



**RESERVE  
BANK**

O F N E W Z E A L A N D  
T E P Ū T E A M A T U A

**Consultation Paper:**

**A framework for identifying  
domestic systemically important banks**

April 2019

## Submission contact details

The Reserve Bank invites submissions on this Consultation Paper by 5pm on 31 May 2019. Please note the disclosure on the publication of submissions below.

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## Publication of submissions

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*The Reserve Bank may also publish an anonymised summary of the responses received in respect of this Consultation Paper.*

## PREAMBLE

1. The financial system forms the cornerstone of the modern economy. Under the Reserve Bank Act, the Reserve Bank has a legislative mandate to promote the soundness and efficiency of the financial system.
2. The banking sector dominates the New Zealand financial system, accounting for a very large share of overall financial system assets. The Reserve Bank, as the prudential supervisor of banks in New Zealand, aims to protect the stability of the banking system through regulations and supervision.
3. A framework for identifying domestic systemically important banks (D-SIBs) invariably leads to the question as to whether banks that sit outside the group of D-SIBs are not important. This is categorically not the case. All banks, irrespective of size, are important. All banks have customers who want their banks to be sound and efficient, and subject to an appropriate degree of prudential oversight. Contagion is a risk to the financial system. Smaller banks can trigger, and sometimes even cause, financial instability. A D-SIB framework does not deny the importance of smaller banks, nor does it focus the attention only on those banks that are given the D-SIB label.
4. Rather, a D-SIB framework is about identifying those banks whose failure has a larger impact on the financial system due to their size, interconnectedness, lack of substitutability, and complexity. These banks are seen as producing more negative externalities compared to their smaller competitors. Internationally, this problem is solved by additional regulatory requirements such as D-SIB capital surcharges.
5. This consultation paper is about the potential use of a D-SIB framework to identify those banks in New Zealand that might be subject to a capital surcharge as mooted in the December 2018 consultation paper "[How much capital is enough?](#)"

## I. INTRODUCTION

6. The Reserve Bank is consulting on a framework for identifying domestic systemically important banks. This supplements the proposed new capital adequacy framework, as per in the consultation paper "How much capital is enough?" published in December 2018.
7. The method proposed for identifying D-SIBs in this consultation paper aligns with international best practice as recommended by the Basel Committee. The method uses an indicator-based approach across four dimensions: size, interconnectedness, substitutability, and complexity of banks.
8. It should be noted that the use of the term "systemic importance" by the Reserve Bank predates the development of the indicator approach by the Basel Committee. The banking supervision handbook BS 1 defines "systemically important banks" as banks with external liabilities exceeding NZD 15 billion. Once a bank exceeds that threshold, it has to incorporate locally.
9. For the purpose of this document, unless otherwise indicated, the term "systemically important banks" refers to those banks which would be captured by a D-SIB framework and

thus potentially be subject to additional loss absorbing capital requirements as per the Reserve Bank's capital adequacy proposal published in December 2018<sup>1</sup>.

10. The second part of the consultation paper provides more background on what has become widespread practice for identifying D-SIBs in other jurisdictions. The third part sets out how the Basel approach could be used in New Zealand. The fourth part provides more analysis around the pros and cons of the following four options for identifying D-SIBs:
  - A size-only method as per the current BS 1;
  - A relative-size-only framework;
  - An indicator-based framework based on the Basel approach;
  - A D-SIB framework extended to BS 1.
11. The first three options restrict the scope of the framework to the application of a D-SIB capital surcharge. The fourth option extends the framework of identifying D-SIBs to the requirement at which banks have to incorporate locally.
12. The fifth part summarises the Reserve Bank's preferred option and the last part discusses next steps after the consultation paper.

## **II. Background**

### *International practice*

13. Since the global financial crisis, systemically important banks have become the subject of enhanced prudential supervision across many jurisdictions. This is based on the notion that systemically important banks may be difficult to resolve in a crisis since their neighbourhood effects could potentially endanger the viability of the financial system. In order to identify the banks that warrant the systemic importance label, the Basel Committee has proposed an assessment methodology based on a set of indicators. Systemic importance can thus be identified both at the global as well as at the domestic level. Being a G-SIB (global systemically important bank) or a D-SIB tends to come with higher loss absorbency (HLA) requirements.
14. There are four key indicators that form the basis of the Basel D-SIB framework.<sup>2</sup> These are:
  - size;
  - interconnectedness;
  - substitutability; and
  - complexity.
15. Many jurisdictions have incorporated this approach into their own D-SIB assessment methodology. In 2014, the European Banking Authority (EBA) published the guidelines for

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<sup>1</sup> See the following link for details of the consultancy. <https://www.rbnz.govt.nz/regulation-and-supervision/banks/consultations-and-policy-initiatives/active-policy-development/review-of-the-capital-adequacy-framework-registered-banks>

<sup>2</sup> The Basel D-SIB framework is in line with its global systemically important banks (G-SIBs) framework developed in 2011. Besides the four categories of importance for D-SIBs, the framework of G-SIBS also include "cross-jurisdictional activity" as the fifth dimension.

assessing D-SIBs which provided detailed indicators for the four categories. Other institutions that have implemented a version of this approach include the Australian Prudential Regulation Authority (APRA), Bank of England (BoE), Bank for International Settlements (BIS) and Office of the Superintendent of Financial Institutions of Canada (OSFI), etc.

16. In addition to the four categories of indicators, it is common practice for authorities around the world to use an element of supervisory judgment when deciding on their list of D-SIBs.
17. The Basel's framework sets Higher Loss Absorbency (HLA) requirements for banks identified as D-SIBs. This HLA requirement implemented through an extension of the capital conservation buffer is justified on the basis that a D-SIB's failure is expected to have a greater impact on the domestic financial system and the economy. A bank's HLA requirement should be commensurate with its systemic importance as assessed by the indicator-based approach.

#### *Current practice in New Zealand*

18. The Reserve Bank's use of the term "systemically important banks" predates the global financial crisis. The local incorporation policy was developed in the early 2000s and, as stated in BS 1, requires banks whose New Zealand liabilities, net of amounts due to related parties, exceed NZD 15 billion (prior to 2007 the threshold was NZD 10 billion) to incorporate locally. Local incorporation means that banks are subject to the full set of Reserve Bank prudential requirements, such as the requirement to hold sufficient capital in New Zealand. The local incorporation policy is part of a suite of policies that also includes the Outsourcing Policy (BS 11) and Open Bank Resolution (BS 13). These policies combined provide New Zealand authorities with the full range of distress management and resolution options so that decisions that are in the best interest of New Zealanders can be made.
19. Basel's definition of systemically important banks, on the other hand, is based on the four categories listed above. The main purpose is to mitigate the negative externalities of D-SIBs through imposing HLA requirements.
20. The difference in how the term "systemic importance" is defined by the Reserve Bank and by Basel is a potential source of confusion.
21. The lack of a framework for identifying D-SIBs also leads to confusion when other similar terms are used to refer to banks that are of systemic importance. The recent consultation paper on a new capital adequacy framework entitled "How much capital is enough?" refers to "large banks" in the context of a potential additional D-SIB capital charge. However, in the BS 11 Outsourcing Policy, the term 'large banks' refers to those banks whose external liabilities exceed \$10 billion.

### **III. An explorative analysis of an indicator-based approach**

22. In this part, an explorative analysis is carried out based on the Basel's indicator-based approach. The following three principles are followed in selecting the specific indicators for each category:

1) *International practice*

International organisations (BIS, EBA, etc.) recommended a set of indicators for each category of systemic importance. For each category, indicators available vary slightly from one another. In this case, the following two principles are applied.

2) *Relevance to New Zealand*

The features of our banking system differ from those of other countries. Hence, the chosen indicators must be closely related to our domestic financial system and economy. This is in line with the Basel recommendations, which allow for a degree of national discretion to reflect domestic characteristics.

3) *Transparency*

The results (bank rankings and scores) obtained from publicly available data are shown in the explorative analysis. Jurisdictions vary in the transparency of their identification methodologies. Some countries use an approach that is more descriptive (e.g. Canada), while others show parts of the quantitative assessment (e.g. Australia) or the final score of banks without a more granular break down of the scores for each category (e.g. UK). The Reserve Bank considers it important that its approach is as transparent as it can be. This means that the scores of assessing banks' systemic importance can be verified and be subject to public scrutiny. Hence, the indicators chosen are based on publicly available data. Where there are alternative measures that draw on unpublished data, the Reserve Bank has analysed that data to determine whether it would change the results significantly.

23. The following analysis uses data extracted from the Bank Financial Strength Dashboard as at 30 September 2018. It finds that regardless of the indicators selected, the big four Australian banks (ANZ, BNZ, ASB and Westpac, denoted by "big four" hereafter) are dominant across all four categories of systemic importance with an observable cliff effect between their scores and those of other banks.

24. It should be noted that there is some flexibility around the selection of indicators in each category and the Reserve Bank welcomes feedback on the ones it has chosen. The following analysis only applies to locally incorporated banks in New Zealand.<sup>3</sup>

**Q1: Do you have any comments on the Reserve Bank's general approach to the internationally used D-SIB framework?**

*Category I: Size*

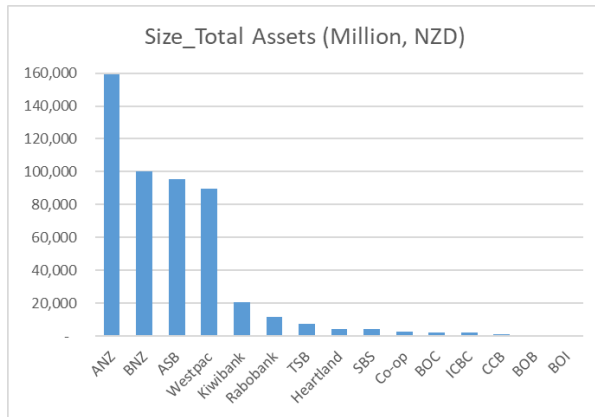
25. A bank's distress or failure is more likely to damage the domestic financial system if its activities account for a large share of the domestic banking activity. *Total Assets* is the most

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<sup>3</sup> To quote Basel Committee on Banking Supervision *A framework for dealing with domestic systemically important banks*, "Principle 4: Home authorities should assess banks for their degree of systemic importance at the consolidated group level, while host authorities should assess subsidiaries in their jurisdictions, consolidated to include any of their own downstream subsidiaries, for their degree of systemic importance."

direct way of measuring a bank's share in the banking system. Figure 1 shows the total assets of locally incorporated banks.

Figure 1: Total assets of all locally incorporated banks as at 30 Sep 2018



26. Banks are assigned a score based on their share of total assets of all locally incorporated banks. Specifically, the score is calculated by dividing the indicator value of a single bank by the sum of all locally incorporated banks' indicator value. Table 1 reports the score of each bank regarding their total assets.

Table 1: Share of total assets in all locally incorporated banks

Bank	Size: Total Assets
ANZ	31.63%
BNZ	19.89%
ASB	19.05%
Westpac	17.88%
Kiwibank	4.16%
Rabobank	2.34%
TSB	1.50%
SBS	0.91%
Heartland	0.91%
Co-op	0.53%
BOC	0.44%
ICBC	0.42%
CCB	0.29%
BOB	0.02%
BOI	0.02%

27. The rankings of banks show that there is a significant step down in size between the big four and the others. The assets of the big four range from 18% to 32% individually as a percentage of the total assets of all locally incorporated banks. The figure for Kiwibank is less than 5%, while other banks are less than 2.5%.

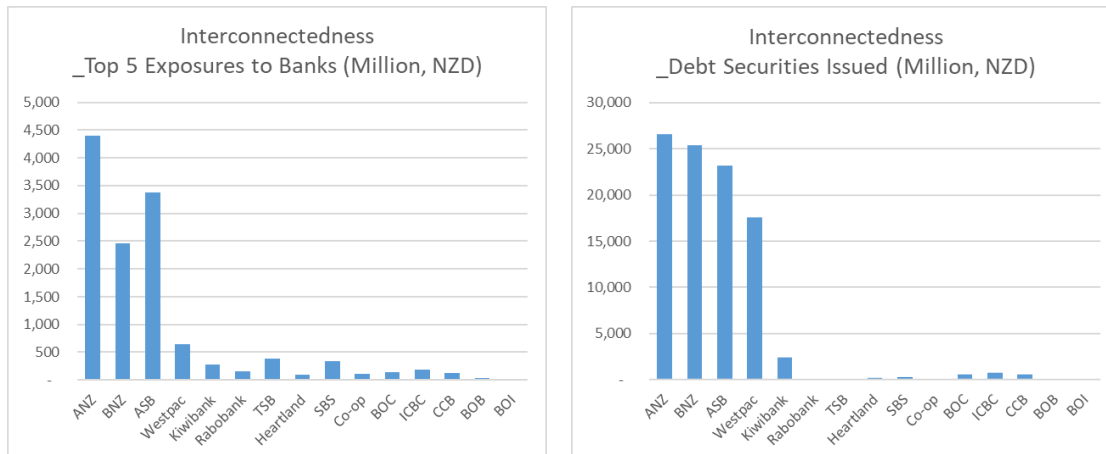
28. Relative to the domestic economy, the assets of the big four banks are equivalent to approximately 1.5 times that of New Zealand's GDP, showing a similar pattern to Australia.<sup>4</sup>
29. *Total Exposures* and *External liabilities* are also considered as proxies for size. Using unpublished data, these two indicators produce similar results to those obtained from *Total Asset*.<sup>5</sup> The similarity of outcomes indicates that *Total Assets* as an indicator can sufficiently capture the structure of size in the New Zealand banking industry.

**Q2: Do you have any comments on the proposed use of *Total Assets* as the indicator for the category of Size?**

*Category II: Interconnectedness*

30. Interconnectedness measures the extent to which a bank is connected to other banks via bilateral transactions. The more interconnected a bank, the greater the scope for contagion it brings to the financial system should the bank experience a negative shock.
31. The sum of each bank's *Top 5 Exposures to Banks* (exposures to related parties such as the parent bank are excluded) is used to measure the degree to which banks are interconnected. *Debt Securities Issued* is also included in this category to help capture how vulnerable banks are to funding shocks as well as the risk of spill-over to the broader financial system.

Figure 2: Measures of interconnectedness for all locally incorporated banks as at 30 Sep 2018



32. Results from *Top 5 Exposures to Banks* produce different rankings from those measured by size.<sup>6</sup> As shown in Figure 2, the most notable difference is the ranking within the big four. ASB surpasses BNZ as the second largest bank, while Westpac ranks the fourth with a score similar to those of TSB and SBS. Nevertheless, the big four still rank the top four. Ranking banks according to the volume of *Debt Securities Issued* produces a similar result

<sup>4</sup> Information paper "Domestic systemically important banks in Australia" by ARPA shows that the aggregated assets of the big four banks in Australia (National Australia Bank, Westpac, ANZ, and Commonwealth Bank) are equivalent to 1.5 times of Australia's GDP, using the data for August 2013.

<sup>5</sup> It is noteworthy that using *External liabilities* assigns Rabobank NZ a significantly lower score because they are less reliant on external sources for funding.

<sup>6</sup> For the ease of comparison, banks are shown in descending order of total assets.



to that using size. The big four banks account for the majority of debt issues, followed by Kiwibank with a much smaller amount.

33. *Top 5 Exposures to Banks* includes exposures to all banks regardless of whether or not the banks or the banks' subsidiaries/branches are registered in New Zealand. For domestic systemic importance, exposures to banks that do not have a presence in New Zealand are less relevant. Using the unpublished data for *Total Exposures to Banks that operate in New Zealand* produces a very similar pattern of bank ranking to that using *Top 5 Exposures to Banks*. This indicates that *Top 5 Exposures to Banks* can properly capture the interconnected structure of our domestic banking system.
34. *Intra-financial System Assets* (loans, reverse repos and derivatives with FIs) and *Intra-financial System Liabilities* (deposits, repos and derivatives with FIs) are also considered as alternative indicators of interconnectedness, since they are widely used by other jurisdictions. These metrics capture how a bank is connected to other financial institutions rather than just to other banks. The results obtained from unpublished data show that the big four still dominate while the relative ranking of the four banks changes.
35. Table 2 reports each banks' share of top 5 interbank exposures and debt securities issued among all locally incorporated banks.

Table 2: Share of Top 5 Exposures to Banks and Debt Securities Issued in all locally incorporated banks

Bank	Interconnectedness: Top 5 Exposures to Banks	Interconnectedness: Debt Securities Issued
ANZ	40.98%	27.27%
BNZ	17.60%	26.01%
ASB	23.58%	23.77%
Westpac	4.96%	18.02%
Kiwibank	1.97%	2.45%
Rabobank	1.03%	0.00%
TSB	2.56%	0.04%
SBS	2.43%	0.30%
Heartland	0.75%	0.20%
Co-op	0.75%	0.05%
BOC	0.95%	0.58%
ICBC	1.26%	0.73%
CCB	0.87%	0.58%
BOB	0.19%	0.00%
BOI	0.13%	0.00%

**Q3: Do you agree with the use of *Top 5 Credit Exposures to Banks and Debt Securities Issued* as indicators for the category of Interconnectedness?**

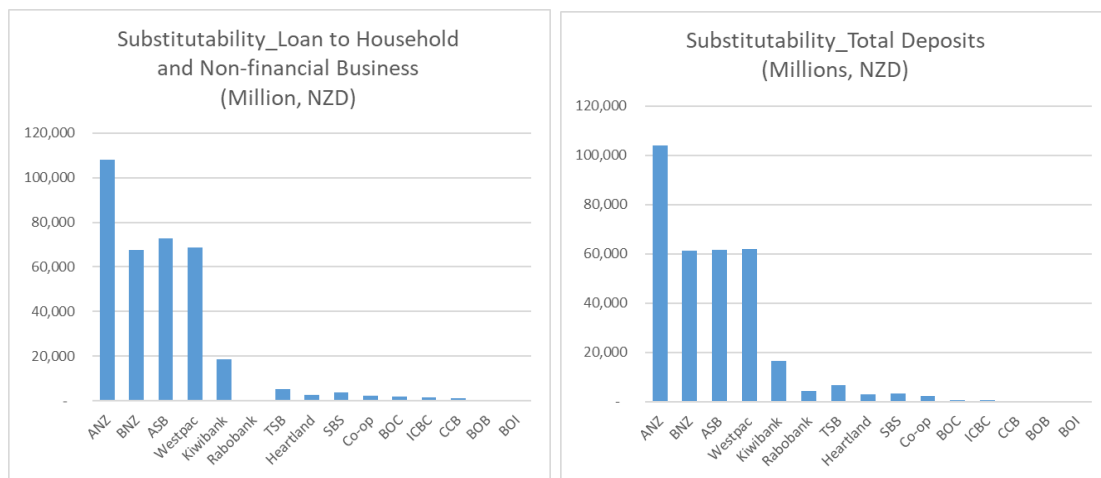
**Q4: What are your views on the need to also use data on *Intra-financial System Assets and Liabilities to measure interconnectedness*? Would it produce any benefits**

**in addition to the two indicators proposed above? Bearing in mind that this data is not currently publicly available, what is your view on making this data available?**

*Category III: Substitutability*

36. Substitutability measures to what extent the services a bank provides can be replaced by another bank in a timely manner in the event of a bank failure. In other words, it measures the importance of the service provided by a bank in the economy. In New Zealand, business models of banks are predominantly centred on lending and deposit taking. Some banks are systemically important because customers, notably borrowers, rely on them for the continuous provision of key services. Therefore, *Loans to Household and Non-financial Business* and *Total Deposits* are considered as the main measures of substitutability.

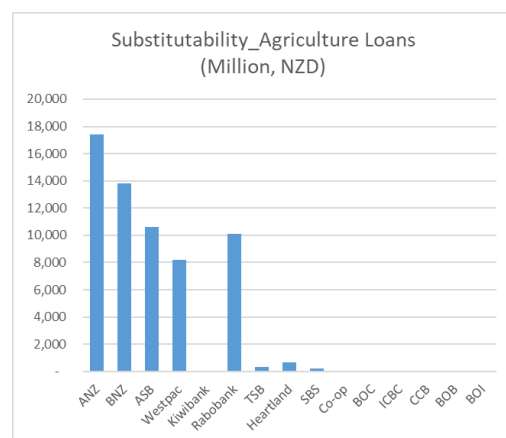
Figure 3: Measures of substitutability for all locally incorporated banks as at 30 Sep 2018



37. As shown in Figure 3, the rankings of banks by *Loans to Household, Non-financial Business* and *Total Deposits* are quite similar to that of *Total Assets*. This indicates that the big four banks are also the main service providers to the economy, with Kiwibank being the fifth biggest provider.
38. *Private Sector Deposits* (deposits from non-financial corporations and households) is also widely used as the indicator for substitutability because it focuses on banks' service to people's everyday needs within a nation. The unpublished data for *Private Sector Deposits* shows that the banks' ranking is very similar to that using *Total Deposits*.
39. Another alternative measure to *Total Deposits* might be the number of customers. Unfortunately, reliable data on this is not available but there is unpublished data on the *Number of Deposit Accounts* which can be used as a rough proxy. This sense check still shows the big four banks are ahead of, albeit with a smaller gap to Kiwibank.
40. Since the agricultural industry plays a vital role in New Zealand (more than 5% of GDP and more than 50% of export revenue are from agriculture industry), it is worth looking at the banking services provided to the agriculture sector. As shown in Figure 4, the ranking of

banks in *Agriculture Loans* reveals the importance of Rabobank in this area.<sup>7</sup> Rabobank ranks fourth, ahead of Westpac, and accounts for roughly 1/6 of the market.

Figure 4: Additional measure of substitutability for all locally incorporated banks as at 30 Sep 2018



41. Besides providing loan and deposit services, banks also play a critical role in facilitating payment transactions. Hence, the substitutability of a bank is partly determined by their role in the payment system. Unpublished data for the transaction values through the Exchange Settlement Account System (ESAS, New Zealand's principal high-value payments system) shows that the big four dominate in this field.

42. The scores of each measure for substitutability/importance are shown in Table 3.

Table 3: Share of Total Loans to Household and Non-financial Businesses, Agricultural Loans and Total Deposits in all locally incorporated banks

Bank	Substitutability: Loan to Household and Non-financial Business	Substitutability: Agriculture Loans	Substitutability: Total Deposits
ANZ	30.50%	28.38%	31.87%
BNZ	19.01%	22.50%	18.78%
ASB	20.48%	17.29%	18.82%
Westpac	19.39%	13.38%	18.98%
Kiwibank	5.29%	0.01%	5.03%
Rabobank	0.09%	16.41%	1.28%
TSB	1.47%	0.53%	2.08%
SBS	1.03%	0.37%	1.03%
Heartland	0.77%	1.11%	0.91%
Co-op	0.67%	0.00%	0.69%
BOC	0.52%	0.00%	0.19%
ICBC	0.44%	0.01%	0.22%
CCB	0.30%	0.00%	0.08%
BOB	0.02%	0.00%	0.02%
BOI	0.02%	0.00%	0.01%

<sup>7</sup> The two indicators *Loans to household and non-financial businesses* and *Agriculture loans* are not overlapping.

**Q5: Do you agree with the use of *Loans to Household and Non-financial Business, Total Deposits and Agriculture Loans* as indicators for the category of Substitutability?**

**Q6: Do you think there are any other metrics, e.g. *Number of customers* that would enhance the assessment of banks' substitutability?**

*Category IV: Complexity*

43. Complexity measures the lack of transparency and the difficulty of understanding the exposures of a bank. Banks engaging in complex activities are more difficult and costly to resolve. Banks in New Zealand source approximately 30% of their debt funding from wholesale markets, around 60% of which is raised offshore. To hedge against exchange rate risk, banks use cross-currency basis swaps—an OTC derivative that cannot currently be centrally cleared and is believed to carry a higher risk.
44. The turnover of OTC derivatives in New Zealand only accounts for a small proportion of the global market. However, this does not imply that, relative to their size, banks in New Zealand engage in less OTC derivative activities than their peers overseas. Adjusting for size, the total turnover of OTC derivatives in New Zealand is comparable to the level in many other countries. Table 4 shows the data for some countries extracted from the triennial survey conducted by BIS for the latest period (2016).

*Table 4 Turnover of OTC derivatives vs. total assets of banking system (2016)*

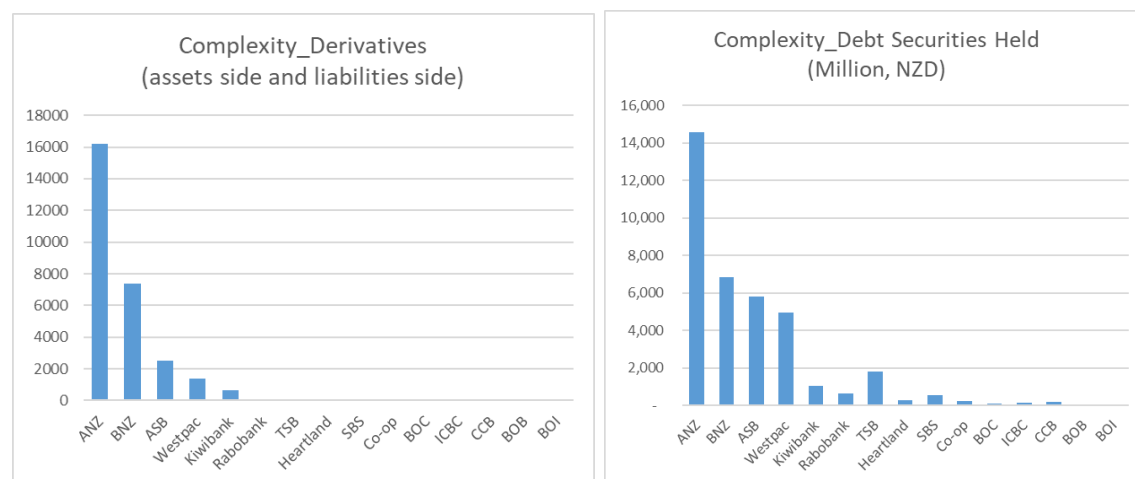
Country	(1) Turnover of OTC interest rate derivatives (billion, USD)	(2) Turnover of OTC foreign exchange instruments (billion, USD)	(3) Total assets of banking system (billion, USD)	(1) + (2) (3)
Australia	56	121	2,909	6.1%
Belgium	17	23	501	8.0%
Canada	33	86	3,709	3.2%
China	4	73	26,106	0.3%
Germany	31	116	7,538	2.0%
<b>New Zealand</b>	<b>5</b>	<b>10</b>	<b>352</b>	<b>4.3%</b>
UK	1,180	2,406	6,811	52.7%
US	1,241	1,272	14,220	17.7%

45. However, the turnover of OTC derivatives or the notional amount of OTC derivatives is not available on bank level in New Zealand. The relevant information may be collected in future to refine the framework of D-SIB. At this stage, *Derivatives (asset side and liabilities side)* is used as the measure of complexity on bank level, as suggested by EBA. *Debt Securities Held* is also included in the category of complexity, because holdings of trading and ready-

for-sale securities can generate a spill-over effect through mark-to-market losses and subsequent fire sale of these securities if a bank is under severe stress.<sup>8</sup>

46. Both these two indicators show the dominant roles of the big four in all locally incorporated banks.

Figure 5: Measure of complexity for all locally incorporated banks as at 30 Sep 2018



47. Table 5 reports each bank's complexity score.

Table 5: Share of Derivatives and Debt Securities Held in all locally incorporated banks

Bank	Complexity: Derivatives	Complexity: Debt Securities Held
ANZ	51.61%	39.19%
BNZ	27.67%	18.40%
ASB	11.85%	15.57%
Westpac	6.26%	13.34%
Kiwibank	2.32%	2.85%
Rabobank	0.03%	1.78%
TSB	0.01%	4.89%
SBS	0.02%	1.45%
Heartland	0.00%	0.80%
Co-op	0.02%	0.68%
BOC	0.01%	0.27%
ICBC	0.02%	0.33%
CCB	0.18%	0.46%
BOB	0.00%	0.00%
BOI	0.00%	0.00%

<sup>8</sup> Debt securities held by banks is used as a rough equivalent to "holding of trading and available for sale securities" used by Basel and other jurisdictions in gauging the complexity of banks. Since other debt securities (mainly hold-to-maturity securities) only takes less than 1% of total debt securities held by locally incorporated banks, it is more convenient to use data for *Debt securities* available on the Bank Financial Strength Dashboard than requiring disclosing the information of *Holding of trading and available for sale securities* for each individual bank.

**Q7: Do you agree to use *Derivatives (Assets Side and liabilities side) and Debt Securities Held* as the indicators for the category of Complexity?**

**Q8: What other indicators should be considered to assess systemic importance?**

*Total score of systemic importance:*

48. In determining a bank's overall systemic importance score, each category is weighted equally at 25%. Within a category, indicators are weighted equally, with the exception of *Agriculture Loans*. The aggregate value of *Agriculture Loans* is equal to about  $\frac{1}{4}$  of *Loans to Household and Non-financial Business*. Therefore, within the category of Substitutability, weights are assigned as follows: i) 10% to *Agricultural Loans*, ii) 40% to *Loans to Households and Non-financial Business*; and iii) 50% to *Total Deposits*. Multiplying the sum of these scores by 100 gives the final score. This weighted sum method ensures the overall score of a bank can be easily interpreted as a percentage of all locally incorporated banks.<sup>9</sup>

Table 6: Weighting system

Category	Weight in systemic importance	Metrics	Weight within the category
Size	25%	Total assets	100%
Interconnectedness	25%	Top 5 exposures to banks	50%
		Securities issued	50%
Substitutability	25%	Loans to household and non-financial corporations	40%
		Agriculture loans	10%
		Total deposits	50%
Complexity	25%	Derivatives (assets side and liabilities side)	50%
		Debt securities held	50%

49. For the purpose of comparison between the indicator-based method and the calibrated-to-size method, Table 7 reports the final scores of banks according to both methods by their *Total Assets* in descending order. In terms of ranking and the magnitude of the scores, these two methods produce similar results. This suggests that in a relatively small financial system like New Zealand with traditional lending and deposit-taking services as the main models in the banking industry, most aspects of systemic importance—interconnectedness, substitutability and complexity—show high correlation with banks' size.
50. There is a significant difference between the big four banks and other locally incorporated banks. The case for categorising the big four banks as D-SIBs seems reasonably clear. Kiwibank has a significantly lower score than the big four, but it is nearly twice as big as the next bank. While significantly smaller, Rabobank has a bigger presence as a lender to the agriculture sector than Westpac. This raises the question as to whether Kiwibank and/or

<sup>9</sup> For example, a bank with a final score of 20 indicates its systemic importance measured by the four different categories accounts for 20% of all locally incorporated banks in New Zealand.

Rabobank should also be given the D-SIB label or a second tier of D-SIBs should be considered. An answer to this question requires a high degree of supervisory judgement.

Table 7: Systemic importance scores for all locally incorporated banks

Bank (in order of total assets)	Total score (equal weight)	Total score (size*100)
ANZ	35.53	31.63
BNZ	20.99	19.89
ASB	18.94	19.05
Westpac	14.44	17.88
Kiwibank	3.40	4.16
Rabobank	1.52	2.34
TSB	1.73	1.50
SBS	0.99	0.91
Heartland	0.66	0.91
Co-op	0.47	0.53
BOC	0.41	0.44
ICBC	0.47	0.42
CCB	0.37	0.29
BOB	0.03	0.02
BOI	0.02	0.02

51. At this point of time, the Reserve Bank believes a single tier D-SIB framework would be simpler in practice. Moreover, the difference between these two banks and the big four is so substantial that neither of the two banks should be in the D-SIB category. However, it does show that both the framework and the list of D-SIBs should be reviewed regularly to confirm that they are still fit for purpose. The bucketing approach remains as an option for the regulator in refining the capital adequacy framework in future.

**Q9: Do you agree with the outcome of the indicator approach which identifies the big four banks, i.e. ANZ, BNZ, ASB and Westpac as D-SIBs? What other factors do you think ought to be considered? Please explain your answer.**

#### *Threshold of D-SIBs*

52. There is a question as to whether there should be a threshold above which a bank automatically becomes a D-SIB. On the one hand, a threshold would provide clarity. On the other hand, it would be highly inflexible. The Reserve Bank does not propose to set a threshold for the following four reasons.

- 1) It is international practice for regulators to use supervisory discretion when deciding on the list of their D-SIBs. A threshold would undermine the effectiveness of supervisory judgement.
- 2) It is not usual for national regulators to set a fixed threshold in identifying D-SIBs, except for the guideline by EBA. EBA requires a bank with a total score higher than 350 basis points (equals to 3.5 using our scoring approach) being automatically classified as a D-

SIB. However, the threshold of European countries can hardly be justified in New Zealand due to the unique feature of our banking system which includes the dominating position of foreign banks and the cliff effect between the big four and other banks.

- 3) Any threshold would be arbitrary. There is a significant gap between the big four banks and the remaining banks. If the threshold is set at a high level, e.g. at 12 or 14, it appears more likely that a big bank would fall below that bar than a smaller bank would cross into the D-SIB category. Should any locally incorporated bank (except the big four) double its total assets, it would still have a gap (measured simply by size) of several hundred basis points compared with the big four. If the threshold is set at a low level, e.g. 5 or 7, a smaller bank might be more likely to cross it, but there would still be a huge gap to the big four banks. To conclude, it would be better to use supervisory judgement should there be significant change to the composition of our banking sector.
- 4) Having a very high score in one category of systemic importance might warrant a D-SIB label, although the overall score of that bank might still show a big gap from identified D-SIBs. Again, supervisory judgement rather than arbitrarily constructed threshold seems to offer a better solution.

**Q10: Do you have any comments on the Reserve Bank's position that a score-based threshold is not warranted?**

#### **IV. Pros and Cons of different options**

53. The indicator approach outlined in the previous section is one way of identifying D-SIBs. This section describes alternatives and compares the pros and cons of four options before proposing a preferred one.

*Option 1: A size-only method as per BS 1 (the status quo)*

54. Under this approach, the term of D-SIB will be defined as per BS 1. That is, a bank will be designated D-SIB status if they hold NZD 15 billion (the threshold may be reviewed in future) or more in external liabilities and be subject to a D-SIB capital surcharge.

#### **Pros:**

55. The benefit of adopting the definition given in BS 1 is that further policy work on a D-SIB framework will not be required. Any cost associated with developing a D-SIB framework will be minimised.

#### **Cons:**

56. The primary disadvantage of this option derives from the original policy intent of the definition in BS 1. Specifically, it was designed to impose a cap on branch registration for overseas banks rather than to set a threshold for HLA requirements as per Basel's definition. Therefore, using the definition provided in BS 1 may not be appropriate for determining which banks should be subject to a D-SIB capital surcharge.



57. The current definition also suffers the ambiguity of which banks should be designated as D-SIBs. For example, Kiwibank holds more than NZD 15 billion in external liabilities but it is not a branch of any overseas banks and therefore does not meet the requirements for being systemically important as per BS 1. Consequently, it remains unclear whether the proposed D-SIB capital surcharge should be applied to Kiwibank.
58. The second issue arises from using a specific value of size as the threshold in identifying D-SIBs. The NZD 15 billion of external liability limit was increased from NZD 10 billion in 2007, when banks other than the big four fell far below this threshold. Having a specific value rather than a relative number to measure a bank's importance to the whole financial system creates unnecessary work for the regulator through onerous policy reviews or updates to reflect the growth of the banking industry.

*Option 2: A relative-size-only framework for implementing D-SIB capital surcharge*

59. This approach uses a simplified version of the indicator-based framework by only considering the relative size of banks in measuring their systemic importance.
60. As shown in the explorative analysis, most aspects of systemic importance are highly correlated with the size of a bank, at least at the time of measurement (September 2018). Using this approach, ANZ, BNZ, ASB and Westpac NZ are identified as D-SIBs in New Zealand.

**Pros:**

61. The primary advantage of this option is its simplicity and ability to produce the same identification results (as at the time of writing) as the more complicated indicator-based framework.
62. Using a relative measure of size would also remove the burden of regular policy reviews and updates associated with a numeric threshold as Option 1.

**Cons:**

63. Measuring systemic importance by the relative size of banks risks regulatory myopia. Specifically, the size of a bank fails to capture the complexity of banking activities and thus may not be an appropriate measure for systemic importance if the banking sector becomes more complex in the future. This perspective is shared by the BIS and supported by studies.<sup>10</sup> While this policy may be feasible now, it is not forward looking and may require revision as the banking industry develops.
64. Another shortcoming of using a relative-size-based method is its inconsistency with the proposed framework of identifying systemically important financial market infrastructures (SIFMIs) in New Zealand. In April 2017, Cabinet agreed to adopt an enhanced legislative framework for the regulation of FMIs. Cabinet agreed that when designating SIFMIs, the

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<sup>10</sup> One example is the paper *Bank Complexity: Is Size Everything?* published by FEDS Notes, authored by Oldfather, J., Gissler, S., & Ruffino, D. (2016).

following factors may be included: the size, degree of market penetration and concentration of financial risks; the role and nature of transaction; the degree of substitutability; and interdependencies with other FMIs or markets, to better reflect international standards (i.e. the CPMI/IOSCO Principles for FMIs).

*Option 3: An indicator-based framework*

65. This option adopts the indicator-based framework as shown in the explorative analysis. The indicator-based framework will be used in the proposed new capital adequacy framework (i.e. an updated BS2A&B) to facilitate the implementation of capital surcharge for the identified D-SIBs. Using this method, ANZ, BNZ, ASB and Westpac NZ are identified as D-SIBs in New Zealand.

**Pros:**

66. This approach can comprehensively measure different aspects of systemic importance and reflect the evolution of dynamic banking activities. Although most aspects of systemic importance are highly correlated with bank size in New Zealand at this stage, it is possible that this correlation may weaken in the future due to emerging and more complex business models in the banking industry. This approach enables the regulator to have the flexibility to adjust and redesign the indicators included in different aspects of systemic importance to reflect the change in risk and importance of banks to the economy in a timely manner.

67. Other benefits of this option include: i) reducing regulatory burden to update a numeric threshold as described in Option 1; ii) being consistent with the multi-dimensional framework for identifying SIFMIs; iii) aligning New Zealand's D-SIB framework with international practice.

**Cons/costs:**

68. The explorative analysis of an indicator-based framework presented in this document was based primarily upon publicly available data from the Bank Financial Strength Dashboard. Therefore, the additional costs associated with data collection are expected to be close to zero. Should alternative measures be adopted, consent is needed from locally incorporated banks to make such information on individual banks publicly available.

69. The additional cost associated with assessing different categories of systemic importance is reasonable and feasible given RBNZ's current resources. Should more measures be considered in future, resources will need to be commensurate with the additional requirement.

70. Table 8 summarises Option1-3.

Table 8 comparison of different options

No.	Description	Meet the requirements of regulation	Easy to interpret	Align with international practice	Save cost in implementation
1	As per BS1	★	★	★	★★
2	A relative-size-only framework	★★	★★★★	★	★★★★
3	An indicator-based framework	★★★★	★★	★★★★	★★

*Option 4: A D-SIB framework also applied to BS1 for branch registration*

71. This option proposes that the framework for identifying D-SIBs (either Option 2 or 3) will be applied to the BS1. As a result, banks designated as D-SIBs under the agreed upon framework will be required to incorporate locally in New Zealand.

**Pros:**

72. Since BS 1 already uses the term “systemic important banks”, it may lead to confusion if there are two definitions of systemic important banks—one in BS 1 and one for BS 2A&B. This option ensures that language used regarding systemically important banks is consistent across policy documents.

**Cons:**

73. It should be noted that the local incorporation requirement and a potential additional capital charge for D-SIBs address two different risks. The former is mainly to do with the resolvability of banks in New Zealand. The latter aims to ensure that capital is optimally calibrated by taking into account the impact on the financial system from a misalignment between private and social benefits. The two thresholds might therefore not always fully align.

74. From the point of view of industry, applying the D-SIB framework to BS 1 may also introduce a degree of uncertainty as to when a bank would be required to incorporate locally. This is because the proposed D-SIB framework includes the exercise of supervisory judgment by the regulator. Compared to the current threshold of NZD 15 billion of external liabilities in BS 1, the D-SIB framework provides a less clear cut.

**Q11: What other potential aspects do you suggest to include in the comparison of different options?**

**V. The Reserve Bank’s preferred option**

75. Options 1 and 2 would be somewhat simplistic, which in themselves might be desirable, but lead to a definition that is misaligned with international practice. It might also miss some of the important intricacies of the banking system that the more sophisticated Basel approach

allows one to identify. Option 4 has the disadvantage of introducing some uncertainty as to when a bank has to incorporate locally.

76. The Reserve Bank's preference is Option 3. This approach allows for a clear identification of those banks that should be captured by the D-SIB framework and align New Zealand with international practice in this aspect. The explorative analysis confirms what has already been foreshadowed in the capital adequacy consultation, namely that the big four Australian owned banks would be classified as D-SIBs.

77. Adopting Option 3 would result in two different definitions for "systemically important bank" in BS 1 and BS 2A&B. To mitigate any confusion, a different terminology could be developed for the BS 1 local incorporation requirement as part of the planned restructure of the banking supervision handbook.

**Q12: Please comment on the different options under consideration and state whether or not you agree with the Reserve Bank's preferred option. Please give your reasons.**

## **VI. Next Steps**

78. This consultation will close on 31 May 2019. After the consultation has closed, the Reserve Bank will publish the submissions received as per its policy on publishing submission, as well as a summary of the feedback received and its decision on how to proceed with the proposed D-SIB framework.

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