Statement to Finance and Expenditure Select Committee on Reserve Bank (Covered Bonds) Amendment Bill, 25 July 2012

Covered bonds are financial derivatives – products of financial engineering.

Derivatives have been at the heart of financial-market instability and fragility in the past decade.

For the most part derivatives are not about reducing risk – they are about transferring risk to other parties.

When it is said that covered bonds provide 'greater security' or 'greater certainty' for those who invest in them, that means that risk has been shifted onto someone else, who will carry the loss in the event of a crisis.

So the first key question is who faces increased risks and costs, as the counterpart to the reduced risk for covered bond holders and reduced cost of finance for the banks?

The answer basically is the other, unsecured, creditors of the banks – predominantly ordinary depositors like myself – and, potentially, ordinary taxpayers like myself.

- Once the banks' top-ranking assets are sequestered into cover pools, the quality of the assets available to provide security against other liabilities (including to depositors) is reduced, which means that returns to depositors probably fall and the security of deposits becomes less;

- If a retail deposit guarantee scheme is in place, the probability of the guarantee being called on in a crisis is increased, which means increased risk for the guarantor – and in New Zealand, that means the taxpayer

The second key question is: what is the chief function of covered bonds as part of the institutional setup of the financial system?

The answer to this is that covered bonds are part of the machinery being set up by the banks to enable their losses to be socialised in the next financial crash, while increasing their profitability in the interim.

The whole point of increasing the security of a favoured group of investors is to strengthen their position when and if a financial collapse occurs – either of a single bank, or of the financial system in general.

That means you need to focus on the role of covered bonds in a crisis situation – not just in day-to-day operations under normal conditions. Whether there are net benefits to the New Zealand economy from allowing covered bonds under normal conditions is unclear to me, and I have seen no serious attempt to quantify those net benefits if indeed they exist. I am sceptical. What is clear to me is that covered bonds impose clear and substantial costs on depositors and taxpayers in the event of bank failure.

When a bank fails, the assets on its books provide the means of paying-out all or some of the claims of the bank's creditors. In this process, seniority is the key. Some creditors hold prior claims which get first place in the queue for repayment as assets are liquidated, leaving less-secured and unsecured creditors further back down the queue, with the bank shareholders at the back of the queue.

Covered bonds are designed to put their holders at the front of the queue. The assets placed into cover pools are not to be available at all to meet claims from unsecured creditors, unless and until the covered bond holders have been fully reimbursed. Liquidators will be legally barred from accessing those assets if the Bill is passed.

In my view this is unacceptable. Covered bonds ought to be banned, not given statutory protection. I urge you to send back an amended bill that stops development of these derivatives in its tracks.

Covered bonds are not the only device by which the banks can and do shift their assets out of the reach of a liquidator, and hence out of reach for their depositors. Repo transactions place financial assets such as government bonds into the hands of other parties on an overnight basis in exchange for cash advances, with the result that if the bank fails overnight and is unable to return the cash, the assets remain with the counterparty and can be onsold to other third parties to recover the cash. The bank's depositors would then be left with a much reduced set of assets on which they, and the liquidator, can call to recover their money.

Similarly, I understand that New Zealand banks can transfer loans to their parent banks on terms which effectively strip prime assets out of the local bank's balance sheet. If the New Zealand subsidiary were to transfer its best loans to its parent, this would mean that the average credit quality of the remaining assets would be poorer, with consequent adverse impacts on depositors in case the bank was liquidated. Thus an Australian-owned banking group threatened with failure might arrange for its New Zealand subsidiary to transfer good loans to the parent (for value), and then dissipate any cash that was transferred - or acquire a different portfolio of loans of lesser quality. This is just one of a number of ways of stripping good assets out of a New Zealand bank if the parent gets into trouble, transferring costs from Australian bank shareholders to New Zealand taxpayers/depositors.

So in a liquidation situation, it could well turn out that a majority of a local registered bank's apparent assets, including all the high-quality ones, are missing in action so far as unsecured creditors are concerned.

The task of a regulator should be to ensure that financial sector interests are prevented from manipulating financial derivatives, and other transactions of the sort I have mentioned above, to push their downside risks off onto depositors and taxpayers while reaping short-term private rewards from the upsides of "greater investor certainty".

In my submission, the Reserve Bank of New Zealand is being far too accommodating in the face of this sort of financial engineering. Allowing covered bonds to be introduced in New Zealand means failure to close a loophole that has existed, apparently unnoticed until 2008, in our regulatory

framework. In my view this is a clear example of "regulatory capture" – the effective takeover of the regulator by the regulated.

It is my hope that this select committee will call a halt to this risk-shedding exercise, and insist that the banks' risks must lie with the banks – or with any overseas counterparties they can find who are keen to bear shifted risk. The New Zealand taxpayer should not be stepping up to provide a featherbed for financial-sector players, effectively incentivising them to act in ways that increase the fragility of our financial system and the threat to our economy in the event of financial crisis, whether local or global in origin. If the taxpayer is to be called on to look after anyone's interests, it ought to be ordinary retail depositors who benefit – not big financial players in the wholesale markets.

My submissions therefore are the following:

1) Covered bonds ought to be banned, and those already issued and sold should be allowed to mature without replacement.
2) If they are not banned outright, covered bonds ought to be subject to the most stringent regulation and oversight, with transparent reporting requirements to make their character and extent fully visible in the official financial statistics.
3) Specifically the following restrictions should apply if an outright ban is not adopted:
    a. Covered bonds should be denominated only in New Zealand dollars, so that there is no currency mismatch between the cover pool and the bond claims, and hence no exposure to exchange-rate movements.
    b. Covered bonds should not be issued to or acquired by any associated party of the issuing bank, so that the bank's owners and partners cannot put themselves at the head of the queue to recover their own assets in the event of failure.
    c. The limit on covered bond issuance should be well below the RBNZ's proposed 10% of bank assets; maybe 4% as in some other jurisdictions.
    d. The stock of "assets" used to calculate the permitted volume of outstanding covered bonds should not include any assets already tied up in repo or other transactions that have the effect of removing those assets from the reach of depositors and liquidators.
    e. There may be a case for imposing a rule that if one of the Australian bank's credit ratings were to fall to BBB+ or below, their assets in New Zealand should be strictly ring-fenced under the supervision of RBNZ-appointed accountants, to prevent any asset-stripping raid on a New Zealand subsidiary.
    f. Banks should be required to publicly disclose all assets they nominally hold which are not available to cover depositors, including covered bonds, repos and related party transactions, to enable depositors to more accurately judge the risk level of their deposits. The disclosures should be at regular intervals (perhaps three months) and should show the maximum level of repos and other such transactions during the period preceding the reporting date. Probably they should also show separately the credit rating of any segregated blocks of assets and that of the assets available to cover depositors' claims.
    g. The committee should demand a regulatory impact statement that addresses directly and in detail the issues I have raised – not just an acknowledgment in passing that "covered bonds do pose a risk to unsecured creditors" (RIS paragraph 8).