by $2,500 to $3,750. - ASB notes a range of plausible estimates: - 25-75 basis points for lending interest rates; - 15-60 basis points for the cost of funds.
BNZ	- In December 2018, National Australia Bank (BNZ's parent) estimated the proposals would require a potential capital increase of about NZ$4 billion to NZ$5 billion for BNZ.
Westpac	- Higher capital requirements will lead to upward pressure on bank lending rates and downward pressure on bank deposit rates. - Higher lending rates would affect asset prices and GDP.
NZBA	- A report prepared for the NZBA estimated, based on the Reserve Bank's own assumptions, that the increased interest costs from the proposal will result in: o direct economic costs of $1.6 billion per annum; and o indirect economic costs (e.g. if firms invest less because of the higher interest costs) of $1.1 billion per annum. - The cost may be several times this level, once the assumptions are adjusted for New Zealand conditions.

The *Australian Financial Review* has reported that credit funds, as a result of the Capital Review, have been approaching the four main banks and offering to buy some of their loans, including for the agriculture sector. Generally, an increase in capital requirements could have the effect of pushing lending to less-regulated non-bank lending institutions.

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Suggested talking points

Reserve Bank's Capital Review

- The Reserve Bank is operationally independent in setting bank capital levels.
- The Reserve Bank is considering all submissions on the Capital Review before making its final decision.
- The Treasury does not intend to peer review the Reserve Bank's proposals, but we are interested in the proposals from a macroeconomic perspective.
- What do you consider are the key macroeconomic impacts from increasing capital requirements?
- What are key themes of your submissions on the latest consultation? Would you send us a copy of your submission?
- What do you think the consequences of a financial crisis would be? What sort of measures can safeguard New Zealanders against these risks?
- What is driving your estimates of higher lending rates? To what extent is this about maintaining existing returns on equity?
- Do you see any unintended consequences and what are the impacts of the proposal?
- Do you consider that the increased capital requirements could lead to more lending by non-bank lending institutions (eg. credit unions or credit funds)? What would be the consequence of this?

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Comparison of RBNZ and Sapere Capital Adequacy Analyses

28 May 2019

Factor	RBNZ	Sapere	Reference/Comment
Quantity of additional capital	6.5 to 7.5 % RWA		
Voluntary buffer	0.5% of EAD =→ 1% RWA [EAD = exposure at default]	1%-2% RWA. Adopt midpoint 1.5% RWA.	RBNZ background paper p42; Sapere para 67.
Required increase in CET1	4% of EAD	4.1%-4.6% EAD; Adopt midpoint 4.3% EAD	RBNZ background paper Table 10; Sapere Appendix A.
Direct economic costs			
	Assume MM offset of 50% [range: 25% to 75%]	MM offset could be minimal.	RBNZ consultation paper para 73; Sapere para 92.
	100 bps increase in tier 1 ratio (unweighted) increases wacc by 6.6 bps, with impact on lending rates of 8.1 bps [range: 11.8 to 4.5].		RBNZ background paper pp36-37 & Table 7.
	Credit cost $ effect not estimated.	4.3% EAD with 8.1bps impact implies increased credit cost of **$1.6 billion**.	Sapere Appendix B.
		But MM offset could be minimal, implying an impact on lending rates of up to 16bps, and increased credit costs of up to $3.1 billion.	Sapere Appendix B (scenario 2).
Indirect economic costs			
Reduced economic activity from higher interest rates	From literature review, a 100 bps (1%) increase in Tier 1 capital ratio could lead to an 8 bps decline in the steady-state level of GDP.	Alternative plausible scenarios give estimates ranging from 17 bps to 40 bps decline in steady state GDP per 100 bps increase in capital.	RBNZ papers are inconsistent on this. 3bps (consultation paper para 75); 8 bps (explanatory paper table 7); 8.8bps (FSOC decision paper para 38); Sapere Appendix C.
	8bps * 4% EAD increase gives 32 bps GDP reduction impact in steady state GDP: $900m [=.32%*$285bn]	The 17-40 bps range indicates considerable uncertainty, but all scenarios are significantly higher than RBNZ's 8 bps estimate. Lowest impact estimate gives $2,100m GDP reduction. This would be an even greater reduction if the MM effect is less than the 50% that RBNZ assumes.	Sapere para 101. Note: Sapere also gives the calculation of 8bps*4.3% EAD, which gives a GDP reduction of **$1.1 billion** (Appendix D).
Total direct and indirect costs			
	"Minimal".	Using the RBNZ assumptions (except with 4.3% EAD instead of 4% EAD), total cost would be at least: $1.6 billion direct costs plus $1.1 billion indirect costs = **$2.7 billion**	RBNZ consultation paper p 5; Sapere para 114.
Economic Benefits			
Economic cost of a crisis	20% to 90% of GDP. Central estimate = **63%** of GDP.		RBNZ background paper p 32.
Change in probability of a banking crisis	A 1% probability of banking crisis is consistent with existing capital levels, so a change to 1/200 (0.5%) is a reduction of **0.5%**.		RBNZ FSOC decision paper p 5 and Appendix 4
Expected value of avoided loss		Using RBNZ assumptions, central estimate is: $286 billion annual GDP * 63% central estimate * 0.5% change in probability = **$900 million**	Sapere para 126
		… with low/high of $286m/$1,286m (using RBNZ's 20% to 90% GDP).	
Net Economic Benefit			
		Central estimate: **negative $1.8 billion** (=900m-2.7bn) … with low/high of negative $2.4bn/$1.4bn.	Sapere para 127.

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Reserve Bank review of capital requirements for locally incorporated banks

Date:	26 July 2019	**Report No:**	T2019/1425
		File Number:	SH-11-4-3-1

Action Sought

	Action Sought	Deadline
Hon Grant Robertson **Minister of Finance**	s9(2)(f)(iv) [redacted] **Indicate** whether you would like to meet with officials from the Treasury to discuss this report.	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Daniel Jury	Senior Analyst, Financial Markets	s9(2)(k) [redacted]	N/A (mob)	✓
Robbie Taylor	Team Leader, Financial Markets		N/A (mob)	

Actions for the Minister's Office Staff (if required)

Return the signed report to the Treasury.

Note any feedback on the quality of the report	

Enclosure: No

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Treasury Report: Reserve Bank review of capital requirements for locally incorporated banks

Executive Summary

This report responds to your request for advice on the proposals made by the Reserve Bank of New Zealand (Reserve Bank) arising from its review of capital requirements for locally incorporated banks.

In particular, this report: (i) provides information about that review, the Reserve Bank's proposals arising from that review, and their implications; s9(2)(f)(iv) [redacted]

The Reserve Bank is proposing to increase capital adequacy requirements for banks

The Reserve Bank is proposing several changes to increase the resilience of banks. There are three main proposals. The headline proposal is to nearly double the capital banks are required to hold. The Reserve Bank also proposes to narrow the gap between the risk models used by different banks and to limit the types of capital that count toward the regulatory requirements. Final decisions are expected in November 2019.

s9(2)(f)(iv) and s9(2)(g)(i)

[redacted] The main banks have indicated that risker sectors like small businesses and the rural sector are likely to face relatively higher increases in interest rates and that banks might also retreat from lending in some marginal areas.

The extent of these impacts is uncertain and is heavily reliant on assumptions. The Reserve Bank provided preliminary estimates as part of its consultation that its proposals could result in a reduction to GDP of 0.32 per cent per year (approximately $950 million per year based on GDP for the year ended March 2019). Other groups estimate that the costs could be significantly higher. There will also be various distributional impacts.

Final decisions will depend on a value judgement about society's risk tolerance for banking crises

Theoretically, a good outcome would be to set regulatory capital requirements that maximise the net benefits to New Zealand. However, there is likely to be significant uncertainty involved in estimating these net benefits. Given this uncertainty, final decisions will depend on value judgements about society's risk tolerance for banking crises, and about who in society should bear the costs and benefits of the changes. The Reserve Bank's proposals reflect a judgement that society is very intolerant of the risk of a banking crisis – even if the costs of managing the risk to this tolerance may themselves be high.

A comprehensive cost-benefit analysis is necessary to inform these value judgements

The Treasury agrees that New Zealand society is likely to be relatively intolerant of banking crises. However, risk tolerances reflect judgements about the relative costs and benefits of

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different options for managing these risks, including distributional impacts across various groups in society. A comprehensive cost-benefit analysis provides a means to explore the range of potential impacts, even if the analysis is subject to a great degree of uncertainty.

The Reserve Bank has not yet published a consolidated cost-benefit analysis. In our view, a comprehensive cost-benefit analysis is necessary to inform decisions on the final proposals. In particular, this analysis should consider the extent to which alternative options (including different calibrations of capital, such as allowing different types of capital to meet the requirements) are likely to achieve the objectives of the policy.

The proposals also need to be considered within a broader policy context

Bank capital is only one part of New Zealand's wider 'financial safety net' (which includes, among other things, bank supervision, liquidity requirements, resolution options, and depositor protection). Some of these aspects are also subject to review at the current time. We think it is important for the Reserve Bank to explicitly take these other tools and reviews into account in its decisions on capital adequacy requirements.

s9(2)(f)(iv)

[redacted]

Recommended Action

We recommend that you:

a **note** that the Reserve Bank has proposed changes to the regulatory capital requirements for locally incorporated banks, is reviewing submissions and other feedback on its proposals, and expects to make final decisions and publish a consolidated cost-benefit analysis for its decisions later this year.

b s9(2)(f)(iv)

[redacted]

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s9(2)(f)(iv)

Agree/disagree.

c s9(2)(f)(iv)

d **indicate** whether you would like to meet with officials from the Treasury to discuss this report.

Yes/no

Robbie Taylor
Team Leader

Hon Grant Robertson
Minister of Finance

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Treasury Report: Reserve Bank review of capital requirements for locally incorporated banks

Purpose of this report

1. This report responds to your request for advice on the proposals made by the Reserve Bank of New Zealand (Reserve Bank) proposals arising from its review of capital requirements for locally incorporated banks.[1] In particular, this report:

   i provides information about that review, the Reserve Bank's proposals arising from that review, and their implications; and

   ii s9(2)(f)(iv)

Background

Review of capital requirements for banks

2. The Reserve Bank is responsible for the prudential supervision of banks. In this role it has the power to set conditions of registration for registered banks, which includes setting regulatory capital requirements. It must exercise this power for the purposes of:

   i promoting the maintenance of a sound and efficient financial system; and

   ii avoiding significant damage to the financial system that could result from the failure of a registered bank.

3. The Reserve Bank announced a review of capital requirements for banks in 2017. The review has been informed by the operation of the current framework, as well as international developments in bank capital requirements.

The role of the Minister

4. The Minister and the Treasury do not have a specific formal role in the process of setting bank capital requirements. However, the Minister does have a broader interest in the accountability and performance of the Reserve Bank from a stewardship perspective, and in the wider implications of its regulatory settings. It is therefore appropriate for the Minister to obtain comfort that the Reserve Bank exercises its powers in ways that address these concerns – for example, through the use of effective stakeholder engagement and transparent decision-making.

5. This interest is also reflected in the Minister's power to direct the Reserve Bank to have regard to a government policy that relates to certain Reserve Bank's functions.[2] This power provides the Minister with the ability to influence major prudential decisions, such as capital adequacy requirements.

[1] For simplicity, we refer to locally incorporated banks as "banks" for the remainder of this report.

[2] Section 68B of the Reserve Bank of New Zealand Act 1989. The applicable Reserve Bank functions include setting capital requirements for banks.

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Process and timing

6. The Reserve Bank has published a series of consultation papers over the past two years as part of this review. Public submissions on the last paper closed in May 2019. The Reserve Bank has now commissioned three independent experts to review its analysis on the proposals. It is also continuing its stakeholder outreach programme, which includes conducting focus groups to understand the public's risk appetite, and engagement with iwi, social sector and industry groups, financial institutions, and investors.

7. The Reserve Bank plans to announce its final decisions by November 2019. These decisions will be accompanied by a comprehensive cost-benefit analysis. Implementation is proposed to begin in 2020, with a five-year set of transitional arrangements being proposed before banks would be required to comply fully with the new capital requirements.

8. Some commentators have raised concerns about the process adopted for the capital review, including the sequencing of different elements of the review, the type and timing of engagement, and the absence of a formal cost-benefit analysis as part of the consultation process.

9. The Reserve Bank has noted that, while it has not yet produced a comprehensive cost-benefit analysis of the proposals (or of alternative options), it has published a number of separate pieces of analysis on the various costs and benefits of its proposals. It has also noted that there are benefits in undertaking the comprehensive cost-benefit analysis after submissions have been received (including allowing submitters' concerns to be considered as part of finalising the cost-benefit analysis).

10. However, not publicly consulting on the comprehensive cost-benefit analysis creates challenges for the public and stakeholders to provide feedback on the assumptions the Reserve Bank ultimately relies upon and to assess the relative merits of different risk tolerances and corresponding different options. These challenges may be mitigated by an effective stakeholder outreach programme.

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The proposals

11. There are three main elements to the Reserve Bank's proposals:

    i an increase in the total capital required to be held by banks;

    ii narrowing the gap between standardised and internal risk models; and

    iii limiting the types of capital that count toward the requirements.

Increase in the total capital required to be held by banks

12. The Reserve Bank's headline proposal is to require banks to hold substantially higher levels of capital. The Reserve Bank is proposing that the requirement to hold Tier 1 capital (the 'highest quality' capital, such as ordinary shares) as a percentage of risk-weighted assets (described more fully below) increase from 8.5% to 16% for 'systemically important' banks (which are likely to be the four main banks), and to 15% for other banks.

13. The proposals are at the higher end of the range of international requirements. This reflects the Reserve Bank's intention to adopt a conservative approach relative to other jurisdictions (reflecting the risks inherent in New Zealand's financial system and the

Reserve Bank's regulatory approach). However, international comparisons of headline capital requirement levels can be difficult because:

a headline total capital levels are not directly comparable (e.g. there can be differences in jurisdictions' approaches to calculating risk weighted assets and the types of capital permitted in meeting requirements); and

b differences in jurisdictions' economic contexts (e.g. different inherent financial vulnerabilities of each country) and differences in regulatory contexts (e.g. the effectiveness of each country's wider bank resolution regimes) can drive different appropriate capital levels.

Narrowing the gap between standardised and internal risk models

14. The total level of capital required by banks is expressed as a percentage of banks' risk-weighted assets. Essentially, banks' assets are adjusted to reflect the fact that different types of assets have different levels of risk. This means that the riskier an asset, the more capital a bank is required to carry against that asset.

15. The Reserve Bank currently allows the four main banks to use their own 'internal ratings based' (IRB) models to calculate their risk-weighted assets. This reflects a Reserve Bank judgement that the four main banks have the systems and processes in place to develop and operate their risk models competently.[3] Other banks must use a standardised approach prescribed by the Reserve Bank.

16. Banks using the IRB approach generally have lower risk weighted assets (and hence need to hold less capital against equivalent assets) compared to banks using the standardised approach. Banks using the standardised approach argue that it makes them less cost-competitive and that they earn a lower return on equity than banks using the IRB approach.

17. The Reserve Bank is proposing to narrow the gap between calculations using the IRB and standardised approaches, and expects that these changes will add an additional 1.8 percentage points, on average, to the capital required by the banks using the IRB approach.

Limiting the types of capital that count toward the requirements

18. Different types of bank funding count towards the capital requirements. The Reserve Bank is proposing that banks would only be able to meet the proposed increase in capital levels with Tier 1 capital.

19. The figure below illustrates the main types of funding, and the extent in which they incur losses in the event of a bank failure:

[3] Following compliance failures when using the IRB approach, the Reserve Bank has required: (1) Westpac to hold higher capital, and (2) ANZ to revert to the standardised approach to calculate its operational risk capital requirements (instead of the IRB approach).

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Types of bank funding		Examples of holdings
Tier 1 Capital	Common Equity Tier 1 (CET1)	Ordinary shares Retained earnings
	Additional Tier 1 (AT1)	Preference shares
Tier 2 Capital		Qualifying long-term subordinated debt
Other liabilities	Unsubordinated, unsecured liabilities	Call and term deposits Senior unsecured debt
	Secured liabilities and preferred creditors	Covered bonds Employee entitlements

Incurs bank losses first

Incurs bank losses last

20. The main differences between Tier 2 and Tier 1 capital are:

    i Tier 2 capital is generally cheaper and easier to access than Tier 1 capital.

    ii Tier 1 capital has 'going concern'[4] loss-absorption capacity, while Tier 2 capital has 'gone concern'[5] loss-absorption and recapitalisation capacity.

    iii Tier 2 capital can be harder to define and measure than Tier 1 capital, so allowing greater use of Tier 2 capital would require more regulatory effort.

21. The Reserve Bank's proposals to focus on Tier 1 capital result from a decision to focus on reducing the likelihood of bank failure, rather than increasing the ability to recapitalise banks on failure. The Reserve Bank also prefers Tier 1 capital because it is more straightforward from a compliance and administration perspective.

22. The approach to focus on Tier 1 capital is diverging from the approach being taken in other developed countries, particularly Australia. The Australian Prudential Regulation Authority (APRA) focused on increasing recapitalisation capacity (to balance out the existing focus on loss-absorbency) when it recently reviewed the capital requirements for Australian 'authorised deposit-taking institutions' (which include banks). As a result of its review APRA has also decided to increase its capital requirements, but will allow banks to meet the new requirements with Tier 2 capital (as Tier 2 capital is more cost-effective and provides recapitalisation capacity).

23. s6(b)(i) [redacted]

24. The smaller New Zealand-owned banks have concerns about the focus on Tier 1 capital and have submitted that the requirement to use solely Tier 1 capital would:

    i undermine their growth;

    ii put them at a competitive disadvantage relative to the larger Australian banks; and

[4] Tier 1 capital will automatically absorb losses while the bank is still operating as a going concern. This helps keen a bank solvent.

[5] Tier 2 capital generally absorbs losses or provides recapitalisation capacity at or close to the point of failure itself when the bank is being wound up or liquidated.

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iii create a risk that small banks are ultimately absorbed by the large banks.

25. These smaller banks also argue that they already have challenges in accessing Tier 1 capital, and that the outlook for meaningful growth from retained earnings is limited.

Contingent convertible debt

26. The Reserve Bank is also proposing that banks will not be able to use contingent convertible debt (known as 'CoCos') to meet the regulatory capital requirements.

27. A CoCo is a type of debt instrument that is convertible into equity or written off if a bank's financial position falls below certain prescribed limits. A CoCo can theoretically provide 'going concern' loss-absorption capacity depending on design. CoCos are cheaper than ordinary shares, but their complexity could limit their effectiveness to absorb going-concern losses and are likely to make the capital regime more difficult to comply with and administer.

The benefits of avoiding a banking crisis are significant …

28. The main benefit of higher bank capital levels is that banks would be more resilient to economic shocks and crises. This benefit has two components:

i Banks would be likely to continue to lend and promote economic activity for longer and at relatively greater levels during a crisis. This means businesses and consumers would be able to continue to borrow, transact, employ, and pay tax deeper into a crisis. This promotes a resilient economy.

ii Banks are less likely to fail. Bank failure involves significant disruption to society, with depositors affected, critical economic functions disrupted, and a significant cost to the Crown (e.g. increased social support and/or costs associated with any government bailout or support of a distressed bank).

29. The Reserve Bank has concluded that the costs of banking crises are significant. In coming to this conclusion, it has referred to international literature on the negative economic and social impacts of severe financial crises.

30. s9(2)(f)(iv) and s9(2)(g)(i)

… but the costs are also likely to be significant

31. Banks would need to increase their capital levels to meet the proposed requirements. Standard and Poor's has estimated that banks will need to increase their Tier 1 capital by 43%, on average, with the requirement varying significantly among banks.[6]

32. Holding more capital will have ongoing economic costs and wider impacts – on interest rates, overall economic activity, particular sectors, the market landscape, and the

[6] The Reserve Bank expects that banks will be able to fund the new requirements (which amount to about $20 billion of additional capital) by retaining 70% of their expected profits each year over a five year transition to full implementation. It will be up to each bank to determine how they actually fund the new requirements.

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Crown's balance sheet. The extent of these impacts is uncertain and is heavily reliant on assumptions. The benefits to society of reducing the likelihood of a crisis to a tolerable level (discussed above) must be weighed against these ongoing costs to society of increased capital requirements.

33. The Reserve Bank included some preliminary estimated economic impacts in its public consultation, including possible interest rate impacts and impacts on the economy more generally (discussed below). s9(2)(f)(iv) and s9(2)(g)(i) [redacted] However, this was the information provided to the public as part of its consultation.

Impact on interest rates

34. The Reserve Bank has noted as part of its public consultation that it expects that the proposals will have "only a minor impact" on borrowing rates. The Reserve Bank has also indicated publicly that lending margins above borrowing costs may increase by 20 to 40 basis points (that is, 0.2 to 0.4 percentage points). This implies an increase in annual interest costs of between $1,000 to $2,000 for $500,000 of lending.

35. However, some stakeholders have argued that the Reserve Bank has underestimated the impacts on interest rates. The range of views includes the following:

Stakeholder	***Stakeholder comment***	***Implied additional annual interest costs for $500,000 of lending***
Harbour Asset Management	… The likely economic costs and increases in interest rates will be larger than Reserve Bank's 20-40 basis point estimate, and a **50-70 basis point increase is more likely.** A 50 basis point increase in the annual interest cost of a $500,000 mortgage is about $2,500 …	$2,500 to $3,500
Macquarie	… We estimate that banks would need to **raise their average pricing by 90-140 basis points** to offset the reduction in returns …	$4,500 to $7,000
ANZ	… Our range of estimates [of the long-run impacts on the cost of credit] is wide, due to the many uncertainties that exist. However, **our mean estimate is considerably larger than cited by the Reserve Bank**…	NA
ASB	… ASB economists estimate that the higher capital requirements will likely result in a **50 to 75 basis point increase in customer lending rates**, which is significantly above the Reserve Bank estimate.	$2,500 to $3,750
Kiwibank	… it is our observation that the **Reserve Bank's estimation of a 20-40bps increase in borrowing costs falls within the lower end of our range of estimations** if the cost is solely applied to loan balances.	NA
Westpac	… The increase in capital could up the cost to borrowers by **adding more than 100 basis points** to the interest rate on a home loan - an increase of around $6,000 to an average home loan in Auckland. …	$5,000

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36. The Reserve Bank's expected 20 to 40 basis point increase amounts to total increased lending costs of $880 million to $1.8 billion per year.[7] However, the adjustment would be more complicated than this with the potential for:

    i lower demand for credit at higher interest rates;

    ii lower supply of types of credit that attract a higher risk weighting;

    iii expansion of non-bank lending and credit providers; and

    iv substitution to bond markets by the larger corporates, and by mortgage securitisation.

37. Increased interest rates from the proposals could also be offset by reductions in the OCR if the OCR were lowered due to lower demand and lower inflation resulting from the proposed changes. The Reserve Bank indicated in its February 2019 Monetary Policy Statement that monetary policy would be able to respond "as needed" if additional support were required during the proposed five-year transition period.

Impact on overall economic activity

38. The Reserve Bank provided as part of its consultation preliminary estimates that a 1 percentage point increase in Tier 1 capital could lead to a 0.08 percentage point reduction in long run steady-state GDP. For the Reserve Bank's proposed increases in capital requirements, this would equate to a loss in economic output of 0.32% per year (approximately $950 million per year).[8]

39. However, the Sapere Group suggests that alternative plausible scenarios give estimates of potential reductions in long run steady-state GDP ranging from 0.17 to 0.40 percentage points, which are significantly higher than the Reserve Bank's estimate.

40. s9(2)(f)(iv) and s9(2)(g)(i)

Impacts on particular groups or sectors

41. The changes will have different impacts on particular groups or sectors.

Agricultural and small businesses

42. s9(2)(f)(iv) and s9(2)(g)(i)

43. The main banks argue that increased capital requirements and changes to their risk models will lead to less lending and/or more expensive lending to riskier sectors (particularly rural and small business customers). KPMG is reported as estimating that the main banks (including Rabobank, which is a significant lender to this sector) will reduce agricultural lending by between 15 to 25% (mainly in dairy) and will increase margins across their remaining agricultural lending by 100-125 basis points.

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[7] Based on total bank lending of $440 billion (Reserve Bank, February 2019).
[8] Based on the Reserve Bank's estimate of the cumulative impact of the proposals on GDP (Table 7 of the Reserve Bank's Capital Review Background Paper: An outline of the analysis supporting the risk appetite framework) and GDP for the year ended March 2019 ($296 billion).

44. There may be some negative impacts at the margin for businesses that are already struggling to service existing levels of debt. For example, the Reserve Bank recently noted that a material portion of New Zealand dairy farms have high debt levels that they would struggle to service if their costs rose.[9]

45. s9(2)(f)(iv) and s9(2)(g)(i) [redacted]

46. Moreover, the proposals come at a time when these sectors are also facing other challenges. The agricultural sector, for example, is currently facing other regulatory proposals that are under development, including water, climate change, and biodiversity reforms, while small businesses in New Zealand face high interest rates relative to comparable jurisdictions. These proposals are likely to exacerbate these challenges further.

Residential lending

47. s9(2)(f)(iv) and s9(2)(g)(i) [redacted] Also, some banks have indicated that they are likely to shift their lending towards housing (and away from the business sector), because housing will require significantly less capital than other areas.

Deposit holders

48. s9(2)(f)(iv) and s9(2)(g)(i) [redacted]

Impact on the market landscape

49. The Reserve Bank does not expect the proposals to compromise the competitiveness of the banking market. However, the main banks argue that the proposed changes to capital requirements will discourage lending to riskier sectors by banks (particularly rural, construction and small business customers). Alternative lenders may fill this gap and there may be an increase in lending by branches of foreign banks, private equity, investment funds, and non-bank deposit takers (NBDTs).

50. The regulatory perimeter for NBDTs is being considered as part of the Reserve Bank Act Review. The Government has already made an in-principle decision to combine the regulatory regimes for banks and for NBDTs into a single 'licensed deposit taker' perimeter. An increase in lending by NBDTs would also have implications for the scope of any deposit insurance regime, which is also part of the Reserve Bank Act Review.

Impact on the Crown balance sheet

51. We expect there to be second-order impacts only on the Crown's balance sheet. [redacted] s9(2)(b)(ii) and s9(2)(g)(i) [redacted] A marginal positive impact could arise from there being a lower likelihood of a bank failure leading to the Crown being called on to provide assistance, and possibly higher corporate tax receipts from banks

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[9] Reserve Bank Financial Stability Report, May 2019.

resulting from them holding relatively lower levels of debt (which lowers their interest costs and raises their profits).

52. The Reserve Bank's stress testing indicates that for a major bank to fail the New Zealand economy would likely need to be under significant stress, with multiple years of negative economic growth and double-digit unemployment. If the New Zealand economy is in this state, the Crown balance sheet's capacity to absorb any costs may be more limited.

Value judgements about society's risk tolerance are key to final decisions

53. Different capital levels result in different:

i expected costs of bank crises (e.g. greater capital will generally result in lower likelihood of crises and hence lower expected costs of a crisis on a yearly basis); and

ii ongoing costs to the economy (e.g. greater capital will generally result in higher costs for banks that will be passed into the economy).

54. Theoretically, a good outcome would be to set regulatory capital requirements that maximise the net benefits to New Zealand. However, it is difficult to assess the costs and benefits because of the need to make judgements about a variety of highly-debatable factors, including:

i the costs of a crisis – the extent of both financial and non-financial social impacts of crises, and how long the negative effects of a crisis will last; and

ii ongoing costs to the economy – how and where banks will raise additional capital; and where, and to what extent, they will pass on costs or accept a lower return on equity. This depends on the level of competition across the banking sector, the structure of each bank's balance sheet and exposure, and the structure of its capital (including between the parent and subsidiary for the four main banks).

55. This uncertainty could result in significant ranges of possible net benefits for each option, which could overlap. Given this uncertainty, final decisions will depend on value judgements about society's risk tolerance for banking crises, and about who in society should bear the costs and benefits of the changes.

56. In the course of its work, the Reserve Bank has focused primarily on the risk tolerance of society.[10] Given the high costs of banking crises, the Reserve Bank has concluded that New Zealand society is likely to be relatively intolerant of banking crises. The proposals are based on society having a 1/200 year tolerance for a banking crisis (that is, a 0.5 percent tolerance for failure in any *one* year).[11] The Reserve Bank noted that 1/200 is a 'starting assumption,' and is not calibrated on the basis of any specific evidence about New Zealanders' tolerance for banking crises.[12]

[10] Under the Reserve Bank's 'risk appetite framework' the Reserve Bank follows a two-step decision-making process where it first takes into account soundness considerations and then, second, efficiency considerations.

[11] This means that there would be sufficient capital to absorb a loss that is so large it might arise once every 200 years.

[12] 1/100 was also used earlier in the process, and gave results similar to the existing capital requirements (FSOC paper, November 2018, footnote 2). .

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Comprehensive cost-benefit analysis can inform these value judgements…

57. s9(2)(f)(iv) and s9(2)(g)(i) However, a particular social risk tolerance will reflect a consideration of the relative costs and benefits of different options for capital requirements, including distributional impacts across various groups in society. A comprehensive cost-benefit analysis of different options provides a means to explore the range of potential impacts, even if the analysis is subject to a great degree of uncertainty.

58. The Reserve Bank has published a number of separate pieces of analysis on the various costs and benefits of higher capital requirements, but has not yet produced a comprehensive cost-benefit analysis of the proposals (or of alternative options). However, in the absence of a comprehensive cost-benefit analysis of the preferred proposals and other options, it is difficult to assess the relative merits of different risk tolerances (including the Reserve Bank's proposed 1:200 year tolerance) and corresponding different options.

…and is a necessary step to justify the proposals

59. In the absence of a comprehensive cost-benefit analysis from the Reserve Bank to support its proposals, other commentators have produced their own assessments. For example, analysis prepared by the Sapere Group for the New Zealand Bankers' Association suggests that the proposals will have a net economic *cost* of $1.8 billion (i.e. the proposal will destroy value).[13]

60. The Reserve Bank has indicated that it plans to produce a comprehensive cost-benefit analysis as part of its assessment of the expected regulatory impacts (which is required to support final decisions).[14] It rests with the Reserve Bank to undertake a complete analysis that includes a consideration of alternative options to achieve its objectives, with adequate engagement with the public and stakeholders.

There is an important broader context

Capital requirements are only one part of the broader 'financial safety net'

61. Capital adequacy requirements are arguably the most important tool for reducing the likelihood of bank failure and mitigating the impacts on society. However, they are just one part of a broader regulatory framework – the 'financial safety net' – that also contributes to these objectives. The financial safety net includes:

    i the Reserve Bank's approach to supervising banks and its ability to use other regulatory tools to encourage responsible lending or increase stability;

    ii bank resolution tools, and their effectiveness in quickly resolving banks in the event of a crisis so that a bank's critical economic functions can be maintained;

    iii deposit insurance and deposit guarantee schemes that cushion depositors from the impacts of bank failure; and

    iv the strength of the Crown's balance sheet and a Government's willingness to bail out a bank to avoid costs to society.

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[13] In our view, the Sapere Group's analysis is not a complete analysis of the costs and benefits.
[14] Section 162AB of the Reserve Bank of New Zealand Act 1989. There are no specific requirements under this Act for when this assessment needs to be prepared.

62. There are choices about the extent of reliance that is placed on each of these various elements. More emphasis on one element may mean that less emphasis needs to be placed on another. Setting capital levels should take into account how the Reserve Bank's objectives are, or could be, met through the financial safety net as a whole. We would expect that the Reserve Bank's comprehensive cost-benefit analysis would clearly articulate how their proposals and the different components of the 'financial safety net' interrelate.

Phase 2 of the Reserve Bank Act Review is underway

63. Phase 2 of the Review of the Reserve Bank of New Zealand Act 1989 is currently underway. The potential for changes to be made as part of that review, including to the 'financial safety net', may affect the setting of capital requirements.

64. That review is considering changing the framework under which the Reserve Bank operates, including contemplating clearer ministerial involvement in setting the high-level strategy, objectives, and direction for the Reserve Bank (while protecting its operational independence). That review is also considering the use of a financial policy remit (covering the Government's risk appetite and economic and financial priorities), and bank crisis management and resolution tools. The Government has also made an in principle decision to introduce depositor protection.

65. More specifically, that review is considering options that enable systemically important banks that fail to be kept open without putting taxpayer funds at risk. Internationally, this is achieved by ensuring that a bank's capital and liability structure contains appropriate capacity to effect a recapitalisation (in additional to loss absorption). [redacted]
s9(2)(f)(iv) [redacted]

Next steps

66. The Reserve Bank's proposals involve significant costs to the economy – as well as significant benefits – and ultimately rest on difficult judgement calls about society's risk tolerance for banking crises given these costs and benefits.

67. s9(2)(f)(iv) [redacted]

68. s9(2)(f)(iv) [redacted]

Pages 16 and 17 of this document have been withheld under s9(2)(f)(iv).

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Adam Antao [TSY]

From: James Sergeant <James.Sergeant@rbnz.govt.nz>
Sent: Tuesday, 26 March 2019 3:43 PM
To: Amir Mehta [TSY]
Cc: Stan Christian
Subject: Input for aide-memoire for meeting with BNZ
Attachments: Aide Memoire Minister of Finance meeting NAB CEO BNZ Chair April 2019 _ Capital Review Culture and Conduct.docx

Amir,

As requested, here is some material for the Minister's briefing.

James Sergeant
Adviser **|** Reserve Bank of New Zealand **|** Te Pūtea Matua
2 The Terrace, Wellington 6011 **|** P O Box 2498, Wellington 6140
s9(2)(k) | s9(2)(a)
Email: james.sergeant@rbnz.govt.nz | www.rbnz.govt.nz

From: Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>
Sent: Monday, 25 March 2019 9:21 AM
To: James Sergeant <James.Sergeant@rbnz.govt.nz>
Subject: Input for aide-memoire for meeting with BNZ

[IN-CONFIDENCE]

Good morning James,

I hope you had a good weekend.

As you'll see below, I am preparing an aide-memoire for the Minister of Finance's meeting with NAB/BNZ. Are you able to provide, by **COP Thursday 28 March**, any background on the Capital Review and Culture/Conduct Review that relates to BNZ (e.g. views, progress)?

Let me know if this timing doesn't work.

Regards,

Amir

From: Angus Hodgson <Angus.Hodgson@parliament.govt.nz>
Sent: Monday, 11 March 2019 5:02 PM
To: Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>; Matthew Gilbert [TSY] <Matthew.Gilbert@treasury.govt.nz>
Subject: BNZ

Kia ora kōrua

Minister Robertson will meet with the newly appointed National Australia Bank Chair and interim CEO Phil Chronican and Bank of New Zealand Chair Doug McKay on Monday 8 April at 8am (30 minutes). They have indicated

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their willingness to discuss "capital adequacy and the ongoing RBNZ/FMA review." Could Treasury please supply an aide memoire **by Thursday 4 April** to cover:

- Capital Review
- Reserve Bank Act Review
- Response to the Bank and Life Insurers Reviews
- Provision of Regional Bank Services

The aide memoire should cover these points in brief as well as provide any other salient information, suggested talking points and short biographies for Mr Chronican and Mr McKay. Please consult as appropriate with the RBNZ and FMA.

Please confirm that the above request and timing works for Treasury.

Mauri ora

Angus Hodgson, Private Secretary (Finance and State Owned Enterprises)
Office of Hon Grant Robertson | Office of Rt Hon Winston Peters
Minister of Finance | Minister for State Owned Enterprises

Level 7.6 Executive Wing, Parliament Buildings, PO Box 18041, Wellington 6160, New Zealand
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Aide Memoire: Meeting with the National Australia Bank Acting CEO and Chair Designate, and Bank of New Zealand Chairman on 8 April 2019

Capital Review

The Reserve Bank of New Zealand (the Reserve Bank) is consulting on the capital adequacy framework for banks (the Capital Review), which will see capital invested in banks by their owners, mostly composed of Tier 1 capital (equity) increase from 8.5% to 16% over a proposed five-year transition period.

The consultation document also proposes changes in the way banks calculate their capital ratios, which will result in a more 'level playing field' in terms of competition between the large banks (ANZ, ASB, BNZ and Westpac) and smaller banks (Kiwibank, TSB, etc.).

The Reserve Bank anticipates strong opposition from the banks most affected by the proposals (ANZ, ASB, BNZ and Westpac). The Reserve Bank has had discussions with the banking industry and maintains an open dialogue to discuss the proposals. Industry reaction to date has been that the flow-on impact of the increased capital invested would likely be increased lending rates, lower return on deposits and constrained credit risk appetite in sectors that did not provide an adequate return on equity.

The Reserve Bank is still consulting on the proposals and will consider all information put forward by banks and other submitters. However, it has yet to receive any formal submissions, which close on 3 May. The Reserve Bank is planning to publish the finalised policy in mid-2019.

Section 105 of the Reserve Bank of New Zealand Act

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s9(2)(f)(iv)

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Copy of RBNZ Q&A – The Capital Review

Our proposals would lead to the highest capital ratios in the world

- The aim of the capital review is to calibrate the framework to New Zealand's risk appetite for banks operating in New Zealand, not to peer benchmarks. If that means we have some of the world's best capitalised banks, that's a desirable outcome. Comparisons across countries are fraught with difficulties, because all countries use different measurements and have different banking systems. There is no "right" metric. Against the benchmarks we have considered, the proposed capital levels would place the large banks' capital levels at the top end of their relevant international peers, e.g., S&P's methodology suggests the four large banks would come out closer to the 80th percentile of benchmark small open economies.

UBS states mortgage rates will go up 122bps, RBNZ says 20-40bps

- UBS' analysis is based on flawed assumptions. UBS assumes that:
  - Banks keep paying interest on debt that would be retired by the move to higher capital levels
  - Banks' target return on equity is unaffected despite the lower risk of that equity investment
  - Banks concentrate all repricing on just one business line – mortgages – with no changes to other loans, deposit rates etc.
- The RBNZ believes risk and return are related so shareholders will adjust their expectations, and that repricing will occur across more than just residential mortgage lending. We will consider the estimates being made by other analysts as part of the next stages of the Review.

Credit rating agencies (e.g. Fitch) state credit ratings could decline

- A media report mis-stated what Fitch actually said in their report. Fitch affirmed NZ banks' ratings. Fitch said that if the parent banks sold their NZ operations then the NZ banks would lose their parental support credit rating uplift. Fitch was clear that this is an extremely unlikely scenario.

Why 1 in 200?

- We needed a number to undertake quantitative analysis of different capital levels. Based on the social costs associated with banking crises, our judgement is that 1 in 200 is a reasonable definition of 'very rare', but this is a key input which we are seeking feedback. We think there are net gains to societal welfare moving from the current level of capital to our 1 in 200 calibration, but that beyond 1 in 200 the increased financial system stability is likely to be outweighed by the costs of achieving that stability.

How do we reconcile the proposals with positive stress test outcomes?

- While stress tests are useful to understand how a particular stress event might pan out, they don't allow for unknowns outside the stress test scenario. In a real-life banking crises events happen that can exacerbate the effects of any initial shock. These unknown events are not captured and modelled in stress tests.

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Why was a full cost-benefit assessment (CBA) not undertaken?

- It is important to gather the views of all stakeholders to get an accurate picture of all likely costs and benefits. Capital calibration is subject to uncertainty. Once stakeholders have identified all the costs and benefits, and decisions are made about what levels of capital will be needed, then the final cost-benefit analysis will be completed.

Why a 5-year transition period?

- We thought 5 years was enough time for the large banks to meet the requirements through their earnings over a manageable but not prolonged period. We will listen to submitters views on the manageability of 5 years, and are open to alternative transitions (particularly for individual institutions, e.g. mutuals).

General response to Ian Harrison on modelling inputs

- People are more than welcome to have different views on the proposals. We encourage people to provide their views, as well as any additional evidence they think we've missed. We will take a detailed look at stakeholders work and submissions from independent analysts and, where they make reasonable and credible points about our judgements, then we will take that on board in our final decision making.

Error in capital review background paper

- A typographical error was contained in a formula that was published in the April 3 background paper.

- It was simply a transmission error and does not affect or change any calculations.

- We've put a note on the document and on our website, and advised stakeholders.

The Reserve Bank has suggested the capital proposals could raise interest rates by 20-40 percent. Would the increase be even higher for agricultural lending? If so, do you have an estimate?

- It will be up to banks to make their own pricing and lending decisions.

- Lending to the agriculture sector in New Zealand accounts for around 14 percent of total lending.

What will the penalty be for breaching capital requirements?

- A bank will not be in breach of its Conditions of Registration if it enters into our proposed prudential capital buffer. However, we propose that banks will be subject to automatically triggered restrictions on discretionary payments and an increasingly intensive supervisory response (for example, preparation of a capital plan, as is the case with the current conservation buffer). These two responses are quite separate in that they may be triggered at different levels within the prudential buffer.

- Banks have several options for meeting the proposed new requirements.

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What percent of agricultural debt is held by what proportion of farmers?

- Lending to the agriculture sector in New Zealand accounts for around 14 percent of total lending, of which the dairy sector accounts about for two-thirds.

- The level and concentration of dairy sector debt has increased significantly in recently decades, to become the next largest share of bank lending after housing.

- The latest data we have suggests 20% of dairy farm units account for 45% of dairy sector debt. This is based on 2017 data from DairyNZ.

The report prepared by PwC says your proposals amount to NZ having capital ratios of 27%, which is far higher than other countries.

- Many assumptions and judgements underlie the PWC analysis and exercises such as this are inherently difficult. We have yet to fully assess all of the details in the report, but think that it overstates the relative position.
- The underlying assumption of studies like this is that it makes sense for one country to have the same amount of bank capital as another – but this ignores the fact that risks differ from country to country.
- The risk associated with a mortgage in NZ is not going to be the same as one in Canada, or Europe or elsewhere – so the amount of capital needed against mortgage assets differs too.
- Fundamentally, studies like this don't address how much capital is appropriate locally, and that's the key issue.

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From: Amir Mehta [TSY]
Sent: Tuesday, 21 May 2019 10:30 AM
To: Richard Downing
Cc: Susan Ivory [TSY]; Ian Woolford; Daniel Jury [TSY]
Subject: RE: Background and talking points on Capital Review

Thanks, Richard – that's appreciated.

I take your point re: the credit funds point and will add a bit more information. I was referring to this article:

https://www.afr.com/business/banking-and-finance/credit-funds-flood-to-nz-chasing-loanbooks-20190516-p51nxo.

Essentially, credit funds are apparently approaching the main banks and offering to take on their loanbooks.

Can we also confirm that the meeting on Thursday at 2.30 – 4.00 is going ahead? Are you able to host?

Regards,

Amir

From: Richard Downing
Sent: Tuesday, 21 May 2019 10:17 AM
To: Amir Mehta [TSY]
Cc: Susan Ivory [TSY] ; Ian Woolford
Subject: RE: Background and talking points on Capital Review

HI Amir

A few suggestions on your talking points:

- Timeframe: The RBNZ expects to publish the submissions on the 4th consultation paper of the Capital Review during June. Final decisions are expected later in 2019.
- Summation of bank views: "The four big banks have generally noted that increased capital requirements are likely to lead to larger downside impacts on economic activity than estimated by the RBNZ. The proposals are likely to reduce banks' returns on equity. To lift the returns on equity the banks may try to increase the cost of borrowing to consumers, or restrict the availability of credit. The banks note that they believe these impacts will be larger than RBNZ estimates and could lead to larger downside impacts on economic activity."

If you want to get a sense of the bank submissions, the NZBA have published their submission:
https://www.nzba.org.nz/2019/05/17/capital-review-paper-4-how-much-capital-is-enough/

Some extra talking points you could consider:

- What do you think the consequences of a financial crisis would be? What sort of measures can safeguard New Zealanders against these risks?
- What is driving your estimates of higher interest rates? To what extent is this about maintaining existing returns on equity?
- What are the impacts of any 'unintended' consequences?

One further comment. It's not clear to me what the talking point below refers to. It may need some further context.

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- What do you make of reports that international credit funds are approaching banks regarding their loan books as a result of the Capital Review?

Cheers

Richard

From: Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>
Sent: Monday, 20 May 2019 2:39 PM
To: Richard Downing <Richard.Downing@rbnz.govt.nz>
Cc: Susan Ivory [TSY] <Susan.Ivory@treasury.govt.nz>
Subject: RE: Background and talking points on Capital Review

Hi Richard,

Early tomorrow morning is fine.

The meetings are with:

David Hisco (ANZ – CE)
Dean Schmidt (BNZ – GM, Corporate Affairs)
Vittoria Shortt, CEO, Chandu Bhindi (General Manager) + Nick Tuffley, (Chief Economist) (ASB)

Thanks,

Amir

From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Monday, 20 May 2019 2:02 PM
To: Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>
Subject: RE: Background and talking points on Capital Review

Hi Amir

We are looking at this now. Will try to get it back to you today, but might be a challenge as I am about to go into a 2 hour meeting. Would early tomorrow morning be ok if we can't finalise today.

Who are the meetings with at the banks (eg. CEO, Treasurer etc)?

Richard

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Sent: Monday, 20 May 2019 1:02 PM
To: Richard Downing <Richard.Downing@rbnz.govt.nz>
Cc: Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>; Daniel Jury <Daniel.Jury@treasury.govt.nz>; Brian McCulloch [TSY] <Brian.McCulloch@treasury.govt.nz>; Susan Ivory [TSY] <Susan.Ivory@treasury.govt.nz>
Subject: Background and talking points on Capital Review

[IN-CONFIDENCE]

Hi Richard,

The Treasury's Secretary and Deputy Secretary are meeting with ANZ, BNZ, and ASB this Friday. We are providing some brief background material and talking points for these meetings, including for the Capital Review.

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I have attached the brief background and talking points on the Capital Review. Would you be able to provide any comments by the end of today? I appreciate you are busy at the moment, so please let me know if this timing does not work.

Much appreciated,

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From: Susan Ivory [TSY]
Sent: Tuesday, 21 May 2019 3:40 PM
To: Richard Downing
Cc: Amir Mehta [TSY]; ian.woolford@rbnz.govt.nz
Subject: RE: Background and talking points on Capital Review

Hi Richard

Thanks for help with the background and talking points. I see on the RBNZ website that there is a little more detail on the proposed timeframes. I was proposing to also include this in our briefing, as follows:

The Reserve Bank expects to publish the submissions on the consultation paper in June. It will continue its stakeholder outreach programme, which includes conducting focus groups to understand how New Zealanders feel about risks in our financial system. It is also in the process of appointing external experts to independently review the analysis and advice underpinning the proposals. An announcement is planned by the end of November 2019, with implementation of any new rules starting from April 2020. There will be a transition period of a number of years before banks are required to fully comply with any new rules.

Kind regards
Susan

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Susan Ivory | Senior Analyst, Financial Markets | Te Tai Ōhanga – The Treasury
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One further comment. It's not clear to me what the talking point below refers to. It may need some further context.

- What do you make of reports that international credit funds are approaching banks regarding their loan books as a result of the Capital Review?

Cheers

Richard

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Thanks,

Amir

From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Monday, 20 May 2019 2:02 PM
To: Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>
Subject: RE: Background and talking points on Capital Review

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Richard

From: Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>
Sent: Monday, 20 May 2019 1:02 PM
To: Richard Downing <Richard.Downing@rbnz.govt.nz>
Cc: Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>; Daniel Jury <Daniel.Jury@treasury.govt.nz>; Brian McCulloch [TSY] <Brian.McCulloch@treasury.govt.nz>; Susan Ivory [TSY] <Susan.Ivory@treasury.govt.nz>
Subject: Background and talking points on Capital Review

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[IN-CONFIDENCE]

Hi Richard,

The Treasury's Secretary and Deputy Secretary are meeting with ANZ, BNZ, and ASB this Friday. We are providing some brief background material and talking points for these meetings, including for the Capital Review.

I have attached the brief background and talking points on the Capital Review. Would you be able to provide any comments by the end of today? I appreciate you are busy at the moment, so please let me know if this timing does not work.

Much appreciated,

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From:	Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent:	Wednesday, 22 May 2019 4:29 PM
To:	Daniel Jury [TSY]
Subject:	RE: TSY-RBNZ discussion on Capital Review

Hi Daniel – we will have some material on the following that I will send to you first thing tomorrow morning:

- Impact on GDP (item c)
- Sectoral impacts (item d)
- Risk weighting (item f)

We will talk to these (and the rest of the agenda) at the meeting.

I expect this will be ready to send to you around 9am tomorrow. Hopefully this will give you time to review in advance of the meeting.

Cheers

Richard

From: Richard Downing
Sent: Wednesday, 22 May 2019 1:19 PM
To: Daniel Jury <Daniel.Jury@treasury.govt.nz>
Cc: Brian McCulloch [TSY] <Brian.McCulloch@treasury.govt.nz>; Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>; Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>
Subject: RE: TSY-RBNZ discussion on Capital Review

Thanks Daniel. That looks like a good (and full) agenda.

We are putting some info together following your previous emails, hopefully we will get this to you before the meeting.

I think (h) and (j) in your list are new, but we should be able to talk to these tomorrow, time permitting.

Richard

From: Daniel Jury <Daniel.Jury@treasury.govt.nz>
Sent: Wednesday, 22 May 2019 12:49 PM
To: Richard Downing <Richard.Downing@rbnz.govt.nz>
Cc: Brian McCulloch [TSY] <Brian.McCulloch@treasury.govt.nz>; Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>; Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>
Subject: RE: TSY-RBNZ discussion on Capital Review

Hi Richard

Here is a proposed agenda for tomorrow's meeting:

1. Introductions [RBNZ / TSY]

2. General overview of the proposals [RBNZ]

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3. Discuss specific issues/queries: [RBNZ / TSY]

   a. **Timing:** Can RBNZ provide any further detail (in addition to what was announced yesterday) on the timelines for the rest of the process? – e.g. finalising the RIS?

   b. **Submissions/feedback:** Does the RBNZ have any initial feedback on the themes covered in submissions, and would it be possible to see the submissions prior to publication?

   c. **Impact on GDP:** We'd like to discuss the GDP impact numbers. For example, it would also be useful if you could please provide us with any key data-points that were made/found when considering the impact of the changes to capital levels on NZ GDP. We understand that your Econ team may have undertaken some additional analysis/modelling of the impacts for the May MPS? For example, are there any key data points that fed into or were used in this analysis/modelling (impacts on OCR/90-day bank bill rate (if any), house prices, household consumption, anything else, etc)? Also, it appears that a paper was prepared on the impact on monetary policy, which was withheld in the OIA response you pointed us to. Are you able to share with us any of the key assumptions/impacts that may have been included in that paper (or provide us with the paper itself)?

   d. **Regional or sectoral impacts:** Does the RBNZ have views on impacts on regional or sectoral impacts (e.g. rural lending, housing developments, etc) if banks pull back on volumes/widen margins in those areas?

   e. **Relative costs of Tier 1 and 2 capital:** We're interested in more information on the relative costs of Tier 1 and 2 capital.

   f. **Banks' risk weighting:** Can you provide us with background on banks' current risk weighting and how different assets are treated at a general level.

   g. **Competition aspects:** i.e. What is your view on the likelihood that competition will fill the market if banks pull back from 'riskier' sectors? Is the position different for different parts of the market (e.g. business lending where relationships, local knowledge, etc, seem important (compared to the more 'commodity' mortgage lending))? What will the impact of the proposals be on competition between big and small banks?

   h. **Australian parent bank responses:** What do you think the Australian parent banks' responses might be?

   i. **Fourth principle for the Review (international conservatism):** Why does the RBNZ consider that this principle is appropriate, including the risks inherent in NZ and RBNZ regulatory approach?

   j. **DSIB failure:** We understand that the RBNZ's stress testing indicates that for a D-SIB to fail the New Zealand economy would likely need to be under significant stress, with multiple years of negative economic growth and double-digit unemployment. Can you provide any data behind this?

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Look forward to discussing tomorrow.

Kind regards

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Daniel Jury | Senior Analyst | Te Tai Ōhanga – The Treasury
s9(2)(k) Email: Daniel.Jury@treasury.govt.nz
Visit us online at https://treasury.govt.nz/ and follow us on Twitter, LinkedIn and Instagram

From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Tuesday, 21 May 2019 9:41 AM
To: Daniel Jury [TSY] <Daniel.Jury@treasury.govt.nz>
Subject: RE: TSY-RBNZ discussion on Capital Review

Great. I suggest RBNZ kick off with a general overview of the proposals, then we can discuss the detailed points.

From: Daniel Jury <Daniel.Jury@treasury.govt.nz>
Sent: Tuesday, 21 May 2019 9:26 AM
To: Richard Downing <Richard.Downing@rbnz.govt.nz>
Cc: Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>; Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>; Brian McCulloch [TSY] <Brian.McCulloch@treasury.govt.nz>
Subject: RE: TSY-RBNZ discussion on Capital Review

No problem. That's a good idea. I'll circulate shortly.

From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Tuesday, 21 May 2019 9:24 AM
To: Daniel Jury [TSY] <Daniel.Jury@treasury.govt.nz>
Cc: Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>; Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>; Brian McCulloch [TSY] <Brian.McCulloch@treasury.govt.nz>
Subject: RE: TSY-RBNZ discussion on Capital Review

Sure thing. It would be handy to have an agenda that pulls this all into one place. Are you able to do that?

Richard

From: Daniel Jury <Daniel.Jury@treasury.govt.nz>
Sent: Tuesday, 21 May 2019 9:21 AM
To: Richard Downing <Richard.Downing@rbnz.govt.nz>
Cc: Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>; Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>; Brian McCulloch [TSY] <Brian.McCulloch@treasury.govt.nz>
Subject: RE: TSY-RBNZ discussion on Capital Review

Thanks Richard – just to clarify, we would be interested to discuss the fourth principle in terms of why the RBNZ considers that this principle is appropriate, including the risks inherent in NZ and RBNZ regulatory approach.

Thanks again,
D

From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Tuesday, 21 May 2019 9:13 AM
To: Daniel Jury [TSY] <Daniel.Jury@treasury.govt.nz>
Cc: Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>; Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>; Brian McCulloch [TSY] <Brian.McCulloch@treasury.govt.nz>
Subject: RE: TSY-RBNZ discussion on Capital Review

Hi Daniel

I will follow up on these points today.

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In the meantime, regarding your point about international conservatism – you may have already seen it, but if not, there are some slides here that show some of the international comparisons that we have done:

- https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Speeches/2019/Safer-Banks-for-Greater-Wellbeing-slides.pdf?la=en&revision=6b8116f7-5052-4d96-8961-0ced6b0591a7

Slides 17 and 18 above have some international comparisons.

Four your other point, yes the estimates discussed in the papers largely cover international estimates of the impacts. We can discuss how we interpreted these for NZ on Thursday.

Richard

From: Daniel Jury <Daniel.Jury@treasury.govt.nz>
Sent: Monday, 20 May 2019 6:44 PM
To: Richard Downing <Richard.Downing@rbnz.govt.nz>
Cc: Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>; Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>; Brian McCulloch [TSY] <Brian.McCulloch@treasury.govt.nz>
Subject: RE: TSY-RBNZ discussion on Capital Review

Hi Richard

Sorry for the additional email, but it would also be useful in advance of the Thursday meeting if you could please provide us with any RBNZ views on impacts from the capital review proposals on lending in key areas (e.g. rural, housing, SMEs, regional impacts, etc).

Also, in addition to the matters outlined below, we are also keen at our roundtable to discuss the RBNZ's fourth high-level principle for the review that *"Capital requirements of New Zealand banks should be conservative relative to*
those of international peers, reflecting the risks inherent in the New Zealand financial system and the Reserve Bank's regulatory approach".

Thanks,
D

From: Daniel Jury [TSY]
Sent: Monday, 20 May 2019 6:15 PM
To: 'Richard.Downing@rbnz.govt.nz' <Richard.Downing@rbnz.govt.nz>
Cc: Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>; Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>; Brian McCulloch [TSY] <Brian.McCulloch@treasury.govt.nz>
Subject: RE: TSY-RBNZ discussion on Capital Review

[IN-CONFIDENCE]

Thanks for this Richard – that information is helpful

The paper you pointed us to re GDP impacts of higher capital levels ("Literature review of optimal levels of bank capital") appears to be focussed on studies of impacts on GDP in various overseas countries (and then using this as a base for estimating possible impacts on GDP in NZ).

It would also be useful if you could please provide us with any key data-points that were made when specifically modelling the impact of the changes to capital levels on NZ GDP. I understand that your Econ team may have undertaken some additional analysis/modelling of the impacts for the May MPS? For example, are there any key data points that fed into or were used in this analysis/modelling (impacts on OCR/90-day bank bill rate (if any), house prices, household consumption, anything else, etc)?

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Also, it appears that a paper was prepared on the impact on monetary policy, which was withheld in the OIA response you pointed us to. Are you able to share with us any of the key assumptions/impacts that may have been included in that paper (or provide us with the paper itself)?

Thanks in advance

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From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Monday, 20 May 2019 4:34 PM
To: Daniel Jury [TSY] <Daniel.Jury@treasury.govt.nz>
Subject: Follow-up info

Hi Daniel

This is the discussion in the MPS:
https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Monetary%20policy%20statements/2019/mpsfeb19.pdf?revision=b2ced7dd-44df-4f5e-885f-e9166142a109

This is the follow-up OIA that covered the MPS
https://www.rbnz.govt.nz/-/media/ReserveBank/Files/OIAs/2019/OIA-response-8-april.pdf?revision=319cf258-b2f7-409f-af81-15ccecda0a48&la=en

There is a suite of background info available here (see 7 Sept 2016 paper for a discussion of the macro impacts, with a focus on interest rates and output):
https://www.rbnz.govt.nz/regulation-and-supervision/banks/capital-review-proposals-information-release

Let me know if you want to discuss further.

Cheers
Richard

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From: Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>
Sent: Thursday, 16 May 2019 12:44 PM
To: Richard Downing <Richard.Downing@rbnz.govt.nz>
Cc: Jessica Young [TSY] <Jessica.Young@treasury.govt.nz>
Subject: TSY-RBNZ discussion on Capital Review

[IN-CONFIDENCE]

Hi Richard,

Apologies for the flurry of emails today.

You'll be aware that Ian, Robbie, and Dasha met to discuss advice the Treasury is preparing on the Capital Review. Ian offered to set up a 'roundtable' between our two teams to discuss the proposals. Can you please let me know the times that would suit RBNZ early next week (Monday/Tuesday)?

Jess – can you help set up this meeting? Attendees on from the Treasury are Robbie, Dan, Brian M, and myself.

We have a rough list of some aspects of the review that we would like to discuss:

- What are the timelines for finalising the RIS and making final decisions?
- Do you have any initial feedback on the themes covered in submissions, and would it be possible to see the submissions prior to publication?
- We'd like to discuss the GDP impact numbers – what are the key data points that fed into this (interest rate impact, impact on house prices and household consumption)? We understand that the RBNZ's Econ team did some additional modelling of impacts for the May MPS, what did this modelling indicate in terms of impacts?
- We're interested in more information on the relative costs of Tier 1 and 2 capital.
- Further information on banks' risk weighting, including how different assets are treated at a general level
- We'd like to discuss the competition aspects – i.e. the likelihood of competition filling the market if banks pull back from 'riskier' and also sector and regional impacts (e.g. rural, housing lending).

Regards,

TE TAI ŌHANGA
THE TREASURY

Amir Mehta | Analyst | Te Tai Ōhanga – The Treasury
s9(2)(k) Email/IM: amir.mehta@treasury.govt.nz
Visit us online at https://treasury.govt.nz/ and follow us on Twitter, LinkedIn and Instagram

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From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Thursday, 23 May 2019 9:09 AM
To: Daniel Jury [TSY]
Cc: Brian McCulloch [TSY]; Amir Mehta [TSY]; Robbie Taylor [TSY]; Ian Woolford; Susan Guthrie; Charles Lilly
Subject: RE: TSY-RBNZ discussion on Capital Review
Attachments: s9(2)(g)(i) s9(2)(g)(i) 2019.05.23 Agenda for RBNZTreasury meeting on 23 May 2019.docx; 2019.05.23 Sectoral impacts email for Treasury meeting 23 may 2019.docx; 2019.05.23 Stylised summary of RWA for Treasury.docx

Hi Daniel

I've attached the information you were looking for ahead of our meeting this afternoon.

For item (c) I have attached the MPC paper that was withheld under the OIA request that we previously discussed. Please note that it is an internal paper drafted with the initial views of the forecasting team to generate discussion, and does not represent the view of the Bank or MPC as a whole.

For item (d) I have attached an email that covers some of our early thinking about sectoral effects. This is something we are progressing as part of the next stage of the work.

For item (f) I have attached a word document that outlines parts of the RWA weighting, with a focus on how these are treated at each level of asset.

We can talk to these topics and the remaining items at the meeting today.

Regards

Richard

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From: Daniel Jury
Sent: Wednesday, 22 May 2019 12:49 PM
To: Richard Downing
Cc: Brian McCulloch [TSY] ; Amir Mehta [TSY] ; Robbie Taylor [TSY]
Subject: RE: TSY-RBNZ discussion on Capital Review

Hi Richard

Here is a proposed agenda for tomorrow's meeting:

1. Introductions [RBNZ / TSY]

2. General overview of the proposals [RBNZ]

3. Discuss specific issues/queries: [RBNZ / TSY]

   a. **Timing:** Can RBNZ provide any further detail (in addition to what was announced yesterday) on the timelines for the rest of the process? – e.g. finalising the RIS?

b. **Submissions/feedback:** Does the RBNZ have any initial feedback on the themes covered in submissions, and would it be possible to see the submissions prior to publication?

c. **Impact on GDP:** We'd like to discuss the GDP impact numbers. For example, it would also be useful if you could please provide us with any key data-points that were made/found when considering the impact of the changes to capital levels on NZ GDP. We understand that your Econ team may have undertaken some additional analysis/modelling of the impacts for the May MPS? For example, are there any key data points that fed into or were used in this analysis/modelling (impacts on OCR/90-day bank bill rate (if any), house prices, household consumption, anything else, etc)? Also, it appears that a paper was prepared on the impact on monetary policy, which was withheld in the OIA response you pointed us to. Are you able to share with us any of the key assumptions/impacts that may have been included in that paper (or provide us with the paper itself)?

d. **Regional or sectoral impacts:** Does the RBNZ have views on impacts on regional or sectoral impacts (e.g. rural lending, housing developments, etc) if banks pull back on volumes/widen margins in those areas?

e. **Relative costs of Tier 1 and 2 capital:** We're interested in more information on the relative costs of Tier 1 and 2 capital.

f. **Banks' risk weighting:** Can you provide us with background on banks' current risk weighting and how different assets are treated at a general level.

g. **Competition aspects:** i.e. What is your view on the likelihood that competition will fill the market if banks pull back from 'riskier' sectors? Is the position different for different parts of the market (e.g. business lending where relationships, local knowledge, etc, seem important (compared to the more 'commodity' mortgage lending))? What will the impact of the proposals be on competition between big and small banks?

h. **Australian parent bank responses:** What do you think the Australian parent banks' responses might be?

i. **Fourth principle for the Review (international conservatism):** Why does the RBNZ consider that this principle is appropriate, including the risks inherent in NZ and RBNZ regulatory approach?

j. **DSIB failure:** We understand that the RBNZ's stress testing indicates that for a D-SIB to fail the New Zealand economy would likely need to be under significant stress, with multiple years of negative economic growth and double-digit unemployment. Can you provide any data behind this?

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Look forward to discussing tomorrow.

Kind regards

TE TAI ŌHANGA
THE TREASURY

Daniel Jury | Senior Analyst | Te Tai Ōhanga – The Treasury
s9(2)(k) [redacted] Email: Daniel.Jury@treasury.govt.nz
Visit us online at https://treasury.govt.nz/ and follow us on Twitter, LinkedIn and Instagram

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Agenda for Treasury/RBNZ Meeting 23 May 2019

1. Introductions [RBNZ / TSY]

2. General overview of the proposals [RBNZ]

3. Discuss specific issues/queries: [RBNZ / TSY]

    a. **Timing:** Can RBNZ provide any further detail (in addition to what was announced yesterday) on the timelines for the rest of the process? – e.g. finalising the RIS?

    b. **Submissions/feedback:** Does the RBNZ have any initial feedback on the themes covered in submissions, and would it be possible to see the submissions prior to publication?

    c. **Impact on GDP:** We'd like to discuss the GDP impact numbers. For example, it would also be useful if you could please provide us with any key data-points that were made/found when considering the impact of the changes to capital levels on NZ GDP. We understand that your Econ team may have undertaken some additional analysis/modelling of the impacts for the May MPS? For example, are there any key data points that fed into or were used in this analysis/modelling (impacts on OCR/90-day bank bill rate (if any), house prices, household consumption, anything else, etc)? Also, it appears that a paper was prepared on the impact on monetary policy, which was withheld in the OIA response you pointed us to. Are you able to share with us any of the key assumptions/impacts that may have been included in that paper (or provide us with the paper itself)?

    d. **Regional or sectoral impacts:** Does the RBNZ have views on impacts on regional or sectoral impacts (e.g. rural lending, housing developments, etc) if banks pull back on volumes/widen margins in those areas?

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    f. **Banks' risk weighting:** Can you provide us with background on banks' current risk weighting and how different assets are treated at a general level.

    g. **Competition aspects:** i.e. What is your view on the likelihood that competition will fill the market if banks pull back from 'riskier' sectors? Is the position different for different parts of the market (e.g. business lending where relationships, local knowledge, etc, seem important (compared to the more 'commodity' mortgage lending))? What will the impact of the proposals be on competition between big and small banks?

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From: Charles Lilly <Charles.Lilly@rbnz.govt.nz>
Sent: Monday, 13 May 2019 2:58 PM
To: Walter Shea <Walter.Shea@rbnz.govt.nz>; FSPA - Financial Policy <FSPA-FinancialPolicy@rbnz.govt.nz>
Subject: RE: Sectoral Impacts of Capital Review

Hi all

Further to the discussion below, I have had a look at some of the data we already collect to better understand the potential sectoral impacts.

In the Income Statement survey we collect interest income by product type (mortgages, different business loans, personal loans and credit cards etc.) which allows for the calculation of an average yield (interest income/stock of lending). Combining that with the data we collect on banks' capital (through the regular surveys and the QIS), we already have a fair amount of data to estimate the capital contribution to loan pricing.

In the chart below I've plotted a first attempt at putting these two data sources together to decompose banks' customer-facing interest rates. Note this only covers the four large banks, and the data mostly relates to 2019 Q1.

The marker shows the average yield (interest income / average loan value) for each lending category, from the Income Statement Survey, with the bars representing:

- An average cost of debt funding (total interest expense / total liabilities). In reality, banks will use a funds transfer pricing model to better allocate the price of debt funding according to maturity etc., but we don't know exactly what their internal pricing curves look like.
- A cost of capital funding. This is based on current RWA per segment, an 11.4% CET1 ratio (average of the four banks), and a 10% notional "cost of capital", i.e. the return that the treasurer requires from each dollar of capital invested.
- A cost of risk. This represents the expected loss component of loan pricing, i.e. pricing to cover expected losses during normal times. I've based this on regulatory EL for each segment, which is likely an overstatement as banks' loan impairments are generally lower than regulatory EL (since we require conservative PD and LGDs).
- A mark-up, which is the residual between the yield and the sum of the three components above. From this banks need to cover their operating expenses (less the contribution of any fees or other income associated with their lending). Mark-up that is left over after deducting expenses represents the excess return to capital above the 10% notional charge applied to it in point two above.

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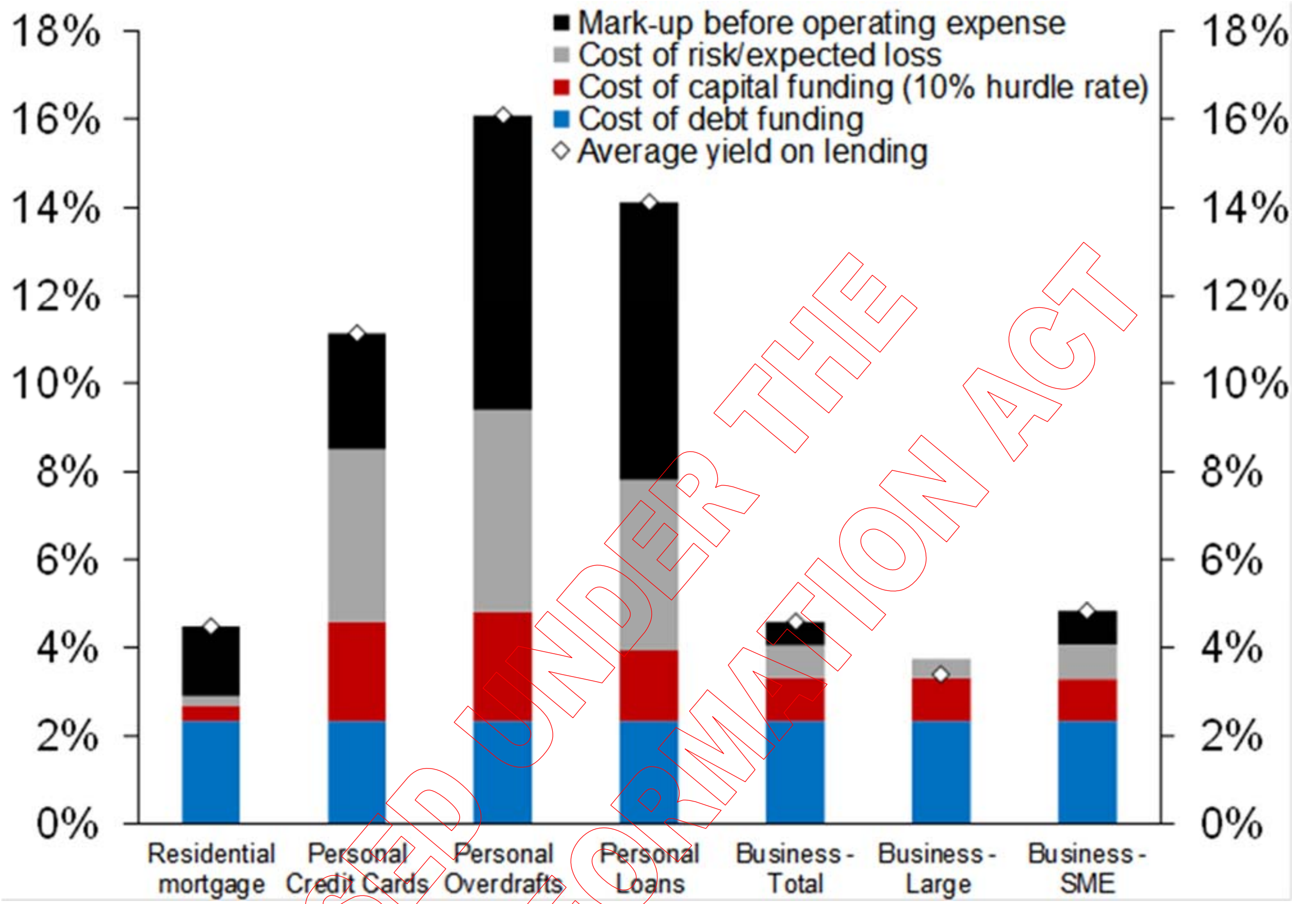

For the capital ratio proposals, effectively we would be increasing the size of the red bar by a factor of about 70% (from a 10% CET1 ratio, after IRB changes, to ~17% CET1). The adjustment to this would come through a combination of:

- A lower cost of debt funding (shrinking the blue bar)
- A lower notional cost of capital given lower risk profile (shrinking the red bar somewhat)
- A combination of a higher average yield on lending (repricing) and a lower mark-up if there are competitive constraints to loan pricing.

It would be great to discuss this on Wednesday, and if others have views on what more quantitative work we could do.

Charles

-----Original Appointment-----
From: Walter Shea <Walter.Shea@rbnz.govt.nz>
Sent: Monday, 13 May 2019 9:47 AM
To: FSPA - Financial Policy
Subject: Sectoral Impacts of Capital Review
When: Wednesday, 15 May 2019 11:00 AM-12:00 PM (UTC+12:00) Auckland, Wellington.
Where: 1st Floor Kōkako Room (16 Seats)

Rescheduling as Susan and Matt are sick today (Monday) and Richard is on a course tomorrow (Tuesday).

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Figure 1: Difference between exposure and RWA, **within asset classes**

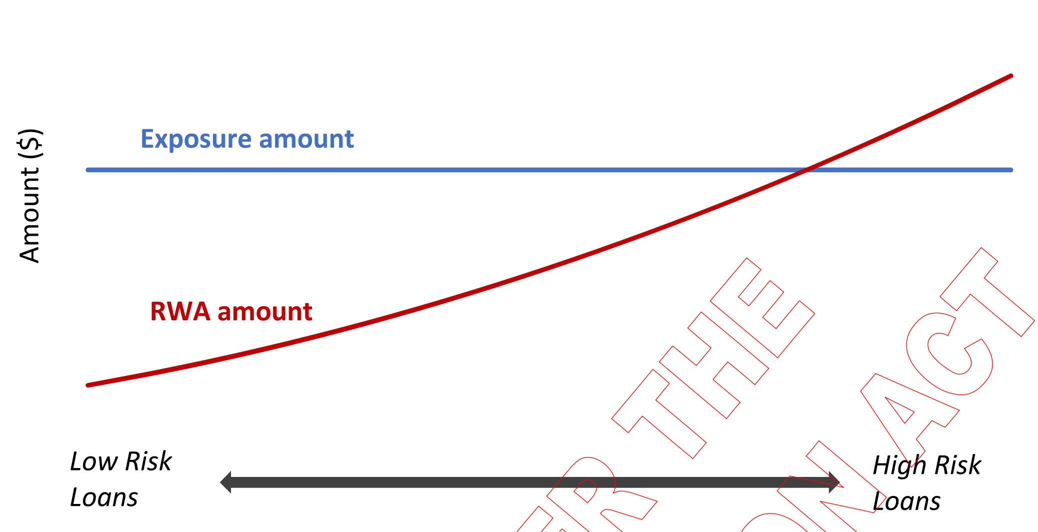
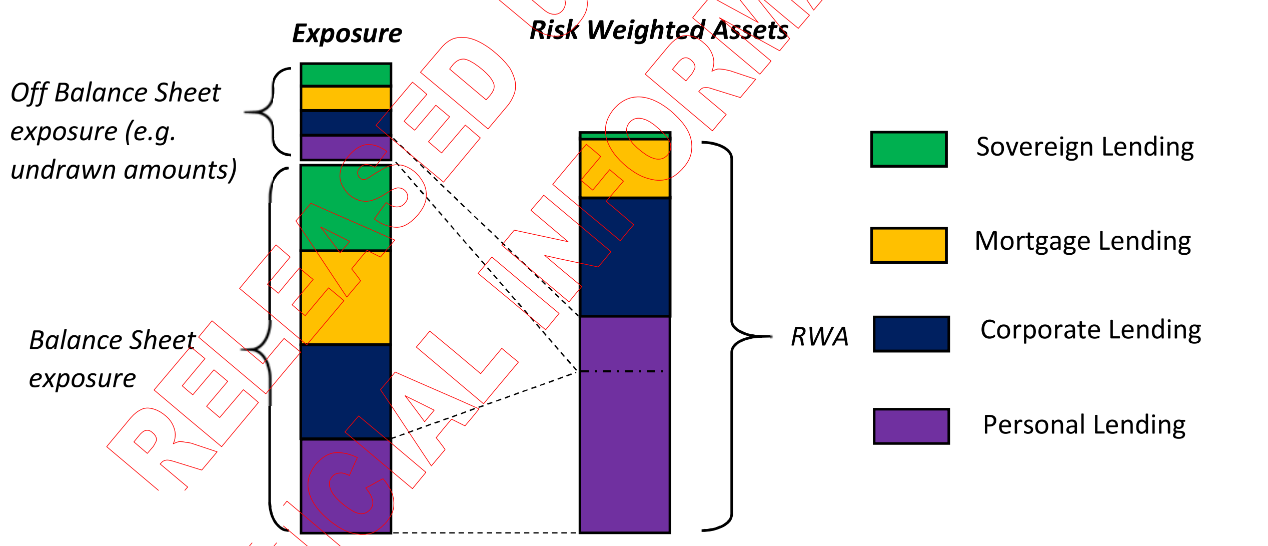


Figure 2: Difference between exposure and RWA, **across asset classes**



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Average Risk-Weight for IRB Banks

41.50%

Corporate (Non-Retail) Lending 65%			Retail Lending 31%				Other*
Farm Lending	Other Corporate	Specialised Lending (Commercial Property and Project Finance)	Owner occupier residential mortgages	Property invetsment residential mortgages	Retail SME	Other Retail	19%
75%	52%	92%	25%	27%	69%	80%	

*Other includes the asset classes: Sovereign, Bank, Equity, Reverse Mortgages, Corporate & Retail Eligible receivables, and Other. The exposure value used is Exposure at Default (EAD) after Credit Risk Mitigation (CRM).
This is also used as the denominator for calculating risk-weights
All averages are EAD weighted

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Share of Bank Exposure for Credit Risk for IRB Banks

100%

Corporate (Non-Retail) Lending 35%			Retail Lending 53%				Other*
Farm Lending	Other Corporate	Specialised Lending (Commercial Property and Project Finance)	Owner occupier residential mortgages	Property invetsment residential mortgages	Retail SME	Other Retail	12%
10%	19%	6%	29%	19%	2%	4%	

*Other includes the asset classes: Sovereign, Bank, Equity, Reverse Mortgages, Corporate & Retail Eligible receivables, and Other. The exposure value used is Exposure at Default (EAD) after Credit Risk Mitigation (CRM).
This is also used as the denominator for calculating risk-weights
All averages are EAD weighted

Share of Risk-Weighted Assets for Credit Risk for IRB Banks

100%

Corporate (Non-Retail) Lending 54%			Retail Lending 40%				Other*
Farm Lending	Other Corporate	Specialised Lending (Commercial Property and Project Finance)	Owner occupier residential mortgages	Property invetsment residential mortgages	Retail SME	Other Retail	6%
18%	23%	13%	17%	12%	3%	8%	

*Other includes the asset classes: Sovereign, Bank, Equity, Reverse Mortgages, Corporate & Retail Eligible receivables, and Other. The exposure value used is Exposure at Default (EAD) after Credit Risk Mitigation (CRM).
This is also used as the denominator for calculating risk-weights
All averages are EAD weighted

From:	Daniel Jury [TSY]
Sent:	Friday, 24 May 2019 12:55 PM
To:	Ross Kendall
Cc:	Karam Shaar [TSY]; Robbie Taylor [TSY]; Brian McCulloch [TSY]; Amir Mehta [TSY]
Subject:	RE: Follow up from 23 May meeting - wider economic impacts of capital proposal
Attachments:	s9(2)(g)(i) s9(2)(g)(i)

[IN-CONFIDENCE]

Hi Ross

Further to the below, we have been asked to prepare some advice for the Minister relating to the RBNZ's bank capital review. As part of this we are interested in the possible wider economic impacts of the proposals.

Richard has forwarded us the **attached** paper you prepared on what higher baking capital might mean for monetary policy. This was very useful.

We would also greatly appreciate any guidance you may have on the impact on household consumption, not only through the channel of housing wealth, but through the impact on disposable income as well (including via the wealth effect).

It would also be useful for us to have the data behind the graphs in your paper. Are you able to send this to us?

We are under quite tight timeframes for this advice and it would be much appreciated if you could get back to us as soon as possible. Please let me know if you have any questions.

Thanks a lot for your help!

Kind regards

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Daniel Jury | Senior Analyst | Te Tai Ōhanga – The Treasury
s9(2)(k) Email: Daniel.Jury@treasury.govt.nz
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From: Richard Downing
Sent: Friday, 24 May 2019 12:22 PM
To: Daniel Jury [TSY]
Cc: Ross Kendall
Subject: Follow up from 23 May meeting

Hi Daniel

It was good meeting with you and the team yesterday.

I have cc'ed Ross Kendall into this email so that you can discuss the macro questions directly with him.

We will come back to you later with the other agreed info, as listed below. We are in the process of doing redactions to submissions at the moment, so this one might take a bit longer.

- RBNZ Q&A material.
- Redacted versions of submissions.
- Contact points in economic forecasting team to discuss economic impacts and modelling assumptions.
- Terms of Reference for the External Experts review.
- Information about reverse stress tests that the RBNZ has run in the past.
- Any additional information about sector impacts.
- Any additional information about RoE impacts.

Cheers

Richard

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From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Monday, 27 May 2019 9:56 AM
To: Daniel Jury [TSY]; Robbie Taylor [TSY]
Cc: Ian Woolford; Susan Guthrie; Charles Lilly
Subject: Follow-up from 23 May meeting
Attachments: 2019.05.24 Capital Review Q&A copy for Treasury.docx; 2019.05.24 External Experts Terms of Reference Public Version.pdf

Hi Daniel and Robbie

Here are some documents to follow-up on our meeting last week.

The External Experts are the Terms of Reference are likely to be published on our website in the next couple of days, so in the meantime please treat the Terms of Reference in confidence.

The Q&A cover a range of questions that we have complied for various people in the RBNZ to use in dealing with external questions.

For the stress tests you might find the papers below useful. The second one includes some scenarios where CET1 goes below current minimums:

Bulletin: The Reserve Bank's philosophy and approach to stress testing [overview of how we do stress tests and limitations to them]
https://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin/2018/rbb2018-81-08

MFC paper: Implications of stress tests for calibration of capital requirements [calibrates a more severe scenario than our APRA/RBNZ industry-wide stress test scenarios]
https://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/banks/capital-review/Capital-review-Implications-of-stress-tests-for-calibration-of-capital-requirements.pdf

As I mentioned on Friday, we don't have redacted versions of submissions ready yet, but we will come back to you on this later.

Also, just regarding the economic forecasting note from last week, I wanted to emphasise again that the numbers in the note aren't RBNZ estimates. The paper was a draft note prepared by one of the forecasting team for discussion purposes, rather than RBNZ forecasts.

Let me know if you need anything further or want to discuss.

Cheers

Richard

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From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Tuesday, 28 May 2019 10:17 AM
To: Daniel Jury [TSY]
Subject: RE: Follow-up from 23 May meeting

Thanks for that info Daniel.

The reviewers are due to be announced today. The third reviewer (David Miles) is an academic and has previously been Chief Economist at Morgan Stanley. We think that we've got a good mix of academic and industry experience, as well as a good geographical spread (Australia, UK, US).

Cheers

Richard

From: Daniel Jury <Daniel.Jury@treasury.govt.nz>
Sent: Monday, 27 May 2019 5:01 PM
To: Richard Downing <Richard.Downing@rbnz.govt.nz>
Cc: Ian Woolford <Ian.Woolford@rbnz.govt.nz>; Susan Guthrie <Susan.Guthrie@rbnz.govt.nz>; Charles Lilly <Charles.Lilly@rbnz.govt.nz>; Dasha Leonova [TSY] <Dasha.Leonova@treasury.govt.nz>; Brian McCulloch [TSY] <Brian.McCulloch@treasury.govt.nz>; Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>; Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>
Subject: RE: Follow-up from 23 May meeting

[IN-CONFIDENCE]

Thanks Richard

As an FYI – Gabs and Bryan met with some major banks on Friday (ANZ, BNZ, and ASB).

As you can imagine, your capital review was a topic of conversation, including the appointment of the external experts to carry out the independent review. s9(2)(g)(i) [redacted] s9(2)(g)(i) [redacted] We just wanted to pass this on as we know you are getting close to announcing the appointments.

Kind regards

TE TAI ŌHANGA
THE TREASURY

Daniel Jury | Senior Analyst | Te Tai Ōhanga – The Treasury
s9(2)(k) [redacted] Email: Daniel.Jury@treasury.govt.nz
Visit us online at https://treasury.govt.nz/ and follow us on Twitter, LinkedIn and Instagram

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From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Monday, 27 May 2019 9:56 AM
To: Daniel Jury [TSY] <Daniel.Jury@treasury.govt.nz>; Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>
Cc: Ian Woolford <Ian.Woolford@rbnz.govt.nz>; Susan Guthrie <Susan.Guthrie@rbnz.govt.nz>; Charles Lilly

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<Charles.Lilly@rbnz.govt.nz>
Subject: Follow-up from 23 May meeting

Hi Daniel and Robbie

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Let me know if you need anything further or want to discuss.

Cheers

Richard

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From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Wednesday, 5 June 2019 2:56 PM
To: Amir Mehta [TSY]
Cc: Daniel Jury [TSY]; Robbie Taylor [TSY]
Subject: RE: Minister's meeting with SBS Bank - content on Capital Review

Hi Amir

Just to clarify the point I made on the phone – my first bullet point is wrong. There is still a role for AT1 in the proposals, but the 1.5% AT1 is already allowed in the existing regulations as part of minimum capital. So the proposed increase *would* need to be funded by CET1.

Sorry for putting you wrong on that.

As a further dimension to this, banks currently have approx 3% AT1, with the excess over 1.5% counting towards their Tier 2 requirements.

Richard

From: Richard Downing
Sent: Tuesday, 4 June 2019 5:20 PM
To: 'Amir Mehta [TSY]'
Cc: Daniel Jury ; Robbie Taylor [TSY] ; Ian Woolford ; Rebecca Palmer ; Susan Guthrie
Subject: RE: Minister's meeting with SBS Bank - content on Capital Review

Hi Amir

Thanks for the opportunity to review this material.

There are a couple of small comments/suggestions below:

- It is not quite right "the increase in tier 1 capital requirements can *only* be met by 'common equity tier 1' CET capital." The proposals include a role for AT1 capital, but only for preference shares, not the contingent convertibles that a number of banks use as AT1 at the moment. These can account for up to 1.5 percentage points of Tier 1 capital. See pg 24 in the link below "Accept non-redeemable, non-contingent, perpetual preference shares as AT1 capital".

https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Policy-development/Banks/Review-capital-adequacy-framework-for-registered-banks/Capital%20Review%20Response%20to%20Numerator%20Submissions191217.pdf?la=en&revision=83e4c8f8-f7ac-43ce-817a-957a325e4d14

- It is worth noting somewhere in the Aide Memoire that you are working on that we have been working on a common equity instrument for banks structured as mutual societies. Mutuals can't issue the sort of contingent-convertibles that the bigger banks currently use for AT1 – the potential new instrument would help enable the mutuals (such as SBS) to issue a form of AT1. In effect the instruments that would no longer be eligible as AT1 are not tools that SBS can currently use (but Kiwibank and TSB can). More info about this is available here:

https://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/banks/capital-review/Capital-review-A-common-equity-instrument-for-mutual-society-banks.pdf?la=en&revision=05e2c167-b77b-48a0-a5ca-66dddcf95318

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- In their joint submission the domestic banks also note that they support moves to introduce a "level playing field" (ie. through changes to the IRB approach, output floor etc) and moves to decrease system risk. (Although they don't support all of the ways the RBNZ has proposed to meet these goals).

I've also attached a copy of the joint submission from the NZ-owned banks so that you can use this to help inform your note. Please treat as confidential and don't circulate this more widely at this point until the submissions are published later this month.

Cheers

Richard

From: Amir Mehta [TSY] <Amir.Mehta@treasury.govt.nz>
Sent: Tuesday, 4 June 2019 1:12 PM
To: Richard Downing <Richard.Downing@rbnz.govt.nz>
Cc: Daniel Jury <Daniel.Jury@treasury.govt.nz>; Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>; Ian Woolford <Ian.Woolford@rbnz.govt.nz>
Subject: Minister's meeting with SBS Bank - content on Capital Review

[IN-CONFIDENCE]

Hi Richard,

I am preparing an aide memoire to support the Minister's meeting with SBS Bank. I have used this article about SBS Bank's joint submission on the Capital Review for the content in the aide memoire.

I have pasted the text on the Capital Review below – could you please review this to see that it is consistent with RBNZ's understanding of SBS Bank's submission? Are you able to get back to me by noon tomorrow?

Regards,

Amir

Capital Review: SBS Bank argues that the Reserve Bank's proposals to increase capital requirements will undermine small banks' ability to compete with the main banks

The Reserve Bank is reviewing the regulatory capital requirements for locally incorporated banks (the Capital Review). The Reserve Bank's key proposals include:

- increasing 'tier 1 capital' requirements from 8.5 per cent to:
  - 15 per cent of risk-weighted assets (RWA) for smaller banks, such as SBS Bank and Kiwibank
  - 16 per cent of RWA for the 'systemically important' four main banks.

- that the increase in tier 1 capital requirements can *only* be met by 'common equity tier 1' (CET1) capital, such as ordinary shares, the highest quality (and most expensive) form of capital. Other forms of capital, such as cheaper 'additional tier 1' (AT1) capital or tier 2 capital, would not be eligible.

SBS Bank jointly submitted with Kiwibank, TSB Bank, and the Co-operative Bank. Whilst the Treasury has not seen the submission itself, it understands from public reports that it points to particular implications for smaller banks of both: (i) significantly increasing regulatory capital requirements *and* (ii) limiting the type of capital that can be used to meet these new requirements (to higher cost CET1 capital).

The joint submission argues that the proposed capital requirements will undermine the growth of small, New Zealand-owned banks, and create a "risk that small banks are ultimately absorbed by the large banks" which would "increase concentration on the existing systemically important banks and lessen competition."

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Specific key issues and proposed remedies raised in SBS Bank's joint submission on the Capital Review are as follows:

Issue	*Proposed remedy*
Small banks have a competitive disadvantage, as it already difficult to access CET1 capital due to: • scale and illiquidity (New Zealand-owned banks are not listed) • investors will favour larger banks offering higher returns	For small banks, set a regulatory capital requirement of 14 per cent of RWA, instead of 15 per cent. "Reasonably practical access to capital" – small banks should be able to use cheaper AT1 and tier 2 capital to meet new capital requirements
Retained earnings are not a practical means to meeting proposed capital requirements	
Limited options to re-capitalise a bank in the event of unexpected losses due to difficulty accessing CET1	
Transition period of five years is too short if small banks need to rely on retained earnings to meet proposed requirements	Transition period of eight years
The four main banks gain a competitive advantage by using their own internal models to calculate lower RWA, compared with the small banks' use of a standardised model prescribed by the Reserve Bank	Greater alignment between the calculation of RWA for large and small banks

Public submissions have now closed. The Reserve Bank received a large number of submissions – 164 in total. It will publish a summary of submissions later in June 2019 and will continue to engage with stakeholders. The Reserve Bank has also appointed three experts to independently review its analysis and advice underpinning its proposals.

The Reserve Bank intends to release the final decisions on the Capital Review by the end of November 2019, with implementation of any new rules starting from April 2020.

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Amir Mehta | Analyst | Te Tai Ōhanga – The Treasury
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From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Tuesday, 16 July 2019 6:08 PM
To: Robbie Taylor [TSY]
Cc: Susan Guthrie; Daniel Jury [TSY]; Dasha Leonova [TSY]; Ian Woolford; FSPA - Financial Policy
Subject: RE: Treasury advice on capital framework proposal
Attachments: s9(2)(g)(i)

Hi Robbie

Thanks for the opportunity to comment on the paper.

The attached document covers our comments. We would be happy to meet to discuss if that would be useful.

s9(2)(g)(i)

Cheers

Richard

Richard Downing
Adviser
Financial Policy

From: Robbie Taylor [TSY] <Robbie.Taylor@treasury.govt.nz>
Sent: Thursday, 11 July 2019 5:04 PM
To: Ian Woolford <Ian.Woolford@rbnz.govt.nz>
Cc: Richard Downing <Richard.Downing@rbnz.govt.nz>; Susan Guthrie <Susan.Guthrie@rbnz.govt.nz>; Daniel Jury <Daniel.Jury@treasury.govt.nz>; Dasha Leonova [TSY] <Dasha.Leonova@treasury.govt.nz>
Subject: Treasury advice on capital framework proposal

[IN-CONFIDENCE]

Hi Ian

We are now in a position to be able to share our draft advice to the Minister of Finance on the capital framework proposal with you for comment. This is attached. We would welcome your team's thoughts, particularly on how we have characterised/described the RBNZ's position/proposals.

Apologies for taking so long to share this. We've wanted to take a lot of care in the advice so this has taken longer than expected. We were also keen to wait until Bryan and James had an opportunity to discuss with Geoff before sending this across. We understand they met yesterday.

It would be great if you could please provide any comments by **COP Tuesday next week (16 July)**. Apologies for the tight timeframes around this. Let us know if this is going to be a problem.

Kind regards

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Robbie Taylor (he/his) **| Team Leader, Financial Markets | Te Tai Ōhanga – The Treasury**
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From: Richard Downing <Richard.Downing@rbnz.govt.nz>
Sent: Monday, 5 August 2019 9:40 AM
To: Daniel Jury [TSY]
Subject: Additional info

Hi Daniel

The speech I mentioned is here:

https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Speeches/2019/Safer-Banks-for-Greater-Wellbeing-slides.pdf?revision=6b8116f7-5052-4d96-8961-0ced6b0591a7

The graph I had in mind is slide 7. Looking at it again it is actually the shareholder equity to asset ratio, not returns on equity. Nevertheless it makes the point that banks are more leveraged.

There is a graph in this bulletin paper too (figure 5) comparing returns in different industries, but it is a bit old now (2000-2009 data):

https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Bulletins/2011/2011jun74-2bloorhunt.pdf?revision=9df2d4a1-58e9-4ff5-932a-f226dcf3aa50

The Stats NZ Annual Enterprise survey also has profit and return on equity data
http://archive.stats.govt.nz/browse_for_stats/businesses/business_finance/AnnualEnterpriseSurvey_HOTP16.aspx

That is all I can think of that we have quickly to hand. Let me know if you want more as there is probably other data we can dig into.

Richard

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From: Charles Lilly
Sent: Tuesday, 5 March 2019 1:12 PM
To: 'Bronwyn Kenna [TSY]' <Bronwyn.Kenna@treasury.govt.nz>
Cc: Susan Guthrie <Susan.Guthrie@rbnz.govt.nz>; Noemi Javier <Noemi.Javier@rbnz.govt.nz>; Walter Shea <Walter.Shea@rbnz.govt.nz>
Subject: RE: Capital and bank failure

Hi Bron

The 16% Tier 1 ratio we arrived at for large banks was based on a number of inputs – international evidence on the link between bank capital and crisis probability, NZ bank portfolio risk modelling, stress testing, and studies looking at 'optimal' (expected GDP-maximising) capital. The short answer is that we don't have a precise/single figure for how frequently individual banks might fail at a 16% Tier 1 ratio, but at that ratio, we think the likelihood of a large bank failing in a given year is around 0.5%.

The 1/200 (0.5%) figure that we have used in the consultation document when referring to the probability of a systemic crisis was most relevant for the first two of these inputs:

- In the international evidence section we essentially looked at the capital ratios that would be needed to limit the likelihood of a systemic crisis to 0.5%, based on the historical experience of countries over many decades. From this evidence we concluded that a Tier 1 ratio of 16% would be sufficient to limit this likelihood to 0.5%.
- For the portfolio risk modelling section, the nature of the exercise was that we needed to set a numerical threshold for the likelihood of failure (a solvency target) to calculate a capital ratio, given the other inputs to the model which each have their own degree of uncertainty. s9(2)(g)(i)
  s9(2)(g)(i)

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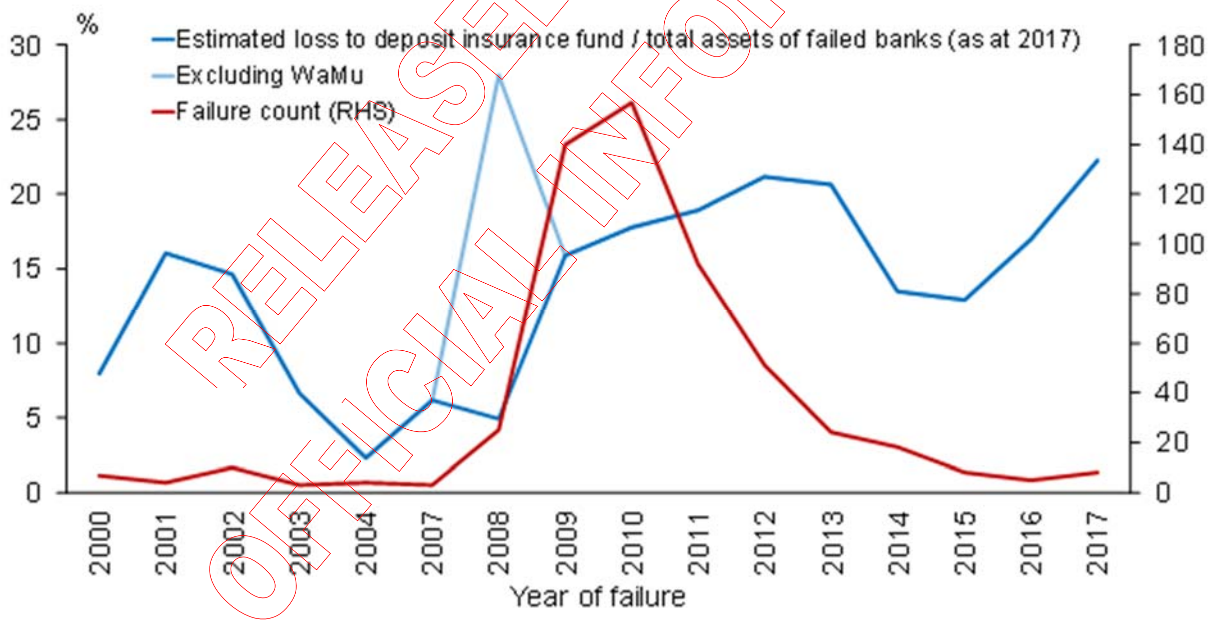
s9(2)(g)(i) [redacted]

In both of these cases the 16% and 0.5% crisis probability link refers to the failure of a large bank – i.e. we are defining a systemic crisis to be the failure of one or more large banks.

For smaller banks, we did not set an explicit failure probability target or do a separate modelling exercise. Rather, from the target 16% Tier 1 ratio for large banks, we considered to what degree that 16% should include a buffer representing the externality related to systemic importance. The Governors settled on a 1% DSIB buffer in line with international practice, meaning the target for small banks was 15% (i.e. 16 - 1 = 15). We haven't calculated a specific failure probability for small banks operating at a 15% Tier 1 ratio – the likelihood is probably higher than 0.5%, given less capital is available, and smaller banks can have more inherent risks (less diversification for example). Small NZ banks are also far more heterogeneous than the large four as well.

For the loss that is realised when a bank has failed, this was not really a figure we needed to take a view on in our work as our focus is on limiting the likelihood of getting into this situation. In other words we didn't model the losses in a resolution/purchase and assumption/liquidation of a bank in a 1/200 year event, but the capital needed to cover the losses a bank might experience in the other 199 years.

There are a range of sources on this from overseas - for example, studies of bank failure in the US from 2007-2009 (e.g. Table 1 in attached article) show a loss ratio of around 20% of asset values. Data available from the FDIC (https://www5.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30, also attached) show losses to deposit insurance funds (estimated loss = disbursements from the fund less amounts ultimately recovered) of c. 19% of the asset values of failed FDIC-insured banks over the past 10 years. See the chart I made below (Washington Mutual was a very large failure but without loss – a bit of an outlier so shown here with/without):



Cheers
Charles

From: Bronwyn Kenna [TSY] <Bronwyn.Kenna@treasury.govt.nz>
Sent: Monday, 4 March 2019 11:35 AM
To: Charles Lilly <Charles.Lilly@rbnz.govt.nz>
Subject: RE: Capital and bank failure

Hi Charles, I am chasing up some data in connection to your capital review.

Basically, I want to know how frequently banks might fail (individual ones) under the new proposals; and when they fail how much they fail by? i.e, on average, when a bank fails, what is the size of its capital hole?

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Susan said she'd give me some data on this but she has since gone silent. Can you please help?

Cheers

From: Bronwyn Kenna [TSY]
Sent: Friday, 1 March 2019 3:04 PM
To: 'Susan Guthrie' <Susan.Guthrie@rbnz.govt.nz>
Cc: Bernard Hodgetts [TSY] <Bernard.Hodgetts@treasury.govt.nz>
Subject: RE: Capital and bank failure

Hi Susan,

Hope it is all going well.

I wondered when you might be able to get back to me on this data? It is very important for progressing work on the depositor protection section of the review. The Minister is very eager to see the connections between your capital proposals and depositor protection. We want to be able to quantify the impact higher capital will have on required deposit insurance scheme sizes. If you could please get back to me early next week with data on how you have modelled the probability of default and loss given default of banks, both under the status quo and under your proposals, that would be great.

Cheers

From: Bronwyn Kenna [TSY]
Sent: Tuesday, 19 February 2019 8:59 AM
To: 'Susan Guthrie' <Susan.Guthrie@rbnz.govt.nz>
Subject: RE: Capital and bank failure

Susan, yup next week would be great.

Thanks a lot – and good luck with all the prep for the bank forum.

From: Susan Guthrie [mailto:Susan.Guthrie@rbnz.govt.nz]
Sent: Tuesday, 19 February 2019 8:54 AM
To: Bronwyn Kenna [TSY] <Bronwyn.Kenna@treasury.govt.nz>
Subject: RE: Capital and bank failure

Hi Bron,

Sure, we can try and fill some of those gaps for you. Would next week be OK? We are in a mad rush to prepare a bank forum for Thursday and a large media briefing Friday?

T'is indeed all crazy busy!

Cheers
Susan

From: Bronwyn Kenna [TSY] <Bronwyn.Kenna@treasury.govt.nz>
Sent: Tuesday, 19 February 2019 8:48 AM
To: Susan Guthrie <Susan.Guthrie@rbnz.govt.nz>
Subject: Capital and bank failure

Hi Susan,

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Hope it is all going well. You are obviously keeping very busy as part of this capital consultation.

As part of the RBNZ Review team's work on deposit insurance, we have been tasked by the Minsiter with explaining better the interconnections between the different safety net elements (prudential regulations; supervision; LOLR; DI; Resolution).

I want to give the Minister a flavour of how frequently – and severely - you might expect (smaller) banks to fail under the proposed capital requirements. I understand that you have done modelling of the losses that banks have suffered in the past, and have used this to estimate that under the proposals the frequency of a ***systemic*** crisis might be reduced to once in every 200 years.

Can you please help me understand what it might mean for idiosyncratic bank failures (and in particular smaller bank failures). What is the average loss that these kinds of banks experience when they fail? What is the average recoveries to general creditors? And how frequently might we expect it to happen. (I.e. what might PD and LGD be under the revised capital requirements vs under the current regime?)

Thanks a lot,

Bron

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