ANZ Research

RBNZ Bank Capital Decision and Change in OCR Call

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Capital, capital!

Bottom line

- The RBNZ today announced its final decision on banks' capital requirements. The overall decision is in line with its previous proposals to increase the overall amount of bank equity, but some aspects are softer.
- We continue to see a lower OCR in time and these changes will contribute to that, though less than previously expected. A softening of the proposals, combined with a more positive domestic outlook (and in particular upside to government infrastructure spending), mean we are changing our OCR call to only one further 25bp OCR cut in May next year, taking the OCR to 0.75%. We will review once we have more detail in the fiscal update next week.
- The total required level of Tier-1 capital for the major banks will be 16%, as proposed, but the transition period has been extended to seven years (from five). Importantly, the definition and amount of allowable Tier-1 capital has been expanded from the original proposals.
- The RBNZ suggests the impact on the economy will be negligible, with an impact of around 20bps on lending rates. We expect a larger impact on both retail interest rates (30-60bp, spread unevenly by sector and subject to considerable uncertainty) and credit availability than the RBNZ does, and therefore more of a negative impact on GDP. However, any impact will be difficult to separately identify, since it will occur over a long time period where many other offsetting forces will be at play.

Key points

The Reserve Bank today announced its final decision on the level of capital New Zealand banks will need to hold. The key points are:

- A 16% level of tier-1 capital for the major banks and 14% for others;
- More of this can be met with alternative Tier-1 capital, a softening from the original proposal (2.5%pts versus 1.5%pts);
- Alternative tier-1 Capital can now include redeemable preference shares and tier-2 can include long-term subordinated debt without conversion features (compared to stricter definitions originally proposed);
- In practice, these changes form the initial proposals mean that less of the increase in capital must be met with common equity, which is expensive, thus reducing the overall cost of the proposals;
- There will be a 7-year transition period for all banks (versus 5 for big banks and 7 years for smaller banks initially proposed) with the policy to kick off in July 2020;
- Raise RWA for the big-4 to ~90% of the amount calculated under the standard approach (as proposed) from October 2020;

The RBNZ estimates that the change will have an impact on retail interest rates of only 20bps. Expansion of the types of capital that are allowable along with a longer transition timeframe are expected to mitigate adverse economic effects and the risk of a material reduction in the availability of credit. Overall, the RBNZ therefore concludes that the impact on the economy will be negligible, with GDP about 0.2% lower in the long run. Accordingly, we do not expect to see any meaningful impact on the Reserve Bank's economic forecasts in the February Monetary Policy Statement.

Data summary

	Proposed	Final
Tier-1 capital requirement	16%	16%
Transition period (big banks)	5 years	7 years
Allowable alternative forms of tier 1 capital	1.5%	2.5%

Our take

A back-of-the-envelope update of our previous modelling of the impact of the RBNZ's proposed changes suggests a 30-60bp impact on the cost of credit. This is less than previously estimated due to a softening in the definition of eligible capital. Impacts are uncertain, however.

There are risks of effects towards the higher end of this range and/or a reduction in the availability of credit, particularly to agricultural and business sectors (reflecting the higher capital required for lending to these sectors). Overall, we expect a larger GDP impact than the RBNZ (perhaps as large as 1% if credit is squeezed, compared with their estimate of 0.2%), but any impacts will be over a long transition period and difficult to identify in practice.

The changes to bank capital requirements contribute to our view that growth will be slower than the RBNZ expects and the OCR eventually reduced further. We had a 25bp cut in August next year as a placeholder for the impact of these changes. However, a softening in the proposals, combined with a more positive domestic outlook and in particular, upside to government spending, mean we are changing our OCR call to only one further 25bp OCR cut, in May next year, taking the OCR to 0.75%.

Risks to this outlook appear balanced and context matters: with the OCR at just 1%, the RBNZ's ability to offset the impact of the capital changes is limited, so if impacts are greater than the RBNZ expects, fire-power will diminish quickly, increasing the probability that unconventional measures are required. This would especially be the case if the economy was hit by any kind of negative shock over the transition period. But for now, the economic outlook appears to be brightening as the impact of previous monetary easing works through.

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