RESERVE BANK

OF NEW ZEALAND

TE PŪTEA MATUA

Summary of External Experts Reports for Capital Review

October 2019

Dr James Cummings	Professor Ross Levine	Professor David Miles
	Overarching comments	
Concludes that the analytical approaches used by the Reserve Bank appropriately capture the relationship between bank capital and financial system soundness and efficiency. Also concludes that the proposals are based on sensible analysis and advice in the New Zealand context and that the analysis represents the risks inherent in New Zealand's financial system and the Reserve Bank's regulatory philosophy.	Concludes that the analysis is not biased, but is balanced and well-reasoned. Concludes that the RBNZ conducted a sound analysis of bank regulatory capital requirements in New Zealand, employed appropriate data, methods, and evidence, considered a broad and proper array of factors, addressed thoroughly submissions by banks and others regarding the RBNZ's analysis and proposals, and focused intently on the New Zealand-specific features of capital regulatory reform.	Concludes that the Capital Review was done with care and in an open minded way. He rejects the idea that the analysis errs consistently in favour of more equity – ie. the level of capital has not been biased upwards. Professor Miles concludes that, viewed in their entirety, the analysis is not skewed towards levels of capital that are clearly higher than they should be. Professor Miles notes that rather than being based on a view of risk that is excessively risk averse, the analysis is closer to risk neutrality.
	Detailed comments	
Contractual loss-absorption features RBNZ should monitor the future performance of Basel III loss absorption measures (as in the contingent convertible instruments) and assess whether they can be adjusted for NZ and introduced back into the framework. Dr Cummings suggests this should focus on the experience in countries with foreign-owned and unlisted banks.	Incentives Professor Levine concludes that the proposals do not sufficiently consider incentives on bankers and therefore the stability and efficiency of banks. This means that a dynamic aspect is missing. While he sees this as a gap in the analysis, he notes that he does not expect this to necessarily cause the RBNZ's recommendations regarding capital ratios to be higher or lower.	Inputs to modelling Suggests that some of the modelling inputs may have been set at levels that are too "pessimistic". However, he also notes that other variables may be too "optimistic" – in particular he considers that the estimates of the costs of crisis that underpin the RBNZ analysis are too low. Professor Miles concludes that these considerations have offsetting impacts and that the results are not biased upwards.
Impact on bank funding costs Suggests that the cost of equity has been overstated, which means that the impact of higher equity on bank funding costs have been overstated. As a result, the impacts on interest rates may be smaller than described in Reserve Bank consultation papers and associated documents.	Distortions and dynamic effects Professor Levine concludes that the proposals would lift the costs of banking, but that the overall impact depends on the extent to which nonbanks emerge to provide competition. Suggests more attention is needed to consider the extent to which there are impediments to entry.	Impact on bank funding costs Professor Miles concludes that the cost of equity funding to banks in the RBNZ's analysis is too high. This means the costs of higher capital will be overstated, and the impact on interest rates will be smaller than RBNZ estimates.
IRB approach to credit risk	Countercyclical buffer (CCyB)	Countercyclical buffer (CCyB)

<table>
<tr><th>Dr James Cummings</th><th>Professor Ross Levine</th><th>Professor David Miles</th></tr>
<tr><td>RBNZ should investigate the extent to which Internal Ratings-Based (IRB) models provide a more accurate prediction of unexpected losses than standardised models. If the IRB models do not outperform then the role of IRB should be reconsidered.</td><td>Professor Levine is sceptical that the RBNZ will be able to accurately assess when to turn the CCyB on and off. He is also uncomfortable that the proposals include scope for banks to continue to pay dividends when operating with capital ratios within the buffer.</td><td>Professor Miles suggests that the RBNZ consider making the CCyB part of the rest of the prudential buffer, to remove direct allocation of part of the buffer to the CCyB. Prof Miles' rationale for this is the difficulties associated with assessing whether a shock to the banking system is complete, or about to become worse.</td></tr>
<tr><td></td><td><u>Analysis of output impacts</u>
Suggests identifying which international studies that are most relevant for NZ. Includes the suggestion that as a small, open economy the impacts of more capital might differ from what would be expected in a larger economy.</td><td><u>Escalating supervisory response</u>
Professor Miles suggests that the RBNZ should make it clear that a temporary dip in the level of CET1 below the (substantially higher) conservation buffer under the new regime is of significantly less concern than a similar size shortfall under the current regime where the conservation buffer is less than one third as large.</td></tr>
<tr><td></td><td><u>Moral Hazard</u>
Professor Levine cites evidence that debtholders and depositors would not permit banks to be as levered as they are without the expectation of government support in the case of a failure. He notes that deposit insurance could affect considerations of moral hazard.</td><td></td></tr>
<tr><td colspan="3">RBNZ Response: the Reserve Bank is considering all of the comments and suggestions made by the External Experts. These issues will be addressed in the final decisions in December and in the Reserve Bank's regulatory impact analysis, including the cost benefit assessment. All of this material will be published alongside the final decisions in December. The Reserve Bank has a number of processes underway to address the points raised by the External Experts, as well as points made in submissions on the Capital Review. This includes:
Refining estimates of the costs and benefits of the proposals.
Considering a range of perspectives about possible interest rate impacts.
Assessing the impact of incentives on the various groups that make up the financial ecosystem.
Additional analysis of the definition of capital and processes for determining the level of risk-weighted assets.</td></tr>
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