RBNZ Capital Review Not So Scary

- RBNZ gives banks longer to achieve capital targets
- Acceptable Tier 1 capital expanded to include redeemable preference shares
- RBNZ sees 20.5 basis point rate impact, +0.43% GDP impact
- Our rate view is unchanged at no change
- Orr says monetary policy in “hold phase”
- Confidence impact should reduce downside risks to GDP

The long awaited RBNZ capital review has now seen the light of day. The changes compared to the initial 2018 document were largely as we had foreshadowed but, clearly, given post announcement movements in asset prices, the details were more benign than many had feared.

The main changes (relative to the initial consultation document) were:
- banks were given longer to meet their targets (seven years instead of five); and
- acceptable tier 1 capital was widened to include redeemable preference shares.

There had been some hope that the amount of capital required might be moderated but this did not eventuate (at least for the majors). The RBNZ still “requires systemic banks to have Tier 1 capital of no less than 16% of RWA, and Total capital of no less than 18% of RWA”, as originally proposed.

Nonetheless the jump is not as aggressive as it appears. Currently the Tier 1 capital requirement is 8.5% of RWA but banks have chosen to adopt a relatively large buffer over this. Under the initial (and now final) regime, it looks like the “penalties” for failure to meet the requirements will be based on an “escalating supervisory response”. This being the case, the banks’ will probably choose to reduce the buffer meaning the actual increase in capital from the current starting point will be lower (and potentially significantly so) than the 8.5% to 16% regulated shift.

Importantly, roughly half the shortfall can be met with the issuance of the now-permitted redeemable preference shares. These shares will be allowed “to contribute to Tier 1 capital requirements up to a maximum of 2.5% of RWA”.

The Reserve Bank re-estimated the expected interest rate effect of its changes and now concludes that the impact is equivalent to a 20.5 basis point increase in the cash rate. This is at the low end of the initially estimated 20 to 40 basis point range largely reflecting the lower cost of capital associated with the preference shares. Importantly, this 20.5 basis points is spread over the seven year implementation period so is completely swamped by other economic developments – a point that Adrian Orr, himself, made.

We have always had the view that the direct interest rate effect was not enough to impact our cash rate forecasts. We remain of this view and will not be changing our rate track one iota as a consequence of today’s announcement.

As an aside, we note that in today’s press conference the Governor referred to the RBNZ as being in a “hold phase” for monetary policy. This is a view we share and makes us even more comfortable with our belief that rates will probably be on hold through 2020 and almost definitely in February.

We have consistently warned that the biggest risk to the economy from the changes in capital requirements was via the credit supply channel such that reduced supply might restrict lending and economic activity. Indeed, it is fair to say that a nervous banking sector had probably already become a bit more conservative in its lending habits as it toyed with “worst case” scenarios from the review. As things have turned out, one gets the feeling that there will be a huge sigh of relief from the banking sector such that relative to initial fears credit constraints will be lower.

We think this will be important as it will assist in reducing the uncertainty facing investors which, in turn, at the margin, might help support investment activity in the economy. We will not be raising our GDP growth forecasts as a consequence but the capital announcement is yet another factor that should reduce the downside risks to growth that had built.

For what it’s worth, the RBNZ estimated that the impact of the policies announced would have a +0.43% impact on GDP. This was all attributed to the lower probability of banking failure. We are very skeptical of this analysis as we think that such estimates are fraught with danger. That
aside, as bank after bank progressively announces that they can meet the new capital requirements, the impact on confidence and then, in turn on GDP, could actually be greater than this.

This is not to say that banks will be rushing around with an open cheque book for all and sundry. With heightened capital requirements, the logical response remains to more aggressively assess the efficacy of lending to customers with higher risk weights. The pressure on these folk will stay.

In summary then, the “best” news from today’s announcement is that the uncertainty around bank capital requirements is now largely behind us. Knowing the lie of the land – even if you don’t like the look of it – is usually so much better than not knowing it. And, in this case, the certainty is significantly better than once feared.

For us, we reiterate that the near term potential confidence impact is the most impactful feature further reducing both our downside fears for growth and the probability of further interest rate reductions. With the NZD up a quarter of a cent and interest rates up a couple of ticks, markets seem to have reached a similar conclusion.

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