RBNZ's bank capital proposal: impact on the OCR

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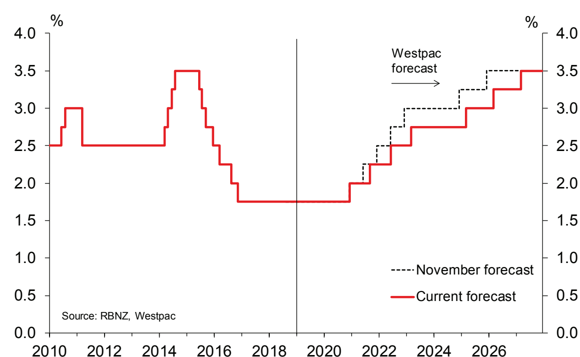
- The Reserve Bank surprised markets in December by proposing that banks should be required to hold far more capital. This bulletin assesses the impact on the OCR outlook.
- Higher capital requirements will lead to upward pressure on bank lending rates and downward pressure on bank deposit rates.
- Higher lending rates would impact asset prices and GDP. The RBNZ would react to that by running a lower OCR than otherwise.
- We are now predicting a slightly slower pace of OCR hikes in the early 2020s. The gap between our old and new forecasts is about 25 basis points.
- We do not expect higher capital requirements to affect the neutral OCR, as others have suggested.
- The final form of the capital requirements is uncertain and any impact on the OCR is years away, so the immediate implications for markets are limited.

Official Cash Rate forecast



In December the Reserve Bank issued a consultation paper proposing that New Zealand banks should be required to hold more capital. The proposed capital ratios were much higher than expected, and have captured the attention of financial markets. This paper summarises what the RBNZ's proposals might mean for the OCR outlook and swap rates.

Directionally, higher capital requirements would put upward pressure on lending rates and therefore downward pressure on asset prices and GDP growth. The RBNZ would soften the impact of that via a lower OCR than otherwise.

Higher capital requirements are negative for the OCR outlook, but they are not game changing. The RBNZ's proposal is for banks to gradually increase their capital levels over five years. Correspondingly, the possible impact on the OCR would be gradual and would last for years, rather than being anything sudden.

In response to the RBNZ's proposal, we are now predicting a slightly slower pace of OCR hikes in the early-2020s. We still expect the hiking cycle to begin in December 2020, but the risk is now that that date could shift later. Our new OCR forecast is approximately 25 basis points lower than the old forecast over a period of roughly five years. Higher bank capital ratios will not affect the long-run neutral OCR, so our forecast that the OCR will reach 3.5% in the very long run has not changed. This estimate of the impact on the OCR is very preliminary, and will be updated as our understanding evolves.

Background

Banks fund their lending activities in two ways: through capital (shareholders' equity and other instruments that would take the first loss in the event of a bank failure), or debt (including taking deposits from the public). Currently, banks are required to hold Tier 1 capital equal to at least 8.5% of risk-weighted assets. But banks actually hold far more capital than the minimum – across the big four banks the Tier 1 capital ratio is currently 13.4%.

The Reserve Bank's consultation paper contained three key proposals:

(1) Changes that would increase the calculation of banks' risk weighted assets. The big banks' current Tier 1 capital would amount to 11.6% of risk weighted assets under these proposed rules.

(2) The minimum Tier 1 capital ratio would be increased to 16%, although the penalty for dropping below that figure would be less severe than the current penalty.

Assuming that banks would choose a safety buffer of two percentage points, the big four banks would have to lift their Tier 1 capital ratio from 11.6% currently to 18%. This is a lift of 6.4 percentage points, or a dollar amount in the order of $19bn. Smaller banks would also have to raise about a billion dollars of additional capital.

(3) A change the definition of Tier 1 capital so that around $6bn of convertible debt would no longer qualify. This quasi-capital would have to be retired and replaced with other forms of Tier 1 capital.

The RBNZ proposes that the increase in capital would be gradual, and envisages that banks would build up capital by retaining earnings rather than paying dividends over a period of five years.

Impact on lending and deposit rates

Capital is more costly for banks than debt, so requiring banks to hold more capital will increase their cost of doing business. Banks might absorb some of this as a lower return on equity. But to at least some extent, higher costs will be passed on to customers in the form of a wider margin between deposit rates and lending rates (see figure 1).

This wider interest margin will partly take the form of higher lending rates, which will tend to slow GDP growth. But we should also expect bank deposit rates and interest rates on wholesale bank debt to fall. With higher lending rates, New Zealanders will choose to borrow less. In turn, that would reduce banks' need to take deposits or find funding from offshore, leading to lower interest rates on deposits or wholesale bank debt. The very act of holding more capital would also reduce banks' requirement to source deposits. Finally, if banks are holding more capital then interest rates on wholesale bank debt should be lower, since the banks would be safer. (At least, that is the theory. In practice we suspect that this effect will be vanishingly small for the main banks, because the interest rate on their debt reflects the fact that they are subsidiaries of larger Australian parent banks.)

The RBNZ's rule of thumb is that for every one percentage point increase in bank capital, the cost of bank credit would rise by 6 basis points. If banks lift their capital ratios from 11.6% to 18%, this implies roughly a 40 basis point widening of the spread between bank deposit rates and lending rates. Our own reading emphasises that the impact is highly uncertain, with estimates varying wildly between studies.

Transitional impacts on the OCR

The transition to higher capital ratios will tend to crimp GDP growth. Higher lending rates would be negative for asset prices (including house prices) and restrict investment in the economy. Furthermore, banks might decide to meet the required capital to risk-weighted assets ratio by reducing the asset side of the equation – in other words, by restricting lending.

The monetary policy arm of the Reserve Bank could react to this lower GDP outlook by keeping the OCR at a lower level than otherwise, at least until the economy has adjusted to its new realities. Our initial estimate is that the OCR would have to be around 25 basis points lower than our previous forecast to keep inflation stable.

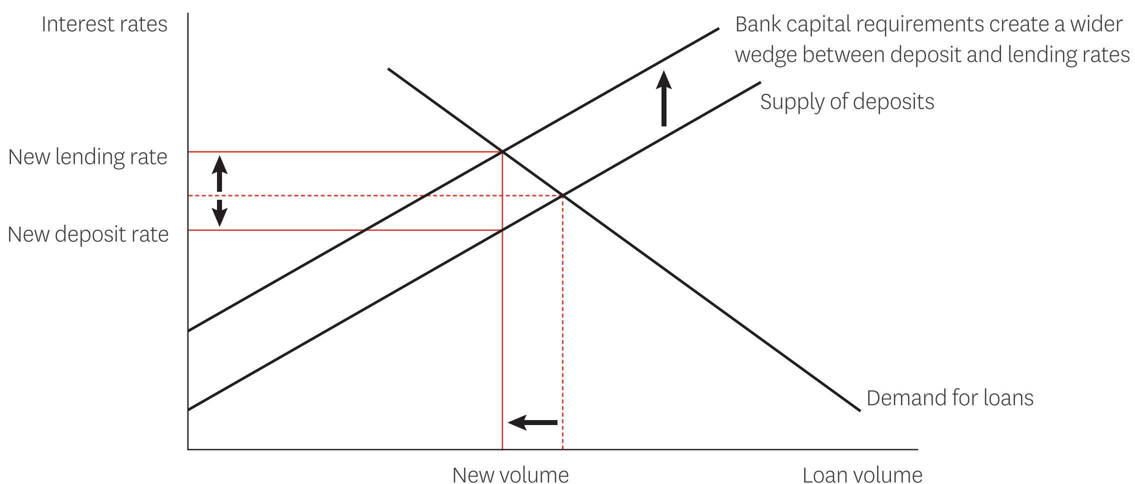
Minimum capital ratios are proposed to rise slowly over a period of five years, starting this year and finishing in 2023. This makes it difficult to pin down when the OCR will be impacted, but as a placeholder we have shifted from forecasting three OCR hikes in 2021 to two.

Long run impacts and the neutral OCR

We have seen suggestions that higher bank capital requirements can be offset by a lower neutral OCR, implying no change in bank lending rates relative to the status quo. We disagree.

As established above, higher bank capital requirements would lead to a wider margin between bank deposit and

Figure 1: Impact of bank capital regulations



lending rates. For the banking system to permanently sustain today's lending rates while also sustaining wider interest margins, it would need to run with permanently lower deposit rates (and permanently lower interest rates on wholesale bank funding). We find that unrealistic, especially as deposit rates are so low already.

Requiring banks to hold more capital amounts to a real increase in the cost of banking services that must be paid somewhere in the system. The "lower neutral OCR" idea implies that the entire cost will be borne by savers in the form of lower interest rates on deposits. That seems unrealistic. Our view is that the costs will be borne widely – by banks themselves, by borrowers in the form of higher borrowing rates, by savers in the form of lower interest rates, and by the economy in the form of lower GDP. The Reserve Bank appears to agree, since they estimate that higher bank capital requirements will lead to slightly lower GDP during normal times.

The idea that higher bank capital requirements can be "offset" with a lower neutral OCR violates the principle that monetary policy is neutral in the long run. Higher funding requirements are a genuine change to the economy's fundamentals that cannot simply be "wished away" by a lower neutral OCR.

Implications for markets

The RBNZ's proposed capital requirements suggest that the OCR outlook is lower over the early to mid 2020s than previously understood. In turn, this suggests some downside for swap rates right across the curve. However, the importance of this development for markets should not be overstated.

The RBNZ's proposal was certainly surprising in terms of how high they would like to push bank capital. Ratings agency Fitch has noted that the RBNZ's proposed standards are "highly conservative relative to international peers", with a conservation buffer "more than double the highest in any other market". However, it is worth remembering that there was always going to be some increase in capital requirements for New Zealand banks, in line with global trends. Therefore, the Reserve Bank's consultation paper should not represent a complete surprise for markets or for OCR forecasts.

It is also worth bearing in mind that many uncertainties remain. The Reserve Bank has only issued a proposal. The final form of the capital requirements is uncertain. Furthermore, there is much water to flow under the bridge before these capital requirements have any impact on the OCR, with an attendant array of uncertainties that could change the OCR outlook by much more than these capital requirements in the interim.

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