MEMORANDUM FOR	FSO Committee
FROM	Financial Policy
MEETING DATE	7 September 2016
SUBJECT	**Three papers on the level of bank capital**
FOR YOUR	Information

Purpose

1. We are presenting three papers relating to the level of bank capital. These are intended to set the scene for the capital review, rather than to be used to justify a particular capital setting. As such they are for information only.

Background

2. We have previously reported to you about the scope of the capital review and the papers FSO could expect to see over the course of the review (see Doc #6537247). The first three papers in that sequence are being presented at this meeting.

3. The papers are:

   - a paper reporting the results of a capital modelling exercise
   - an historical review of New Zealand's current capital settings, and a cross-country comparison of capital ratios; and,
   - a review of the literature which has considered the level of the capital ratio.

4. The papers set the scene in that they attempt to inform the review by providing a high level assessment of our starting point (Gael's paper), the current thinking in capital literature (Charles' paper), and an update to the previous work on modelling 'optimal' capital (Tony's paper).

5. All three papers, as one might expect, demonstrate that it is difficult to be precise about the optimal level of capital, or even what relative conservatism means (i.e. it is always context specific, at both the institution and system level).

6. This is certainly true in modelling exercises: while such models are sometimes referred to as 'optimal' capital models, like many models they are highly dependent on construction and assumptions, and while informed by theory the empirical evidence can be less than conclusive at times. As Tony's paper demonstrates, changes to a key assumption about the degree to which MM1 holds can significantly affect the modelled 'optimal' capital. The literature review shows that over relatively wide ranges of capital settings (10 to 20 percent CET1) are 'optimal' and that the BAU impacts of higher capital are relatively muted. Arguably, economic impacts or potential risks that might arise from higher capital would be more pronounced at levels significantly higher than envisaged in

the nature of the capital review – for example, at the sort of capital levels floated under the “big equity” type proposals.

7. Based on the tone of previous FSO discussions, we are assuming that consideration of fundamental reforms to the capital framework of whatever form (e.g. removing IRB from the framework entirely, or in effect by way of hard floors) would not extent to a serious consideration of “big equity”. We are open to all perspectives and if the Committee is interested in further work on this issue, we would be happy to factor that into the review.