Move to build buffers reaffirms our OCR call

Bottom line

- The RBNZ is consulting on proposals to increase bank capital requirements substantially.
- Greater capital buffers would help safeguard the financial system, but the proposed changes are likely to also have non-trivial macroeconomic impacts via a higher cost of funds and potentially reduced availability of credit, especially during the transition period.
- All else equal this implies a lower OCR than otherwise and reaffirms our call that the next move in the OCR will be a cut rather than a hike.

Key points

This note provides a preliminary, high-level discussion of the RBNZ’s proposals. Our views may evolve as we conduct analysis and as the RBNZ consults on and finalises the changes.

The RBNZ is currently consulting on changes to the capital adequacy framework, aimed at reducing the chance of a bank failing in New Zealand. Banks fund themselves in two ways: through equity (capital) and debt (including deposits), where equity is the stake held by the bank’s owners or shareholders. Banks are required to fund a minimum proportion of their operations through equity to ensure that bank shareholders have “skin in the game” (and thus an incentive to manage the bank well), and also to protect depositors, since shareholders bear losses first. The higher the capital ratio, the greater the buffer to absorb losses and avoid bank failure in extreme cases.

The RBNZ is proposing that regulatory minimum capital ratios be increased substantially in New Zealand for all banks, but particularly for the major (big four) banks. Currently, New Zealand banks are required to hold tier-1 (going concern) capital equal to 8.5% of their risk-weighted assets, plus 2% as tier-2 (gone concern) capital. The RBNZ is proposing that the minimum ratio of tier-1 capital be increased to 16% of risk-weighted assets for major banks (15% for smaller banks), alongside proposed changes to the treatment of existing capital and risk-weighted assets. The RBNZ estimates that major banks currently hold tier-1 capital equal to 11.5% of newly-defined risk-weighted assets.

In order to meet the RBNZ’s proposed new minimum, the major banks would need to increase their tier-1 capital ratios by 4.5%pts – an increase of $12.8bn, based on a number of assumptions. The smaller banks would need to raise $0.9bn. Separately, the major banks would need to replace $6.2bn of capital that is no longer compliant (another 2% of newly-defined risk-weighted assets). Adding to that, both ratings agencies and shareholders expect banks generally to hold more capital than the regulatory minimum, so that they have a buffer to absorb variation in profitability and avoid breaches. Banks currently hold a buffer of about 3%pts over the regulatory minimum, but a smaller buffer may be required given the minimum would be so much higher. Taking this into account, we anticipate that the major banks might need to raise $22bn more capital in total.

Determining the optimal level of capital that banks should hold is difficult and involves trade-offs. Too little capital would leave banks more vulnerable to
insolvency in the case of extreme losses. If widespread across the banking sector, this could precipitate a financial crisis, which in turn could have significant economic (and social) impacts well beyond the economic conditions that precipitated the initial losses. As well as the direct impact of losses to shareholders, depositors and potentially taxpayers of an insolvency, a sharp contraction in bank credit would significantly worsen the economic pain of an economic correction.

But on the other hand, holding more capital is not without costs – like any form of insurance. Too-high capital requirements would weigh unnecessarily on both the cost and availability of credit, which is the oil in the macroeconomic engine. We have not done the analysis and therefore do not have an opinion on what comprises the 'right' level of bank capital. However, we do believe that the economic impact of the proposed changes could be significant.

Capital is a more expensive form of financing than debt. Therefore, higher capital requirements imply a higher cost of funds on average. Some of this is likely to be passed into retail lending rates. The RBNZ’s rule of thumb is that a 1%pt increase in capital ratios increases the cost of credit by 6bps. Based on our calculations, this implies that the increase in system-wide capital could result in a 40-50bp impact on retail lending rates once the transition is complete, though it depends on how much buffer banks choose to hold over the regulatory minimum. The RBNZ’s rule of thumb assumes that pass through to the cost of funds for banks is muted (by 50%) based on the argument that those funding the bank (both lenders and shareholders) don’t mind lower returns because their investment is now safer.

The impact on retail lending rates is highly uncertain. Required returns may not fall as much as expected, especially in the transition period as a result of the hit to – and heightened uncertainty around – bank profits. Also, impacts on retail lending rates may be non-linear, given that the proposed increase in capital is large. But conceptually, a higher cost of funds, whether temporary or permanent, would need to be offset by a lower OCR. If part of the increase in the cost of funds is permanent, as seems likely, the neutral OCR will be lower.

Another reason the OCR may need to be lower during the transition period is that banks can meet the new ratios not only by raising capital, but also by reducing their balance sheet, ie reining in lending. This could reduce the amount of capital required and the short-term impact on the cost of funds, but it would weigh on the economy. Recent developments in Australia demonstrate how important the availability of credit can be, quite independent of its cost. The RBNZ estimates that the impact of the proposed changes on trend GDP is likely to be small, but one could envisage greater impacts over the transition period as a result of credit headwinds.

Of course, the macroeconomic context for the transition matters hugely too. The global credit cycle is mature and liquidity is expected to continue tightening. In this environment, raising extra capital may prove more difficult and expensive than it would have been earlier in the cycle. In fact, it could prove outright problematic if global financial conditions were to tighten significantly at some stage over the five-year transition period, implying some flexibility in timeframes may be optimal in practice.

All up, while it is very difficult to put any precise numbers on it, we expect the RBNZ’s proposed changes would weigh on the outlook for the OCR in coming years. Based on our estimate of a $22bn capital raise, the long-term impact on funding costs could be as much as 50bp, suggesting a similar impact on the neutral OCR. And depending on how developments play out, a still-lower OCR could potentially be required in the transition period.

We will be watching the outcome of the RBNZ’s consultation with interest. The economic outlook is delicately placed with downside global risks rising in prominence. As things stand currently, the possibility of higher capital requirements reaffirms our call that the eventual next move in the OCR will be down – at the dovish end of market expectations.
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