

# Submission to Reserve Bank on bank capital adequacy from David Schnauer.

I am a retired Auckland lawyer with a particular interest in Economics. I have just finished writing a book on the New Zealand economy, which I am currently working on getting published. Important in my book: I suggest there is a need to heighten the importance of the commercial sector of the NZ economy and reduce the current emphasis on housing. The way banking is regulated, impacts significantly on what I suggest is currently an imbalance. My book therefore devotes considerable attention to banking. That in turn made me take an interest in the RBNZ's current consultation on capital adequacy, and led me to decide to put in a submission, which I now do.

## Questions 1-28.

I make the following points in relation to these questions:

- New Zealand is a higher risk country. We are prone to earthquakes and natural disasters. We have high house prices relative to incomes, (even after a limited moderating in house prices since 2022). We are very dependent on fluctuating overseas commodity markets. And we have a sub-optimal economy, with poor productivity and structural government deficits.
- World economic conditions are seriously worrying for the next 10 years, as a result of mounting worldwide government indebtedness. Japan, China, USA, Italy, UK, France- most of the major world economies- already have serious government debt problems, and what is more worrying, appear unable to implement changes needed to balance their budgets. Worldwide demographic changes, delivering more retirees and fewer working taxpayers, will exacerbate these problems, meaning worldwide sovereign debt problems are almost certain to worsen over the next decade. The most likely outcome- world debt markets will impose financial discipline on overly indebted countries by only financing their government debt at increasing interest rates. That will put massive additional interest costs on already unsustainable government budgets in these deficit countries. Central banks only control interest rates at the shorter end of the curve, so that monetary policy will not be effective in offsetting increased interest rates on longer term government debt. Meaning a significant worldwide economic contraction originating from sovereign debt issues, has to be an increasing risk in the next 10 years. The NZ economy will certainly be impacted if this occurs.
- For all these reasons, I suggest New Zealand should have conservative banking capital requirements for the future.
- To the extent that the Deposit Takers Act has reduced the risks of bank failure, it would be reasonable to reduce the 2019 ratios by an amount which reflects the effect of that Act.
- Given the limited competition in the NZ banking market, I discount as very remote, the possibility that a reduction in the 2019 capital requirements, offering cost savings to

banks, will be passed through to customers in the form of cheaper loans. Why have the banks been lobbying so hard to get the capital ratios reconsidered and lowered, if they are going to pass any cost savings which result, on to their customers via cheaper loans, and leave their bank profits unchanged? We should not forget the Hayne Report. It is highly likely our four major banks want the capital ratios lowered, so they can lower their costs, and increase their profits. The possibility of any reduction in the 2019 capital requirements delivering cheaper loans to NZ bank customers (in my submission), should be entirely discounted, when weighing up your final capital adequacy decision.

## Section 5- Standardised risk weights.

This is the part of the consultation which I wish to focus on in this submission. I quote the following extract from your report (the emphasis is mine):

“Furthermore, updating standardised risk weights to be more granular and reflect the risks of the underlying lending **could help to reduce any distortions that capital requirements might have on the allocation of lending across different sectors**. Overall, we agree **that risk weights should reflect the actual risk faced by deposit takers in the New Zealand context**.”

Why have I emphasized this extract from your report? Because in my assessment, bank capital adequacy risk weighting rules currently **DO** seriously distort the allocation and cost of capital across sectors. Risk weights currently **DO NOT** reflect the actual risk attached to many loans. Yet the risk weightings attaching to different types of bank lending has a major impact on the makeup of overall bank lending. Banks are strongly incentivised to make loans in areas which require less bank capital to back them. They are conversely discouraged from making loans in areas which require higher bank capital to back them. The risk weighting rules, in my view are currently doing major damage to the New Zealand economy and urgently need addressing.

So I begin from a perspective that major (not incremental) change is needed in the way risk weights are assessed for individual loans. Your proposals in the consultation document in my respectful submission, fall well short of the bold changes needed to the current bank capital adequacy regime in New Zealand, if the performance of the New Zealand economy is to move on to a heightened plane for the next 75 years (as I advocate in my book).

## Extracts from my pending book

Apologies for the length of the extract which follows, and for commentary on the Basel Accords (which I am sure NZRB is already very familiar with) -but I have reproduced below as part of this submission, around half my chapter on banking, because it is written on the very issues covered by your present consultation:

### 10.2 Trading banks and capital adequacy

“.....an aspect of trading bank activity that has attracted much attention, especially since the worldwide bailouts of 2008, is bank stability. Discussion has focused on bank capital adequacy. Generally banks

around the world have been forced to raise the percentages of their loan books which are backed by their own capital – and the worldwide banking system is more stable as a result. Central banks deserve credit for driving these improved safety margins even if they are not yet fully in place in New Zealand, and there is a dispute whether they are too conservative and onerous at the levels most recently set in New Zealand.

Governments, expressly by law, underwrite a part of bank deposits. That position is being modified in 2025, as a new system whereby a guarantee fund available to protect bank and some finance company deposits, is launched. But even with such new protection, to the extent they do not underwrite them, governments cannot afford to let large banks fail, because the resulting damage to their economy is too great. So governments implicitly underwrite all large trading bank activity. This reality means governments are very interested to see that the trading banks within their economy are stable and properly capitalised. This issue of stability merits close analysis.

### **It all comes from Basel.**

The Bank for International Settlements (BIS) is based in Basel, Switzerland. As its name suggests, BIS operates as a bank through which international payments are transacted. As part of this international clearing role, BIS would want to know that banks making payments through it are solvent and their obligations to BIS will be met.

The Basel Committee, initially called, 'The Committee on Banking Regulations and Supervisory Practices', was established by the G10 leading world economies in 1974. It is headquartered at BIS. The committee now has a membership of 45 institutions around the world. The committee has established a series of international standards for bank regulation, most notably its Accords on capital adequacy. The purpose of the Accords is 'to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses'. The Accords do not have legal force. Members are responsible for their implementation in their countries. The Accords are international standards which countries around the world can adopt to measure and regulate the financial stability of their trading banks.

Three Accords have been issued. These are now called Basel 1 (1988), Basel 2 (2004) and Basel 3 (2010, updated in 2017). Not unexpectedly, complexity has increased from Accord 1 to Accord 3. They all proceed on the same fundamental approach. Trading banks need adequate capital to back the risk assets (especially loans to customers) they hold. Risk assets range from government stock and deposits with the central bank (low risk) to loans the bank has made to its customers (much higher risk). Very little capital is needed to back their secure assets; substantial capital should be held to back their most risky assets.

Basel 1 categorises the assets of financial institutions into five risk categories (0%, 10%, 20%, 50% and 100%). With very secure assets, no capital need be held to back them. So no part of the face value of these very secure assets need be counted in the bank's risk weighted assets. They are assigned a 0% risk category. With significantly risky assets that could potentially be lost entirely, 100% of their face value must be added to the bank's risk weighted assets. This methodology is applied across the whole of the assets held by a trading bank. Basel 1 calls for trading banks to have capital equal to 8% of its risk weighted assets, calculated in accordance with these formulae.

Basel 2 and Basel 3 while more complex, continue the same methodology of calculating the risk weighted assets of individual trading banks, and then require a specified percentage of those total risk weighted assets (usually now around 15%) to be backed by the trading bank's own capital.

### **Basel Accords favour residential mortgage lending.**

There is a key point to make about the Basel Accords: the three Accords all provide a lesser risk weighting for residential mortgages than for most other forms of lending. Under Basel 1 banks were required to count only 50% of their residential mortgages in calculating their risk-weighted assets (whereas they had to count 100% of other lending, including commercial lending and commercial real estate). Under Basel 2, 50% dropped to only 35% of residential mortgages which had to be counted in a bank's risk-weighted assets. Under Basel 3, risk weights attaching to residential mortgages vary, depending on the Loan to Value ratio of the mortgage. Thus if the mortgage loan is less than 50% of the value of the property, only 20% of the loan is included in the bank's risk weighted capital. This increases to 25% when the loan is between 50% and 60% of the property value. It becomes 30% when the loan is between 60% and 80% of the property value; 40% between 80% and 90% of the property value; 50% between 90% and 100% of the property value; and 70% of a residential mortgage loan has to be counted in the bank's risk weighted capital, when the amount of the loan exceeds the value of the property over which it is secured.

Thus under all three Basel accords, **residential mortgages require less trading bank capital to back them, than other forms of bank lending.**

The Basel Accords appear to have been promulgated with only bank stability in focus. And in assessing bank stability, residential mortgages are assessed to be less risky than other types of bank lending. The Basel Accords strongly encourage trading banks to prefer residential mortgages over other forms of lending.

### **What happens when regulation skews bank lending towards houses?**

Our son recently returned to New Zealand with his family after 10 years overseas. He had enough capital to buy a house or a business but not both. Unlike many New Zealanders he decided to buy a business and to rent a house.

Finance for about 60% of the cost of the business was eventually provided by his bank – but only because both my son and I personally guaranteed it. The loan was over five years at 6.7%. The bank charged an establishment fee. The loan required steep monthly repayments, calculated to repay the whole advance on a table basis over the five years. Cash which would otherwise have been available to invest and improve the business in those first five years our son owned it, had to be repaid to the bank.

Had our son opted to buy a house, the mortgage loan would have been much larger, and no guarantee would have been required from me. No establishment fee would have been sought. In fact it is probable banks would have been falling over themselves to provide house mortgage finance to him. Any housing loan would have been at about a 25% lower interest rate, for a much higher percentage of the cost of the house (notwithstanding Loan to Value restrictions then in force) and over 25 years or some similar lengthy period, with minimal table mortgage reductions. In short, a house mortgage would have been available on far more attractive terms, than the commercial loan our son was able to borrow to buy his business.

All of this flows directly from Basel: banks strongly favour housing loans, over business loans.

### **Housing v. Business lending - which benefits society more?**

My son's new business is proving successful. It now employs twelve staff. It is generating GST, PAYE, ACC levies, Company tax, Fringe Benefit Tax, etc for the Government. It makes a product that customers want to buy. It generates benefits for New Zealand every day it operates. What if instead my son had bought a house? What benefit would that have generated? Yes, buying a house indirectly supports the New Zealand building industry, but if (as would be probable) my son had bought an existing house there is no benefit for the country. Buying a business and creating jobs, income and production in this country is surely doing something of greater social benefit than buying a house. And yet banks are incentivised by the Basel Accords to be highly supportive of house buying and unsupportive of business buying. It is no coincidence that house prices have risen significantly in many parts of the world since Basel 1. We have strongly incentivised our banks under Basel to push residential lending – and they have done exactly that.

It is illustrative at this point, to quote from the excellent recent book “Barbeque Economics” by Liam Dann, Herald Economics writer. In discussing New Zealand house prices, he writes at page 158:

“Something changed in the 1990's and house prices took off. For years we had what was an ideal market environment for handy Kiwis to make a few dollars renovating old villas and selling them on-and that kind of became part of our culture. Yes, there were market cycles, - but they were slow and shallow, playing out over years. But then the market got crazy: data shows that prices began accelerating in the mid-1990's and its got crazier and crazier since then.

What changed?

Liam suggests the main cause of this dramatic change in house prices, was the consolidation of the New Zealand banking sector into the ownership of the big four Australian banks, which took place between 1989, (when ANZ purchased Postbank), and 2003 (when ANZ bought National Bank). He goes on at page 160:

“One of the reasons we sold ..(the previously NZ owned banks)...was that we wanted international banks with access to more capital to get the economy humming....Whatever you think of the sale process, it did create an environment of much easier lending conditions. Unfortunately, the capital didn't all flow to productive businesses or technology start-ups, or whatever we hoped would transform the economy back then. Instead, it mostly flowed into housing. We gave our gentle “do up and sell “property culture a powerful boost. Actually, it was more of an *Incredible Hulk* level radioactive steroid shot.

Since the mid-1990's, the average price of a Kiwi house has increased by more than 600%. To be fair, surging house prices have been a phenomenon all over the Western world in the past three decades. The UK, for example, has seen average house price growth of 400% since 1995. But New Zealand leads the pack.

Was the new foreign-owned banking sector the primary cause of the long housing boom? Well, nothing is that simple- but there is certainly a correlation between the sale of our banks and the dramatic acceleration of house prices."

I am sure "Barbeque Economics" is correct, that New Zealand now having an almost exclusively overseas owned banking sector with more access to international capital markets, has provided more funding which has helped stoke the New Zealand property market. But as Liam fairly acknowledges, the housing boom of the last 30 years has been a phenomenon throughout Western economies- even if New Zealand caught the bug worse than other countries. USA (with its housing and sub-prime crisis in 2008); UK, Australia- they all have capital gains taxes, but have nevertheless experienced exceedingly high house price growth since Basel 1. This worldwide house- price boom is not just due to the tax concessions available for housing in New Zealand. It is not just due to shortages of housing supply in New Zealand, although that has surely added to the problem.

The worldwide Western economies property boom has to be significantly due to factors common to banks in all these countries. That common factor is the strong incentivising of house lending over other types of lending under the Basel Accords, from 1988 onwards. It applies to pretty much all banks operating in the developed economies. It has delivered major house price increases in pretty much all the economies where those banks operate. By requiring less bank capital to back them, the Basel Accords incentivise banks to lend house mortgages; and discourage them from making loans to business and the productive sector of their economies. **In Australia from 1990 to 2020 bank loans to business dropped from 55% to 32% of bank lending.**

Banks love housing loans. The larger the loan, the more profit the banks make. Bank profits rise, as house prices rise, and house mortgages increase in size. The staggering profits now earned by the big four Australian banks operating in NZ, shows banks are primary beneficiaries of rising house prices.

## **The downsides from excessive bank lending on houses**

I have already explained (Chapter 8) how much damage I assess the housing boom has done to New Zealand society. It has compelled many two income households, (with children of the household raised in creches), in order to pay the enormous mortgages which go hand in glove with high house prices. Exceptionally high house prices are driving major social disparity, between Kiwis who (almost always with family help) are able to get onto the property ladder, and those who can't. And those excessive house prices have diverted funds into housing, which should have been going into the New Zealand commercial sector, to drive our economic progress. Much of the money the banks lend into the New Zealand housing market – around one dollar in five – is borrowed from offshore. Meaning high house prices contribute to New Zealand's private international debt, which is at high levels and a detriment for the country.

Difficult as it may be to believe, I have little doubt a set of arcane rules developed in Switzerland and governing the operation of banks around the world, have done major damage to New Zealand society and to the New Zealand economy for the last 30 years. Abolishing compulsory funded superannuation in 1972 did the worst economic damage to the New Zealand economy. But adopting the Basel Rules and highly incentivising trading banks to prioritise house lending over other forms of bank lending, gets my award for the second most damaging economic policy mistake of the last 75 years. What is additionally unfortunate- both of these damaging economic positions **remain unreversed, even in 2025.**

If banks are to undertake more commercial lending as I am advocating, then ideally, they do need to have good capital ratios to back their activities. So, despite bank lobbying in early 2025, to wind back the high capital ratios promulgated by the NZRB under Governor Orr, I think this would be a mistake. In my view, the high ratios should be retained, commercial lending encouraged, and the coalition government and the new governor of NZRB should not reduce the capital ratio which has already been promulgated.

Basel has been set up solely with bank stability in mind. It is damaging the NZ economy in the outcomes it is producing. We need to modify that and take the heat out of house prices while putting more wind behind bank lending to our productive sector."

### **Some practical examples to back up this above section from my pending book**

It is always helpful to see what current bank adequacy rules are delivering in practice. There are two sequels to the financing of my son's business, referred to in the above extract from my book. After he had run the business for a year or two, my son got frustrated with paying a much higher interest rate on his business loan, than he would have paid if he had borrowed to buy a house. So he persuaded my wife and I to give the bank a first mortgage over our holiday home, in support of our guarantee of the loan. So now the bank had a residential mortgage over a property worth at least five times the amount my son's bank loan, as additional security for its commercial loan to my son's business. The bank dropped the interest rate it was charging my son's business considerably- but still not as low as it would have offered for a straight housing mortgage. How unfortunate that as a result of Basel, gold plated lending for a commercial purpose still costs more than a house mortgage.

Then having paid off his initial loan used to purchase the business, my son looked to buy a building into which to relocate his business. The bank offered a loan at around 2% above the home mortgage rate, repayable over 15 years- ie repayable in around half the time required for repayment of a housing loan (leaving less cash to invest in improving the business than if the loan had a longer term). A borrower with a successful debt free business generating a good cash flow, wanting to relocate his business into a building owned by the business and offering a first mortgage security; yet still facing a major detriment in the cost and term of the bank loan available to fund that building purchase, compared to the lending which would have funded my son into a house purchase.

Then my wife and I (for retirement purposes), have been shareholders for the last 13 years with several others, in a company which owns an Auckland commercial building. There is a small residual mortgage on the building, equal to about 7% of the capital value of the building. The mortgage is treated as a commercial loan, currently has 100% risk weighting, and accordingly currently bears interest (we have just refixed) at about 2% above the housing rate. Even under the consultation proposals, the loan will only drop to an 85% or 75% (I am not sure exactly which) risk weighting, and the excessive interest rate above the housing rate, will continue or only drop by a small amount.

You say in your consultation document (as I have already quoted) “..that risk weights should reflect the actual risk faced by deposit takers in the New Zealand context.” With respect, risk weights under the existing Basel Accords patently do not currently reflect actual credit risk on many commercial and agricultural loans; and still will not come close to doing so, if the consultation proposals are adopted.

The final example I give of the current risk weighted regime in operation, comes from my having run a North Shore law firm for many years. I am sure I tell the Reserve Bank what it already knows, when I say it was very common among our law firm clients to see smaller tradesmen such as builders, electricians and plumbers owning a house, financed with a bank mortgage. But the mortgage also secured bank lending for their business- a loan to buy a business vehicle, a business overdraft, etc- all secured under the bank's house mortgage. Perhaps the tradesman

had a workshop for his business in the back of the garage at his home. Often his wife did the books for the business, issued the invoices, etc, all from her office in the home. The result: the living and business arrangements were commonly intertwined- sometimes closely intertwined.

How do banks treat this lending to SME tradespeople for capital adequacy purposes? Do they say this is a house mortgage requiring much less capital to back it, and charge much lower interest? Or do they say it is a commercial loan requiring far higher capital backing and charge much higher interest? Or do they split it between the two categories? The reality is that the line between what is house lending and what is SME lending can be grey- and yet for borrowers the financial consequences and interest rate differentials resulting from falling one side or the other of that line, can be major- and will be little diminished even if the consultation proposals are adopted.

### **The importance of sectors in assessing loan risk, is very overrated**

Does the fact that a tradesman is running his business from his home, make the bank loan any more risky, than if he and his family lived in a house which has been financed entirely on a stand alone basis, with no connection to his business? Answer: On most occasions the tying together of the business and house lending into the one mortgage makes negligible difference to the risk profile of the loan. Yes, if the total home + business lending amounts to a higher LVR then obviously risk increases. But whether that higher LVR is made up primarily of loans for the business or primarily loans to finance the house, these different percentages of the overall loan have minimal implications for its risk profile.

And that comment applies equally to lending into every sector of the economy. Yes Figure 21 (page 81) in your Consultation document shows different loss rates for different lending sectors. But those loss rates following from the sector classification of loans, are in my view only a small part of the risk profile of each loan. The Basel approach I suggest, unduly emphasises one factor of loan riskiness- the sector into which the loan has been lent. Yes Basel 2 and Basel 3 brought in LVR as well as “loan sector” as a second consideration in fixing the risk weighting of lending. But “loan sector” still remains very important under Basel today- and that considerable weighting on “loan sector” in determining the riskiness and therefore the cost of loans to borrowers, is continued in your consultation paper.

I suggest the proportion of the risk weighting given to loans according to the sector they come within, is unduly excessive. It penalizes the productive sectors of the economy- especially commercial and agricultural lending. The degree of importance of sectors in assessing the risk weighting of loans, should be strongly scaled back, as it is currently causing unfortunate economic distortions to the overall New Zealand economy.

### **So what are the key factors in a loan's risk profile?**

If economic sectors are not an important or helpful factor in assessing loan risk weightings, what should be changed? How should risks attaching to loans be assessed, so that (in the words of the quote from your consultation document above).” risk weights reflect the actual risks faced”.. on productive sector loans?

It is more than a little incongruous that a retired lawyer should give any advice at all to bankers of any stripe, as to risk factors for loans (apologies, but I need to do this to make a real numbers, coherent submission). You bankers spend your whole life working on risk profiles, and know far

more than me in this area. But anyway, in my simplistic way (and with suitable apology), I would calculate a loan's risk profile by assessing points out of 100.

I suggest the risk profile of a loan primarily depends on two key factors. **First** the chances of getting repaid from realising the security, if the borrower defaults. I suggest this is the most important factor in loan risk assessment, and call it "The Capital Recovery Factor".

**Second** in my assessment the risk profile of a loan depends on the borrower's likelihood of servicing the debt, which breaks down into their income/cashflow and their prior credit history. I call this "The Servicing Factor"

I suggest with this two pronged approach, the sector of the economy into which the loan is made, is of miniscule significance in the overall risk analysis, but as a concession to Basel, I have allowed a minor weight on this factor.

Here is my amateurish attempt at a points system for assessing loan risk

### **Capital Recovery Factor**

- Likelihood of debt being covered by assessed recovery from secured property (this brings in LVR but is wider) .....45 points
- Quality of legal security held (real property mortgage/chattels security, etc).....10 points

### **Servicing Factor**

- Cash flow coverage..... 25 points
- Credit rating/strength/quality of borrower .....15 points

### **Loan sector**

- Sector of loan (housing/agriculture, etc).....5 points

This would NOT apply to personal loans whether credit cards, cars, home appliances, etc, but I think could generally be applied to pretty much all other categories of bank lending- including commercial, agricultural and domestic house mortgage lending. I also expect that the available points for each aspect of the loan's risk which I have set out above for illustrative purposes, would be refined, so as better to reflect actual lending experience- so the percentages I have given above are definitely subject to ultimate adjustment, if the system I advocate was to be adopted.

### **Comment on Capital Recovery Factor and commercial loans**

Lets take a few examples. First my personal example from above. A substantial CBD building with 10 tenants (so the vacancy risk is very low), wanting to borrow on first mortgage security a sum equal to 7% of the capital value of the building as assessed in a registered valuation. Common sense says this is a gilt edged loan, and the security can readily be realized to repay the loan in full. The risk weighting here, if it is to reflect the actual risk, should be minimal. The fact this is a commercial property is irrelevant. The loan should be given the lowest possible risk weighting, and attract an interest rate equivalent to the lowest LVR domestic housing first mortgages.



Second example- a company with a deposit to put down, wants to buy a truck and finance the outstanding cost of the truck on a chattel security. Trucks generally go down in value over time. They can be written off in accidents, be stolen, etc. Chattel securities are not as good as a first mortgage over land. The chances of being repaid from realising the security here are much lower- and are partly dependent on the percentage of the cost of the truck which is being financed. So this loan should have a higher risk weight than the first property mortgage loan over the tenanted building. But this higher risk rating follows from the matters particular to this transaction itself- not from the simple consideration that it is a “commercial” loan.

Third example- a business overdraft secured by a chattels security over the business fitout in leased premises (say a loan to a restaurant). Now the chances of the lender recovering even part of its loan from selling the fitout, if the borrowing restaurant business fails, is very low indeed. So this loan merits a higher risk weighting again.

In the case of all of these three loans I have discussed as examples, I have not mentioned The Servicing Factor. The creditworthiness of the borrower is a major secondary factor. A loan to a long-established business with a good credit history is a far less risky loan than a loan to a borrower just recently in business, and with a limited credit record. So the more creditworthy borrower’s loan should attract a lower risk weighting on that account.

I emphasise that although these examples are all “commercial loans”, this is of little relevance to assessing their real risk. Perhaps in the case of the third loan to a restaurant, a lender could say: “Restaurants are generally struggling in 2025. If this restaurant fails and shuts its doors, the chances of finding another restaurant operator to come in and pay something to take over the existing fitout which we have lent against, is very remote. But if the same loan was made on a private hospital fitout, there would be a higher chance of finding a replacement hospital operator to come in and take over”. On this analysis, SOME weight could be given to the loan sector in assessing the true risk of loans; but it should be minor. I have arbitrarily allowed up to 5%.

**My submission-** a blanket categorizing of the risk of loans according to LVR and the lending sector they come within (as the Basel Accords presently mandate, and as your Consultation proposals continue, albeit with limited reductions in the risk percentages for agricultural and commercial loans), is with respect, of very little real relevance in assessing the true risk of individual business loans.

## **How would my suggested points system work?**

I propose every bank loan would be given a risk weighting of

**{120%, less the points total on that loan}.**

If the loan cannot generate at least 20 points then the bank should not be making it, so should have to overprovide for it in the bank’s risk profile. (Again my suggestion of 120% as a starting point would be subject to reassessment based on more expert input and then later actual lending experience). If the loan is a good one, and qualifies for high points, then the loan (as it

should) would qualify for quite a low capital risk weighting. For example, a loan with an excellent chance of being repaid in full from realizing the assets secured, and taken out by a very creditworthy borrower, may be assessed at 90 points out of 100. So that loan would attract a credit weighting of  $120 - 90 = 30\%$ . The risk weighting on that loan would reflect the actual risk faced by the lender, irrespective of the economic sector into which the loan is made.

Assuming banks operating under such a system, continued their present practice of primarily pricing loans to their customers according to the capital they are required to provide to back that loan (as they do now), then the cost of borrowing should fall as the assessed quality of a proposed loan rose. A loan scoring higher points, would require less capital to back it, and its borrower should be charged a cheaper interest rate. The cost of borrowing would not be significantly determined by the economic sector the loan relates to, and would equate much more closely with the risk profile of the loan.

### **What are some of the implications of such a system?**

- Lenders would have to individually assess the points for each significant loan they make - but it is very probable they do this already, when they internally consider and approve their loans before making them. There would need to be a system of checks or audits to verify lenders were all fairly assessing their points. But if the average loan points reported by one bank on its lending differed significantly from the average points returned by most other banks, then outlier banks would readily be identified and could then be checked in more detail, to make sure they were calculating their loan points accurately.
- Banks could also be required to report confidentially to NZRB the interest rate being charged on each of their loans, alongside the risk weightings of that loan, so that any abnormalities in the normal pattern (for example a high interest rate being charged on a loan to which the bank had given a low risk weighting) would stand out and could be looked into, to ensure fair loan risk assessment reporting.
- In the interests of simplicity, small loans should be excluded from these individual assessments- and fall into a “catch all group” (perhaps 5% or 10% of a bank’s total lending), and assessed with a standard risk weighting assessment arbitrarily given to that catch all group. An extra percent or two on a small loan has less significance than on a large loan. Again an appropriate cut off point between large loans which need to be individually assessed by the bank making them, and small loans falling into the “catch all group” would need setting and refinement by experts in the field after experience for a year or two, to balance the need for precision with the need to avoid undue complexity.
- Larger borrowers would have the cost of their loans and the interest rates they pay, determined with some precision, depending on the ultimate risk profile of their loan. At the moment, (and it is proposed under the consultation document, to continue) there can be quite significant differences in risk profile when a loan is near a LVR ratio boundary. A housing loan with a 79% LVR has a 35% standardized risk weight; while at 81% it has a 50% risk weight. A small change in LVR can result in a large change in risk weight. However with a points based system, the change in risk weight would be much more of a continuum and always proportional to the overall risk of the loan, as determined by its overall points.

- If a loan ran for say 10 years, during which time the principal was paid down and the borrower's income and servicing ability improved (so their loan now scores higher points) then borrowers could apply to have their loan points reassessed, and hopefully then see their mortgage interest rate reduced. That is as it should be- as a loan reduces in risk and justifies higher points, the borrower should be able to have their interest rate reduce.
- The sector of the economy to which the loan is advanced, would have virtually no impact on the cost of the loan, meaning that the productive parts of the economy would pay almost identical interest rates as the housing sector, for loans which otherwise have the same points. The seriously damaging effect which Basel presently imposes on the economy, by skewing lending into housing, would be materially reduced.
- Other assets held by banks (say government bonds) would not be assessed for capital risk under this system- only loans to customers made by the banks.
- Having proposed a wider system for assessing loan risk, I will not comment on the more granulated risk weightings which would be attached to loans to different sectors, as per the consultation document- because I suggest the sector based assessment system originating from Basel, is unhelpful. But if the end result of the consultation is that the Reserve Bank decides to continue with this approach, then clearly I support lowering the risk profiles for the productive sectors of the economy- especially agriculture and commerce- as far as possible.

### **Stimulating the productive sector- not just through risk weights.**

I am making this submission, because I want the productive sector of the New Zealand economy to be boosted and the housing sector restrained. If the present differential between the cost of commercial and agricultural borrowing and the cost of borrowing on houses can be reduced, that should help the NZ productive sector to expand. Individually rating the risk of loans in the way I have suggested will help facilitate this in the case of plenty of commercial and agricultural loans.

But at the same time, I recognize that under my proposals, commercial loans especially will in many cases still be more expensive than housing loans, because they ARE more risky. The second and third examples I have given above, of the truck loan and (particularly) the restaurant fit out loan, will still be more expensive than almost all housing loans- because realizing the security in those cases to try and recover the loan amount, is more problematic than selling a mortgaged house property. I assess that under my proposals SOME commercial and agricultural lending would receive a lower risk weighting than it would under the consultation proposals- but not ALL such lending. I assess that plenty of SME borrowing would still be relatively more expensive than house mortgage borrowing under my proposals. If risk weights genuinely reflect loan risks, I acknowledge that will still leave much commercial lending in particular more expensive than house mortgages.

While not relevant to this consultation, I do point out that in the interests of lifting the performance of the NZ economy for the future, I therefore urge in my book government action to reduce the cost of commercial lending further, beyond just modifying the calculation of risk weightings. I go further and suggest in my book that the government should legislate that banks need only return say 90% of the interest they receive on their agricultural and commercial loans (90% is a suggestion of mine again given purely for explanatory purposes). The remaining 10% would be tax free. That way, although banks

would on plenty of occasions under my points system need to provide higher amounts of capital to back their lending to the productive sector, nevertheless that lending would be more profitable. Such a tax concession would (hopefully!) be setoff by the banks against the cost of the higher capital required to back some of their productive and commercial lending, and further encourage SME lending at more affordable cost. But I recognize any such step would be a government fiscal measure, outside the scope of the present consultation and outside the purview of NZRB.

## **The realities of policy consultation**

What to do with a submission like this, coming from an unlikely source, (not a bank), which takes a quite different approach to the consultation document? It is the problem faced by all submitters, when bodies such as RBNZ put policy changes out for public consultation.

By the time proposals are circulated to the public for comment, the train has not only left the station- it is actually beginning to approach its final destination. Submissions in response which bring in whole new issues and suggest the train should be heading to a different station altogether, are (I am sure) less than welcome. They cut across positions developed by Reserve Bank staff over long periods. RBNZ is currently awaiting a new Governor and a new Chair; so it is not an ideal time for consideration of significant change to current capital adequacy rules. The convenient option in all these circumstances: it's too late and too hard to change course now and seek to adopt proposals that most submitters have not even been thinking about. It's too hard and too late to re-open the consultation and have a second round, so banks and others can comment on any very changed proposals. Good ideas but bin the submission and get on to make decisions on the circulated proposals by the end of 2025 as already flagged.

I realistically expect that to happen here. But please remember, that (on my analysis), the present Capital adequacy rules are seriously deficient; and have done the New Zealand economy massive damage by abnormally promoting our housing sector and abnormally penalizing our commercial and productive sectors over the last 35 years. Reviewing the rules as is currently happening is a very rare and important opportunity significantly to correct this seriously deficient position. Right now, through this consultation, the RBNZ has a once-in-a-generation opportunity to make a major policy improvement in the banking arena, for the long-term benefit of the New Zealand economy.

The NZ Reserve Bank has a proud record of having led the world in developing inflation targeting in its monetary policy role. Now, if these above submissions are seen to have merit, NZRB could develop a second world-leading policy to depart from the Basel Accords, and vary the way risk weighting of bank lending is addressed in New Zealand.

If this perspective is kept in mind, then however inconvenient it now is, the Central bank should embrace the wider issues raised in this submission, and consider these submissions on their merits, rather than viewing them as "outside the box" and ruling them out accordingly.

## **Removing sector bias critical for New Zealand's future economic progress.**

Which leads me to say as strongly as I can that if over the next 75 years up to the year 2100 (the period I write about for economic policy in my book) New Zealand seriously wants to improve its productivity, grow its agricultural and commercial sectors, create employment, boost tax revenue to offset our structural government deficits, and develop a more successful economy which does not primarily depend on high immigration and house price inflation to progress, then major change is needed. The present bias in the banking capital adequacy rules, in favour of house lending and the present bias against business and agricultural lending is part of that required change, It should be addressed more fundamentally and widely than just reducing the ratios a little, as the consultation proposals advocate. The consultation proposals, advocating marginally lower risk weightings for agricultural and commercial lending, while a move in the right direction, still fall far short of what is required materially to lower the cost of credit to these sectors.

Failing to make bold reforms as part of this consultation would in my submission be a serious opportunity lost to help lift New Zealand onto a higher plane of economic performance for the future.

Any additional risk to the overall banking system from departing significantly from the Basel-based sector focused rules as I advocate (and there should not be any significant increase in risk -unless the government was to enact tax incentives for borrowing to the productive sector as I also advocate), would be offset by maintaining and not reducing the high capital requirements promulgated in 2019.

## **Other issues put out for consultation**

This submission does not address all the issues raised in the consultation document. I do not wish to cover any of these other points.

Thank you for the opportunity to make a submission. I am happy to answer any queries you may have, in relation to the points I cover.

Regards,

David Schnauer.

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