NZ Institute of Primary Industry Management

PO Box 5304
Wellington 6145

P: 04 939 9134
E: admin@nzipim.co.nz
www.nzipim.co.nz

To	Ian Woolford Financial System Policy and Analysis Department Reserve Bank of New Zealand PO Box 2498 Wellington 6140
Email:	CapitalReview@rbnz.govt.nz
Submission on:	**Capital Review Paper 4: How Much Capital is Enough?**
From:	**The New Zealand Institute of Primary Industry Management**
Date:	17 May 2019
Contact:	Stephen Macaulay Chief Executive PO Box 5304 Wellington 6145 P: 027 226 3331 E: stephen@nzipim.co.nz

Introduction

The New Zealand Institute of Primary Industry Management (NZIPIM) welcomes the opportunity to submit on the Reserve Bank of New Zealand's (RBNZ) consultation paper *Capital Review Paper 4: How Much Capital is Enough?*

By way of background, NZIPIM is the peak industry body for the rural profession. We have over 1,050 members from a diverse range of occupations within the rural profession, including farm management advisors, rural bankers, farm accountants, fertiliser consultants, rural valuers, representatives from industry good organisations, CRIs, universities and agribusiness service providers.

Our members work with farmers on a day-to-day basis in helping them achieve their goals in running successful and financially sustainable farm business enterprises. This has wider flow-on benefits for the economic and social wellbeing of New Zealand, generating primary export earnings of $42.7 billion to the year ending June 2018.[1]

NZIPIM agrees that it is important to ensure that banks maintain capital requirements to safeguard New Zealand's financial system. However, given the scale and velocity of the proposed changes on bank capital requirements outlined within the consultation paper, NZIPIM believes there is a risk that this will likely impact on banks' lending arrangements within New Zealand's agricultural and horticultural sectors.

Overview of the primary industry

Based on feedback received from members there is considerable uncertainty within the farming community brought about by increased on-farm environmental regulations, growing statutory requirements and additional compliance costs for farm businesses.

In a recent NZIPIM membership survey, over 55% of all respondents reported significant knowledge gaps and understanding of new environmental regulations by farmers, particularly on how to maintain profitable and sustainable businesses under environmental limits being rolled out by a number of regional councils across the country. Not since the late 1980s have we seen the type of upheaval and uncertainty now being experienced on-farm.

We are also seeing increasing requirements from the marketplace from more discerning consumers, along with growing threats posed by new and emerging food technologies such as alternative meat and milk proteins, and lab-cultured foods. All these developments challenge the very way we produce, process and market our agri-food and fibre products to the world.

Farming is typically a capital intensive business. Farmers continue to rely on bank capital to help grow and develop their farming businesses, and to cover funding shortfalls during certain times of the season or through unexpected events such as a severe market downturn or extreme weather occurrences.

[1] Situation and Outlook for Primary Industries: March 2019 (link)

We are concerned that the proposal may lead to increased borrowing costs, adding greater costs to farm businesses at a critical juncture for the agricultural and horticultural sectors. This is also comes at a time when farm confidence is already in the doldrums, which we will expand upon further in this submission.

Recommendations

NZIPIM recommends that:

- Clearer justification and transparency be provided on proposed bank capital levels compared to the Australian Prudential Regulation Authority (APRA) and other central banks globally to ensure New Zealand businesses are not negatively impacted compared to our international competitors.
- Deeper consideration and analysis be undertaken about the likely unintended consequences of increasing bank capital requirements through an in-depth cost-benefit analysis with detailed breakdown by sectors (e.g. agriculture, business sector, commercial property, residential housing, etc).
- A more measured approach be adopted in building capital reserve levels within the banking sector, which limits any disruption to the economy as much as possible.

Comments on the consultation paper

1. RBNZ wants enough capital in the system to cover large unexpected losses in the event of an extreme shock, and have determined this position to be a one in every 200-year event. RBNZ believes this objective is reasonable and consistent with its legislated responsibility to maintain financial system “soundness”.

   It is difficult to determine whether this is reasonable without understanding how the one in 200-year event measure was determined, and how this compares with other central banks globally.

   If this type of measure is over and above that used or considered by other international central banks, what additional risk factors were considered as part of RBNZ’s analysis? If, rather, this is largely based on insurance solvency standards across Europe, what relevancy, if any, does this have to New Zealand?

2. RBNZ are proposing to increase the amount of capital systemically important banks are required to hold from a minimum 10.5% of risk weighted assets (RWA) to setting the Tier 1 capital ratio at 16% of RWA, or 18% including Tier 2 capital. For non-systemically important banks it is proposed that the Tier 1 capital ratio be set at 15% of RWA, or 17% including Tier 2 capital.[2] This represents a significant increase of capital to be held by banks from the current levels.

   While increasing minimum regulated capital from 10.5% seems a prudent approach, the proposed new Tier 1 capital ratio target of 16% for large banks

[2] The 18% percent combines: 2% Tier 2 capital, 6% Tier 1 capital, 7.5% Conservation Buffer, 1% Domestic-Systematically Important Bank Buffer and 1.5% Counter-Cyclical Buffer. Smaller banks are not required to hold the 1% Domestic-Systematically Important Bank Buffer.

would appear to be significantly higher than the APRA capital requirements, whereby major Australian resident banks need to have Common Equity Tier 1 capital ratios of at least 10.5% to meet the "unquestionably strong" benchmark.[3]

Clearer justification and transparency is needed on proposed new bank capital levels compared to that required by APRA and other central banks.

3. We note the proposed Counter-Cyclical Capital Buffer (CCyB) is an untested new macroprudential tool being considered by RBNZ. The 1.5% CCyB is part of the increase in buffers that takes Tier 1 capital to 16%. We note that this buffer is an experimental and unproven tool on top of already significant capital increases that require further consideration, particularly given that most banks typically operate with more capital than required by RBNZ.

4. The lack of a cost-benefit analysis is a shortcoming in the consultation paper and in our view has stifled deeper consideration and objective discussion by those potentially impacted by the changes, namely borrowers.

   The Reserve Bank Governor has acknowledged increased capital requirements would add around 20 to 40 basis points of additional premium between the costs at which banks borrow and lend, while other market commentators estimate upwards of 125 basis points (Swiss investment bank UBS). The upshot is that there will be additional costs to borrowers as banks build their capital positions over a proposed five-year period.

   Agricultural debt has continued to climb and is currently sitting at around $63 billion, with around two-thirds of that debt in the dairy sector. Assuming a 100 basis point increase in interest rates, this would add around $630 million in interest costs for farmers.[4]

   Increased borrowing costs come at a time when farmers are faced with new environmental regulations and productivity limits in a number of regions across the country. Farmers are increasingly being asked to consider and implement strategies to mitigate their environmental risks, many of which require additional capital without necessarily increasing profitability (e.g. developing riparian margins, building feed or stand-off cattle pads, establishing wetlands, etc). The added cost of borrowing, or potentially restrictions on being able to borrow, could undermine a farmer's ability to meet new environmental regulations, which could limit the types of practice change being sought on-farm.

   We are also seeing a generational shift on-farm as owners look to retire or exit the business. Succession arrangements and/or equity partnership arrangements to help transition the family farming business require access to capital to enable this to occur successfully. If capital becomes more difficult to obtain, this transition process will slowdown, thus reducing the opportunity for many young people to enter the agricultural and horticultural industries. This generational transition is needed to further enhance the productivity potential of farms and to speed up the adoption of new and innovative farm practices required to address growing environmental and in-market regulations.

---

[3] APRA announces 'unquestionably strong' capital benchmarks July 2017 (link)

[4] RBNZ: Sector lending (registered banks and non-bank lending institutions) (link)

Up until recently, we were also beginning to see realignment occur within the industry where poorer performing farm businesses were being acquired by much more successful ones, including large family enterprises, corporate farming businesses, and young first farm owners able to attract both debt and equity capital for themselves. While such arrangements have the potential to improve the overall financial health and performance within the agricultural and horticultural sectors and lower banks' overall risk profile, added financial costs as a result of increasing capital requirements will slow this process down.

Banks are already referencing the proposed changes to increase bank capital levels in their discussions with farmers. Anecdotally, members are reporting that banks are tightening their requirements on banking and financial arrangements on-farm through more aggressive repayment of loans, lending margins and access to credit facilities. We have some concerns that the proposed changes could accelerate bank demands on repayment of credit facilities beyond the capacity of the farm businesses to meet them, which in turn could have destabilising affect across the sector.

5. Should banks need to accumulate more capital, weighing up risk will feature more highly in their deliberations, particularly the impact of scarce capital being transferred to other sectors in the economy or potentially being allocated away from the economy entirely.

   Lending to farm business enterprises attracts higher risk weighting in banks' capital calculations as they need to hold more capital for lending in the agricultural and horticultural sectors. Banks may steer away from the sector and look at other sectors where less capital is required on a risk weighted basis, such as residential property. With increased capital potentially being directed to home loans we could see a lift in house prices, which would be contrary to Government's desire to keep a lid on property prices, particularly for first home buyers.

6. The requirement for banks to achieve desired capital levels should be considered over a longer transition period, rather than the five-year period proposed in the consultation paper, to limit any disruption to the economy as much as possible.

Thank you for your consideration of this submission as part of the consultation process. On behalf of the rural profession, NZIPIM is happy to organise a meeting with a representative of RBNZ to discuss the points raised in this submission.