Submission to the Finance and Expenditure Select Committee on the Reserve Bank of New Zealand (Covered Bonds) Amendment Bill

1. My name is Ivo Geoffrey Bertram. I hold degrees from Victoria University of Wellington and Oxford University, including a doctorate in Economics from Oxford. From 1976 to 2009 I taught in the School of Economics and Finance at Victoria University of Wellington. During most of that period, and since my retirement in 2009, my professional research interests have included the role of the banking sector in sustaining and accelerating this country's persistent current account deficit and rising international indebtedness. I have published a number of papers on these issues[1]. I am currently a Senior Associate at the Institute of Policy Studies.

2. The history of the financial sector worldwide over the past two decades, and especially in the USA and Europe, has been characterised by strong financial-industry lobbying against regulation and in favour of the industry's creation of a wide range of products designed by "financial engineering". Prominent amongst these products in the USA were mortgage-backed securities which packaged together a range of mortgage assets on banks' balance sheets and onsold the bundled claims to investors. The global financial crisis of 2008 was triggered in large part by the realisation that many of those derivative securities were worthless, despite having secured AAA ratings from major credit-rating agencies, because mortgage lending had gone far beyond prudent limits and had in the process fuelled a massive bubble in property prices.

3. The covered bonds now being enthusiastically promoted by the New Zealand banking sector, with the apparent acquiescence or support of the sector's regulator, the Reserve Bank of New Zealand (RBNZ), are a new form of mortgage-backed security[2]. As was the case with many of the toxic assets in the 2008 global financial crash, the mortgages and other lending assets being packaged as security for the sale of the new financial instruments to investors are to carry high ratings from the same ratings agencies that supplied the supposed protection for investors in the lead-up to 2008 in the USA.

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[1] Publications of mine that are relevant as the background to this submission include "Overseas Debt as a Constraint on Alternative Policies for New Zealand", *Victoria Economic Commentaries* Vol.9 No 1, March 1992 pp.31-46; "Factor Income Shares, the Banking Sector, the Exchange Rate, and the New Zealand Current Account Deficit", *New Zealand Economic Papers* 36, 2 (December 2002) pp.177-198; "The banks, the current account, the financial crisis, and the outlook", *Policy Quarterly* Vol.5 No 1 (February 2009) pp.9-16; and "New Zealand's Overseas Debt, the Banks, and the Crisis", *CAFCA Watchdog* 120:25-39, May 2009.

[2] The marketing of these securities on a large scale first developed in Europe in the lead-up to the global financial crisis. For detailed descriptions see the 2006 *European Covered Bond Factbook* at http://www.ehipoteka.pl/corporate_site/content/download/1370/9279/file/ECBC_FactBook.pdf .

4. Covered bonds are a device to put a favoured group of investors ahead of other (unsecured) creditors in the queue to recover their money in the event of a bank failure. The best assets in the bank's portfolio are removed from the reach of a liquidator and placed in a separate cover pool devoted solely to providing strong backing for bonds issued and sold to investors, most of whom will be overseas in the New Zealand case. The central effect of this is that unsecured creditors, including the bank's regular depositors, are exposed to greater risk of loss, as the bank uses its more risky and lower-quality assets to match its deposit liabilities.

5. This arrangement is corrosive of the incentives that governments the world over acknowledge are needed to reduce the risk of future banking crises. It works to undermine the RBNZ's core funding requirement, and potentially enables the banks' shareholders to mitigate their losses in the event of bank failure by holding covered bonds in their own institution.

6. To make them more attractive to investors than the previous generation of mortgage-backed securities, covered bonds confer a first claim on a sequestered bundle of high-rated mortgages or other assets in the event of bank failure. This undoubtedly makes the targeted group of investors feel more secure; but that greater comfort for the holders of covered bonds comes at a significant cost in terms of reduced security and comfort for other creditors of the banks including ordinary depositors.

7. To protect those ordinary depositors, a government may provide taxpayer-funded retail deposit insurance or retail deposit guarantees, but these are not costless, and once covered bonds become established the fiscal burden of bailing out depositors in the event of bank failure will be increased by the inability of liquidators to access the sequestered assets held to support the privileged position of covered-bond holders. Bailout costs will be borne by taxpayers, most of whom are bank depositors.

8. It is notable that the Regulatory Impact Statement (RIS) accompanying this Bill provides no quantification whatever of the effect on Crown contingent liabilities under the retail deposit guarantee scheme that may flow from the rise of covered bonds to 10% or so of the banks' liabilities[3]. The issue seems, indeed, not to have been addressed at all, leaving the Select Committee without information that would seem to be material to its deliberations.

9. The Regulatory Impact Statement is equally silent on the issue of currency mismatch in the banks' balance sheets, even as a new round of credit expansion in New Zealand is being funded by selling covered bonds denominated in overseas currency. The RIS is

[3] The RBNZ is recommending that the limit on covered-bond issue be 10% of bank assets; the share of liabilities presumably will be in the vicinity of the same ratio.

silent also on the reasons why the RBNZ considers that 10% of a banks' total assets is a reasonable limit on its covered-bonds issuance, when other jurisdictions impose much tighter limits and some prohibit the issuance of this type of security.

10. The purpose of covered bonds is not a mystery. The New Zealand banking sector, in common with its Australian counterpart (and dominant owner) has for over a decade now been engaged in the profitable business of funding its local credit expansion in New Zealand dollars (NZD) by means of offshore funding - selling bonds denominated in overseas currency. The result has been a massive and worsening currency mis-match in the banks' balance sheets which has greatly increased the riskiness of the industry while fattening its bottom line and increasing the New Zealand economy's aggregate foreign-currency indebtedness and exposure to global financial instability.

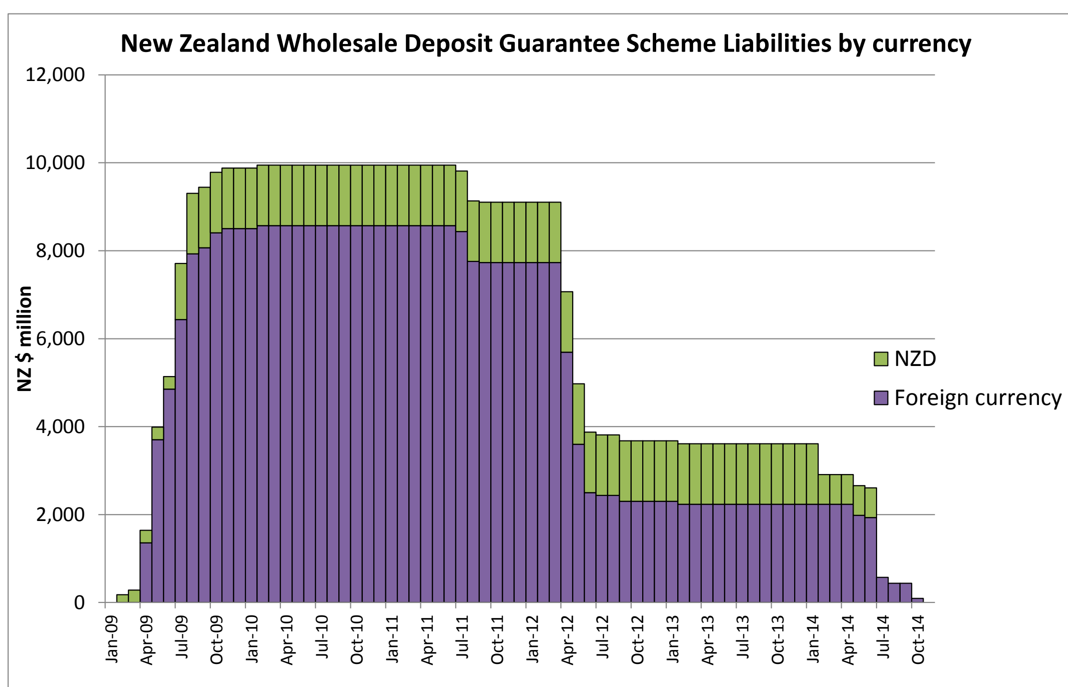
11. The consequences of the banks' currency mismatch were dramatically illustrated in 2008 when the banks were unable to roll over their maturing foreign-currency debts and turned to the New Zealand Government to borrow on their behalf, via the so-called Wholesale Deposit Guarantee Scheme[4]. This scheme made New Zealand taxpayers ultimately responsible for some $10 billion of overseas loans raised by the banks in the course of 2011 – a substantial bailout which has never been officially described as such.

12. In the event of a renewed global crisis, leading to renewed inability of the New Zealand banks to meet their overseas obligations, the effect of the Wholesale Deposit Guarantee Scheme would have been precisely the same as if the New Zealand Government had directly gone overseas and borrowed $10 billion, then passed the cash over to the banks in exchange for IOUs which were subsequently defaulted. The chart below shows that the New Zealand taxpayer as of February 2012 remained liable for $7.7 billion of the banks' total foreign-currency debts, when the banks' foreign currency liabilities stood at $87.4 billion in February 2012, so that the Crown (taxpayers) was carrying the default risk on 9% of the banks' offshore funding liabilities. The Crown's WDG exposure by the end of June 2012 will thankfully have been reduced to $2.5 billion as loans mature – still 3% of bank foreign-currency funding of $85 billion[5]. This substantial contingent liability has remained unquantified in the Crown financial statements on the basis that "the probability of loss is considered remote" by the New

[4] Those maturing liabilities were fully "hedged", but hedging provided no insurance against a seizing-up of the market for refinancing. "Hedging" is not sufficient protection against market situations requiring bank bailouts or insolvency. Hedge contracts are never perfect and commonly incomplete, leaving residual risks arising from matters such as maturity mismatches, differentials in the interest rate basis, and risk of counterparty failure (especially when counterparties have lower credit ratings than the hedging bank). Without knowing the structure of the hedges it is not possible to assess the extent of possible residual-risk blowout in a crisis.

[5] As of April 2012 the figure was $85.2 billion; see http://www.rbnz.govt.nz/statistics/banksys/ Table G3.

Zealand Treasury[6]. The reliability of that assessment would be highly likely to crumble in the event of renewed financial crisis, but no published stress tests appear to have been undertaken.



13. The Government now proposes to further incentivise the banks to increase their overseas exposures and currency mismatches, by giving legislative backing to the marketing of a large volume of covered bonds.

14. I note that until after the 2008 global financial crisis it remained the policy of the Australian financial regulators to prohibit covered bonds altogether[7], and that only the absence of a matching prohibition in New Zealand allowed the Bank of New Zealand to embark on its first issue of these engineered derivative securities in June 2010, exploiting what was then a regulatory loophole[8]. The Australian Government bowed to industry pressure to allow covered bonds only in December 2010[9], and New Zealand now proposes to give them statutory legitimacy.

15. As an ordinary depositor with two of the New Zealand banks, I regard this as regulatory capture by the banking industry, which will put at increased risk the savings of myself

[6] Crown financial statements at June 2011, http://www.treasury.govt.nz/downloands/pdfs/fsgnz-year-jun11.pdf , p.139.

[7] Reserve Bank of New Zealand, “Consultation Document: Covered Bonds”, October 2010, http://www.rbnz.govt.nz/finstab/banking/4206833.pdf , p.4 paragraph 16.

[8] Ibid. p.5 paragraphs 17-20.

[9] http://www.theaustralian.com.au/archive/business-old/bank-reforms-unveiled-by-wayne-swan-aim-to-ease-mortgage-rates-pressure/story-e6frg96f-1225969660748 , accessed 25 June 2012.

and other ordinary New Zealanders in a similar position[10]. The assets bundled into the cover pools for the new bonds are to be sequestered in the hands of Special Purpose Vehicles and will not be available to meet other claims on the banks in the event of their failure. This means in the final analysis either that depositors such as myself will be left carrying losses – or that as taxpayers we shall have to pay for our own bailouts via the Retail Deposits Guarantee scheme. I am unmoved by RBNZ speculation that diversifying the banks' funding by the device of covered bonds "may" benefit me and other depositors because it "can potentially reduce the probability of a failure occurring"[11]. The exchange of a clear and present watering-down of the security of my deposits for an untested and hypothetical reduction of the probability of bank failure does not, in my submission, pass the most rudimentary cost-benefit test.

16. **My central submission therefore is that covered bonds ought to be prohibited explicitly by legislation, and I ask the Select Committee to recommend accordingly**. Existing issues of these bonds would remain on the existing contract basis with no legislative status, and would be allowed to expire without replacement.

17. If the Select Committee feels unable to face down the banking lobby and ban these bonds, I submit that it should demand far stronger safeguards and restrictions than the Reserve Bank is proposing.

    (a) Covered bonds should not be authorised for issue in foreign currency, because increasing the banks' incentives to use foreign-currency funding to boost the profitability of their NZD lending is highly unwise and increases the potential financial fragility of the New Zealand economy.
    (b) Covered bonds ought not to exceed a threshold far lower than the 10% of bank assets adopted by the RBNZ in April 2011[12]. I would regard the 4% ceilings imposed by Canada and the USA as at 2010 as a useful benchmark[13], if a complete prohibition is not accepted.
    (c) Associated parties of an issuing bank should be prohibited from purchasing, holding or trading in the covered bonds issued by the bank with which they are associated; otherwise covered bonds simply become a means for converting a

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[10] "… covered bonds do pose a risk to unsecured creditors [of the banks]": NZ Treasury Regulatory Impact Statement: Covered Bonds Registration Requirements and Insolvency Protections, 28 March 2012, paragraph 8, http://www.treasury.govt.nz/publications/informationreleases/ris/pdfs/ris-rbnz-cbr-apr12.pdf/at_download/file accessed 25 June 2012. "In the event of failure of an issuing bank, [covered bonds] will reduce the value of the assets available to meet the claims of other creditors and depositors and, as such, may increase any losses incurred by them": RBNZ, "Covered bonds Q&A", http://www.rbnz.govt.nz/finstab/banking/4779480.html accessed 25 June 2012.

[11] RBNZ, "Covered Bonds Q&A", p.3.

[12] RBNZ, "Consultation Document: Covered Bonds", December 2011, http://www.rbnz.govt.nz/finstab/banking/4603790.pdf , p.12.

[13] Reserve Bank of New Zealand, "Consultation Document: Covered Bonds", October 2010, http://www.rbnz.govt.nz/finstab/banking/4206833.pdf , p.8 Table 1.

large slab of the $45 billion[14] of unsecured "funding from associates" in the New Zealand banks into protected preferential claims over the prime assets in the event of liquidation.

(d) New Zealand-originated loans which have been transferred to a bank's parent should be deducted from the asset pool available to support covered bonds, in order to pre-empt possible asset-stripping of New Zealand banks by their parents.

(e) Similarly, all bank loans tied up in repo transactions at any time should be deducted from the asset pool when calculating the limit on covered-bond issue. This is because in the event of bank failure, the repo counterparties could sell off the loans which they hold as security, removing them from the reach of a liquidator.

[14] http://www.rbnz.govt.nz/statistics/banksys/ Table G3.