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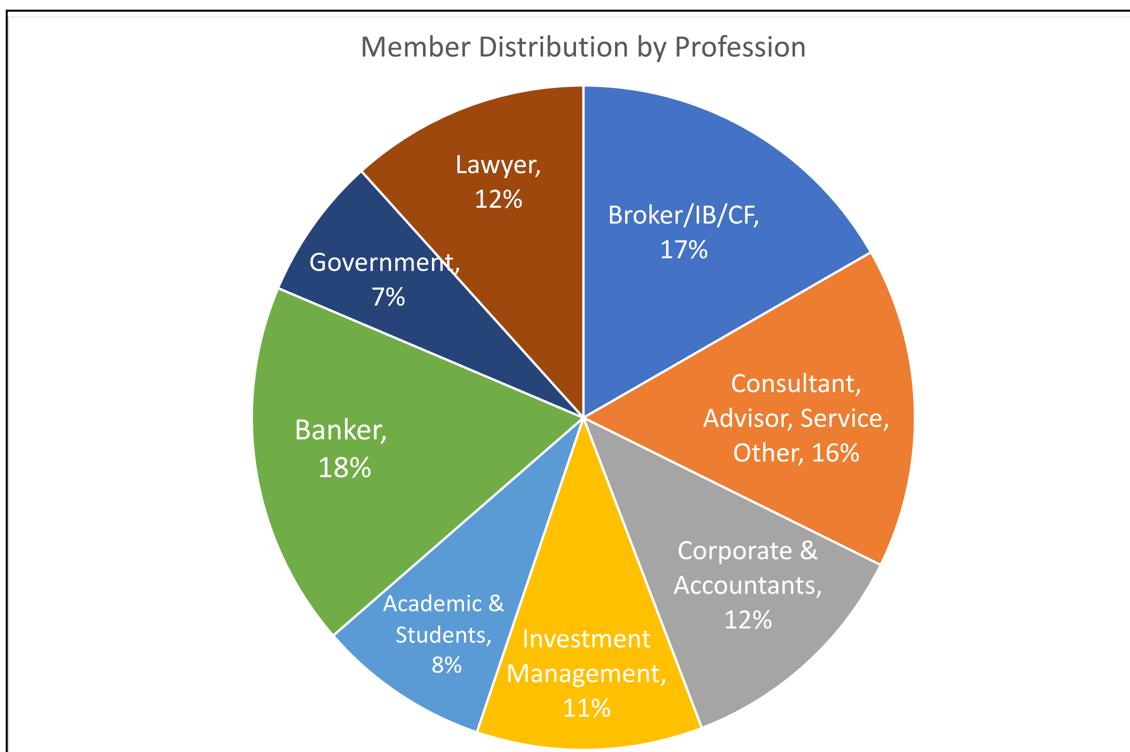
INFINZ Submission to the Reserve Bank of New Zealand's Liquidity Policy Review

Dear Walter

On behalf of INFINZ's Advocacy Committee, I have pleasure in presenting this submission on the RBNZ's Liquidity Policy Review. This submission did not receive input from any of the INFINZ Board members employed by the trading banks.

About INFINZ

The Institute of Finance Professionals New Zealand Incorporated ("INFINZ") is a voluntary, individual member-based organisation formed in 2002 through a merger of the New Zealand Society of Investment Analysts and the New Zealand Society of Corporate Treasurers. INFINZ's current membership base exceeds 2060 individual members, distributed across a variety of financial professionals in the following manner:



INFINZ's objectives are to promote the quality and standing of both the financial services ecosystem, its participants and to represent and advocate on behalf of its members to legislators, regulators and policy makers, government and other professional/industry bodies. We note that despite the diversity in our membership base.

The objectives of INFINZ as stated in its constitution include:

- To promote the quality, expertise and integrity in the New Zealand financial and capital markets.
- To promote the proper control and regulation of the New Zealand financial and capital markets.
- To work to ensure the New Zealand financial and capital markets are relevant, efficient and generally to add value to the operation of the New Zealand financial and capital markets.
- To act as an advocate for its members wherever necessary to support and promote the objects.

General remarks.

1. The intentions to align the (RBNZ ratios) Mismatch Ratio (MMR) and Core Funding Ratio (CFR) with the internationally recognised, Basel III based, Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) is consistent with International markets, and has substantial support. A number of major New Zealand banks have made the point for some years, that given the substantial funding undertaken in international markets, a different name/metric for New Zealand liquidity was a distraction and undermines the quality of New Zealand bank liquidity and stable funding standards. These New Zealand specific ratios were put in place prior to the adoption of the Basel III liquidity rules, which meant that they could not have conformed, but this rationale for a separate set of ratios no longer applies.
2. Of greater concern, however, is the proposal to reduce the range of assets which will be classed as high quality liquid assets, eligible for repo at the RBNZ. If the range of securities eligible for repo is reduced, the effective cost for banks of holding these ineligible securities will be increased. A reduction in banks' willingness to hold these securities will also undermine New Zealand banks' role in making a market in them, thus constraining issuance.
3. This goes against the efforts that have been made in recent decades, and highlighted in the work of the 2008/09 Capital Markets Task Force, which sought to promote the development of New Zealand's capital markets by strengthening the structures for issuance of securities by New Zealand borrowers seeking funding, so that they would not be as dependent on the banking system. A broadening of securities markets was also seen as providing a basis for emerging Kiwisaver operations to better diversify their portfolios by giving them a range of fixed interest securities in which they could invest. See also point (12) below.
4. The lack of depth in the New Zealand debt capital markets (DCM) has long been identified as a significant issue. An added dimension of mounting significance is the need for financial system contribution to a just transition to a low emissions economy and to address other key sustainability issues, including the substantial long-term investment required in infrastructure and in social and affordable housing. Specifically, there will need to be:
    a. A wide-ranging reallocation of capital to new projects and processes that reduce gross emissions across the economy and supply chains, particularly in hard-to-abate sectors. Worldwide, the reallocation need is approximately US$3 trillion per annum through to 2050, an eightfold increase on current investment levels.[1] New Zealand's progress in this regard has

[1] Refer Energy Transitions Commission "Financing the Transition: How to make the money flow for a Net Zero economy" (March 2023) - https://www.energy-transitions.org/wp-content/uploads/2023/03/ETC-Financing-the-Transition_MainReport-.pdf

recently been marked as "highly insufficient".[2] This issue has also been raised by the Climate Change Commission in its recent Draft Advice to the Government, which highlighted the lack of focus given to gross emissions reduction and the limitations on the use of forestry sinks as a means to achieve the Net Zero pathway required under the Paris Agreement.[3]

b. As detailed in New Zealand's National Adaptation Plan, very substantial investment is going to be required not only in climate change mitigation, but in adaptation. While New Zealand now has the tools to underpin private sector investment in adaptation infrastructure – in particular the Infrastructure and Financing Act 2020 – little progress has yet been made in establishing an investable asset class that can meet this need.

5. While the banking system has a crucial role to play in these processes, the banks' funding model is not equipped to carry the whole load because of the key sustainable finance issue of the 'tragedy of the horizon', with the attendant need to develop long term funding instruments. Facilitating sustainable investment, including through institutional investors such as Kiwisaver schemes, sovereign wealth funds and insurance companies, has been highlighted as a key priority by Toitū Tahua – the Centre for Sustainable Finance.[4]
6. We strongly commend the leadership role the Reserve Bank has taken in tackling climate change and supporting the sustainability transition, in its own right and through the Council of Financial Regulators. While it is correct that there are limits on the role that a central bank can play consistent with its core mandates,[5] we submit that due consideration should be given to the effect of the liquidity policy not only on the development of the debt capital markets generally, but on the new debt capital markets instruments that will need to be developed in a comparatively short timeframe to finance the transition.[6] It is increasingly recognised that failure or substantial delay in developing the complementary range of banking and debt capital instruments required to underpin the sustainability transition has implications not only for the environment and economy, but also for financial stability.[7]
7. Another side of this is that there have been, at times, a relative shortage in the amount of government debt on issue, which has limited the amounts able to be held by New Zealand banks in their portfolios. Assuming that ESAS balances will shrink to historically more normal levels as part of the process of quantitative tightening, there might be an insufficient supply of repo-eligible assets if one or more banks got to be under liquidity stress. Experience has been that the supply of NZGB can be affected by factors that are difficult to predict or control, including fluctuations in offshore appetite for high quality NZD assets.
8. The RBNZ proposal to substantially restrict qualifying securities (HQLA) is inconsistent with international market practices, and misinterprets the intention of liquid assets in market stability during stress events. The purpose of HQLA is to ensure that a bank has readily available assets to facilitate meeting outflows in the event of a run on the bank (by deposit holders) or to meet financing needs in the event of a breakdown in wholesale markets. In these circumstances the central bank would be expected to provide liquidity to the bank (or banks) through the use of repo facilities. To suggest otherwise would fly in the face of what we have seen in offshore markets and would undermine the New Zealand banking system through a perceived lack of Central Bank support.

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[2] Climate Action Tracker – New Zealand Update (7 March 2023).

[3] https://www.climatecommission.govt.nz/public/Advice-to-govt-docs/ERP2/draft-erp2/CCC4940_Draft-ERP-Advice-2023-P02-V02-web.pdf

[4] Government priorities 2023 — Centre for Sustainable Finance.

[5] Refer https://www.rbnz.govt.nz/about-us/how-we-work/our-climate-change-strategy.

[6] Refer Toitū Tahua Roadmap for Action https://www.sustainablefinance.nz/roadmap-for-action.

[7] Refer for example Reserve Bank Te Pūtea Matua Guidance and Consultation on Managing Climate-Related Risks - https://www.rbnz.govt.nz/en/have-your-say/2023/managing-climate-related-risks - and Federal Reserve Bank of New York "CRISK: Measuring the Climate Risk Exposure of the Financial System" (revised March 2023) - https://libertystreeteconomics.newyorkfed.org/2023/04/crisk-measuring-the-climate-risk-exposure-of-the-financial-system/.

9. Liquidity is a function of transparent price discovery and underlying belief in valuation. Liquidity is not a function of daily turnover or appropriately measured as a function of price discovery or price stability under broader market disfunction. By way of example the New Zealand Government Bond market required Central Bank support during the recent pandemic period and, similarly, was supported by the RBNZ during GFC. This was consistent with most (if not all) major markets, with central bank intervention /stabilisation in USD, GBP, AUD and Euro markets. This intervention did not indicate a loss of faith in the underlying securities, but is more a reflection of broader market disruption.
10. The New Zealand debt markets lack the depth of the larger markets, but remain the mainstay of debt markets and capital creation for the New Zealand economy. Fluctuations in investment grade bonds in New Zealand are not a reflection of instability in underlying credit quality, but reflects movements in global debt markets for similar organisations. The market is substantially dominated by Kiwisaver funds with substantial correlation in activity, so from time to time will reflect asset allocation moves by the savings industry. This of itself does not indicate a lack of faith in underlying credit quality.
11. Stress events need to be considered in the context of both systemic stress and individual bank stress, and also differentiated between liquidity events and capital events. Liquidity support for a stressed system as a result of external events should be considered as a normal and appropriate action for a central bank. It is this broader market support that reinforces investor faith in a financial market and facilitates stable market growth. This should be differentiated from outcomes for individual banks where stress is as a result of internal decisions, resulting in loss of capital. By way of example, for both SVB and Credit Suisse, while experiencing liquidity issues initially, the lack of investor support was what ultimately highlighted capital shortfalls as a result of underlying losses in the banks' assets base.
12. Actions by the Central bank to restrict HQLA from extending to Local Government or Crown Owned enterprises (as distinct from SOEs) as proposed in the RBNZ paper, undermines the New Zealand Debt Capital Markets (DCM), and is in direct conflict to the Government's strategy of complementing its own direct borrowings with agency and semi-sovereign issuance by these entities. This has implications not just for the core Crown debt position but for the important objective (for example in the case of Kāinga Ora and of the LGFA) of underpinning long run capital investment projects with matched funding that is not subject to the short run exigencies of the annual appropriation cycle (another element of the tragedy of the horizon). A move as contemplated in the paper would substantially undermine domestic issuance for these organisations and as a result undermine local DCMs driving key issuers to international markets. Such action would be inconsistent with efficient local capital markets and inconsistent with financial stability with substantial debt out of the local institutions.
13. Driving key debt issuers (including the aforementioned Crown and Local Government issuers), along with banks and other investment grade issuers to international markets, as well as limiting Kauri issuers in the New Zealand DCMs would distort flows in the derivatives markets resulting in one sided cross currency swap and interest rate swap markets further undermining domestic financial market efficiency, and would add to market volatility in both interest rate and foreign exchange markets.
14. Isolating bank to bank exposure through limitation of banks holding "other bank" securities as HQLA, ignores the broader exposures that banks have to each other in a closed market such as New Zealand, through other broad banking and financial markets business. When contemplating cross bank (or corelated) exposure in small markets, consideration needs to be given to acknowledging and accepting that such exposure exists and as such should be managed at a macro level. To some degree this factor is already in place in New Zealand with materially higher capital requirements particularly for D-SIB organisations.
15. Liquidity holdings should be considered in the context of other safety hand-rails in the New Zealand banking market. Liquidity in this case (as has generally been the case in offshore markets) is about broad systemic liquidity not individual banks. In such an event market liquidity for all securities will be constrained, given the high probability that all banks will be sellers. It is inevitable that the central bank will be the liquidity provider of last resort. Security eligibility should therefore be considered around the ultimate creditworthiness (i.e. borrowers' ability to pay) rather than market liquidity.

16. Holding Liquid assets on the deposit-takers balance sheet should not add substantial risk to the bank, through either duration risk or credit risk. Restricting Liquid Asset eligibility to only New Zealand Sovereign assets, presents a concentration risk (in the event that more than one bank is seeking to monetarise assets). New Zealand government bonds also represent substantial interest rate risk associated with long dated bond maturities (if banks are predominantly acquiring bonds in primary markets). Such interest rate risk can only be effectively hedged through the interest rate swap market, which has limited volume capacity in long dated maturities. Such derivative hedging would also represent system challenges around both collateralisation of margining, and execution on both initiation of the hedge and unwinding on liquidation.
17. We are unclear as the reason for the omission of paper issued by supra-nationals, semi-sovereigns and other agency issuers from the list of eligible High Quality Liquid Assets.
18. We also note the lack of reference to harmonisation with Australia or to a discussion of a Committed Liquidity Facility (CLF), beyond the suggestions of its potential relevance. If a CLF is relevant, more discussion of it is required.

Our response to each of the questions posed in the consultation paper are attached.

Ngā mihi

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Eligibility Criteria

Q1

New Zealand liquidity eligibility needs to balance liquidity under stressed environments with ongoing support for development and support of the underlying functionality of debt capital markets. Without eligibility for HQLA, investment grade assets have limited natural buyers in New Zealand, such as Kiwisaver funds. A key criterion for inclusion in these funds is expectation of a level of liquidity in secondary markets (Kiwisaver funds need liquidity as well, so that they can meet redemptions and other demands for funds). Secondary markets in New Zealand have the support of four major banks, but without HQLA eligibility the banks cannot fully support a debt market.

One of the benefits of having highly (credit) rated banking markets is that they can support domestic debt capital markets through primary issuance (purchased primarily by local institutions, and through secondary market support to facilitate liquidity between market participants). The broad distribution of debt across market participants allows for diversification of investments by local fund managers, avoiding concentrations to any single name event.

RBNZ liquidity support for high quality liquid assets through repo activity in times of stress does not undermine the integrity of the system, instead it facilitates efficient functionality of these markets. Such support by the RBNZ would be consistent with action taken by the Central banks of US, UK, Euro and Australia. The lack of support reflected in the RBNZ consultation paper would undermine New Zealand debt markets for international investors.

The current sets of eligible assets are also subject to haircuts for repo purposes, which provides the RBNZ with good protection against credit risk of the underlying securities.

Q2

We disagree with the proposed classifications of Table 2.

Category 1 should be extended to include:

- LGFA
- AA Local Authority
- Securities Guaranteed by New Zealand government,
- Securities issued by AAA rated sovereigns (held as a percentage of foreign exchange outflows)
- Housing New Zealand/Kianga Ora bonds
- AAA Covered Bonds

This categorisation is consistent with international markets and is consistent with the underlying credit quality of the assets.

Category 2 should be (with individual issuer limits

- AAA Covered Bonds
- AAA RMBS

Other securities as listed in Category 3 should remain as such.

Q3

Assessment of supply and constraints on potential PSLA/HQLA are flawed.

Concerns raised in the paper focus on the potential lack of liquidity. This focus is inappropriate in the context of such securities being available for liquidity either through sale in a normal functioning market or for liquidity purposes in a stress market. The role of the RBNZ is to stabilise a dislocated market, where underlying credit

quality is unquestionable (i.e. sovereign or near sovereign in the case of local authorities). The knowledge of central bank support for a given security, in of itself, provides investors to hold such assets through both normal and stressed markets. Conversely, the absence of such support leads to scepticism in markets to hold such assets even during normal periods of stability for fear of the absence of liquidity during more stressed liquidity events. New Zealand domestic markets functioned in a stable manner through pandemic periods as a direct result of investor comfort that markets continued to function and maintained the underlying support of the RBNZ.

Q4

Where New Zealand banks have outflows in foreign currencies and are required to hold HQLA against these flows, the bank should be permitted to hold such HQLA in that currency. This is more efficient from a currency swap proposition, and also a more efficient matching of HQLA with liabilities. Any concerns about translation risk for calculation of New Zealand Dollar equivalent liabilities is offset by the parallel calculation of assets.

Q5

As discussed in Q3, these concerns are flawed in that liquidity is a facture of credibility of asset value and market functionality. As we have seen in historical events, where there is systemic stress, central bank capacity to support markets through repo activity is fundamental to market functionality. Price stability through credit credibility (and an absence of panic selling), is a fundamental premise for normalising market functionality.

Q6

The establishment with a CLF would be consistent with international markets and is a further pillar of support for perceived stability in the New Zealand domestic market.

Q7

We agree with the proposed review of MMR. While a review of 30 days v one month may provide some value, international observations highlights issues around “end of month” flows on a 30 day horizon, particularly in 31 day months. Quantification of these issues would be useful in understanding materiality in a New Zealand context.

Q8

Consistency with international standards is preferrable where appropriate. There are some key differences with New Zealand banking facilities that may warrant individual consideration.

Q9

Committed (revolving credit) lines as they are structured in New Zealand differ considerably from those overseas, particularly Australia. This is an area where there exists some divergence in local treatment across the banks. It is important that the regulator provide detailed guidance for interpretation, such that all banks adopt the same treatment for such facilities.

Q10

Simplification of assumptions will lead to a more consistent treatment across the banks. As a result this is likely to be on its own more conservative, and more credible to constituents.

Q11

NSFR is an internationally familiar ratio as is its calculation. New Zealand banks marketing issuing in international markets are required to “educate” investors on the New Zealand CFR calculation. The subtle differences add no value to the proposition and should be harmonised for credibility in international markets.

Q12

The key objective of both CFR and NSFR are that banks focus on and quantify the quality of endurability of funding, providing a metric which helps investors make informed judgments on sustained funding. Harmonising New Zealand standards with international standards is a desired outcome.

Q13

To the extent that it consistent with international standards it is desirable, as long as the underlying calculation is not overly onerous but retains credibility in international markets.

Q14

Overly strict interpretation can be counterproductive to the broader aim of promoting financial market stability and providing access to international funding markets, if interpretation is not consistent with New Zealand market practices.

Q15

The adoption of LCR/NSFR should be as replacement of older standards. Retention of the legacy metrics would be counterproductive in adoption of international standards. Although it might be nice to have a consistent longer-run data series, that should not dictate the decision.

Q16

The key issues are with respect to qualification of eligible HQLA and introduction of formal CLF facilities.

Q17

History shows that while the impact of a non-D-SIB failure may have less significant systemic risk, lower standards can also lead to a higher probability of a failure. To the extent that international markets provide guidance, recent events with SVB in the USA highlight that substantially lower standards for deposit takers considered non-D-SIB can still be market disruptive and as such, differentiation in standards need to be non-material in terms of liquidity and funding standards.

Q18

The best metrics for measuring risk for DSIBs is the Total Outflows metric. Ultimately this is the metric that determines the quantum of Liquid Assets required. The metric and the assumptions that drive calculation best inform the DSIB on what their needs could be, and in turn inform regulators in comparing metrics across individual banks. The ongoing monitoring of this metric (in its component parts, will best inform the bank and regulator on both an industry and individual basis.

These metrics are best placed to compare across both DSIB and other deposit takers.

Q19

The transition costs (assuming an alignment of instruments) for LCR and NSFR, are limited to system changes and are therefore relatively marginal given the consistency with current metrics. Changes associated with eligibility will likely have substantial costs for both deposit takers and broad economic impacts associated with offshoring of borrowing for institutions no longer eligible.

Q20

AS per Q19

Q21

Whilst there are aspects of bank regulation that should be reviewed and adapted through a proportionality lens, liquidity regulations should not be.

The (likely) structural nature of retail deposits and deposit insurance will impact deposit outflow assumptions, and will itself positively impact regional banks. What can not be justified is compromising liquidity standards for smaller deposit-takers where failure of a deposit-taker potentially results in possible contagion impact, similar to that which we have recently witnessed in the US through the collapse of a lightly regulated SVB.

Regulatory burden is better addressed around the minimisation of complexity in calculation, where simplicity in assumptions do not represent material risk impact.

Q22

While a simplified quantitative liquidity is useful as a benchmark for comparing banks in the absence of detailed information, simplification should only be applied where the regulator is satisfied that the assumption inherent in a simplified process is consistent with the business to whom the calculations are being applied. This would suggest that, at the least, a more complex calculation should be undertaken on a regular timely basis to ensure that the simplified approach is providing a consistent and adequate calculation.

Q23

Where the sums of deposits held with New Zealand banks by NBDTs is immaterial in the context of total system deposits, the eligibility of such balances is consistent with the broad aims of Liquid Assets, in that the deposits remain available for the purpose of meeting depositor demand. Thought should be given to the Credit Rating standards for such banks, and the consequential implications a run on a NBDT's deposits might have on individual banks holding deposits on behalf of the NBDT.

Q24

As per 23, simplification for regular reporting can only be justified with periodic [annual] complex calculations to provide verification of the alignment.

Q25

Aligning New Zealand liquidity and stable funding with Global metrics is consistent with ensuring a financial system that strong and effective. Providing a pathway to simplified regular execution provides efficiency, but care needs to be taken to ensure there is regular calibration undertaken to ensure simplification is not a compromise to standards, only to calculation.

Undertaking a wholesale exercise in exclusion of HQLA in a small market imposes disproportionate costs, with the likely outcome of significantly restricting the broader functionality of New Zealand Capital Markets. This cost is disproportionate to the limited benefits.