BUDDLE FINDLAY

Where do banks find capital?

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The Reserve Bank of New Zealand (the Reserve Bank) has certainly 'poked the bear' with its most recent bank capital consultation paper in which it proposes to significantly increase the minimum regulatory capital required by New Zealand incorporated banks.

This has generated a lot of talk – from economists to the financial media and everyone in between (including us lawyers). There have been 164 submissions to the Reserve Bank. This level of engagement in what could be regarded by some (well, most) as a very dry topic can only be a good thing for New Zealand.

Our 'two cents' on these proposals is the type of capital instruments a bank should be able to issue to raise more capital, especially if these proposals are introduced.

At the heart of the consultation paper is a proposal to increase the minimum regulatory capital for banks by:

- Increasing the conservation buffer from 2.5% to 7.5% (this is essentially the safety margin banks must hold over minimum capital)
- Introducing an additional 1% buffer for the large banks operating in New Zealand (reflecting the more catastrophic impact on the New Zealand economy should those banks fail)
- Increasing the countercyclical capital requirement from 0% to 1.5% (this is the capital that the Reserve Bank uses to moderate the 'boom' and 'bust' cycle. Banks' capacity to lend is limited in a 'boom' cycle by increasing capital. This requirement is then removed in a 'bust' cycle).

For the big banks this represents a 7.5% increase on the regulatory capital they currently must hold and for the smaller banks an increase of 6.5%. While most of the New Zealand banks are all well above the current minimums, the size of this increase means that virtually all of them will need to raise more capital if it is introduced.

However, the Reserve Bank is also potentially making raising this capital harder at the same time. This is because, following a prior consultation document, it made an in principle decision to disqualify some forms of capital from counting towards minimal regulatory capital.

So, on the one hand the Reserve Bank is proposing to increase minimal capital requirements for banks while, on the other hand, it has made an in principle decision to disallow certain types of capital that can be used to satisfy these requirements.

The types of capital that the Reserve Bank is proposing to disqualify is contingent debt and some forms of preferences shares. The in principle decision has been considered in-depth by the Reserve Bank. However, we believe the legal reasons given (which include the risk of mis-selling and concerns about the instruments not behaving in accordance with their legal terms on insolvency) are too conservative.

Both of these types of capital meet the requirements for regulatory capital allowed by the Bank of International Settlement (which governs principles on which central banks all around the world should operate). Both of these types of capital are well understood internationally in capital markets and allowing access to it gives banks the opportunity to access capital from a wider range of investors.

Closer to home, the risks associated with these types of capital seems particularly low given New Zealand's new and (much) improved financial product disclosure, conduct and licensing regimes, together with the effectiveness of the Financial Markets Authority in monitoring and enforcing these regimes. We believe that the risk of 'mis-selling' these types of capital instruments by highly regulated issuers, such as New Zealand banks, would be very low. Further, there seems limited justification for concerns that these types of capital instruments may not behave in accordance with the legal terms. New Zealand's insolvency law is well established and aligned with international laws. The Reserve Bank itself has extensive power and discretion on bank insolvencies to ensure that instruments do perform in accordance with their terms.

We also believe any 'market overreaction' risk if payments on alternative capital are suspended is overstated and counterbalanced by the benefit of additional oversight of a bank by the holders of this capital. This risk can also be effectively mitigated by a high quality recovery and resolution policy.

Moreover, the Reserve Bank made its in principle decision to disqualify these forms of capital when the potential size of additional capital required by banks was not known. In effect, while banks were concerned about the loss of access to these instruments, because they were all well capitalised and did not expect any additional capital requirements to be significant, it was less of an issue then.

In short, the risks given as reasons for disqualifying certain types of capital do not appear particularly compelling (at least from a legal perspective). Those risks appear to be outweighed by the benefits of providing banks access to a wider range of capital. The in principle decision should be revisited.

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