RESERVE BANK

OF NEW ZEALAND

TE PŪTEA MATUA

Terms of Reference

Capital Review: External Experts’ Reports

May 2019

Purpose

The Reserve Bank began a review of the capital adequacy framework applying to locally incorporated registered banks in 2017. The aim of the Capital Review is to identify the most appropriate framework for setting capital requirements for New Zealand banks, taking into account how the current framework operates and international developments in bank capital requirements.

In December 2018, the Reserve Bank published a consultation paper seeking feedback on proposed higher capital requirements for New Zealand incorporated banks. This was the fourth consultation paper published during the Capital Review. In the proposal, the central change from existing regulations is an increase in the Tier 1 capital requirement to 16 percent of Risk-Weighted Assets for banks deemed Domestic Systemically Important Banks (D-SIBs) and 15 percent for all other banks. The current requirement is 8.5 percent.

Public submissions close on 17 May 2019 and will be published on the Reserve Bank website in June, alongside a summary of the submissions.

As part of the next stage of the Capital Review, the Reserve Bank is commissioning External Expert Reports to independently review the Reserve Bank's analysis and advice underpinning the Capital Review proposals.

The External Experts will look at whether all relevant considerations have been identified. The External Experts will take into account the objectives of the Capital Review, as well as the domestic context, the available literature, the international debate, and policy developments globally, relating to the role of bank capital in supporting the soundness and efficiency of the financial system.

The External Experts' Reports will be part of the suite of information considered in the final decision-making process of the Capital Review. The External Experts' Reports will sit alongside the range of papers prepared by the Reserve Bank during the Capital Review, submissions from industry and the public on proposed changes to the system, any additional analysis and advice completed during the course of the Capital Review, as well as other internal review processes.

The External Experts Reports are to review the analysis and work of the Reserve Bank, and not that of individual staff members.

Context

Since 1 January 2013, New Zealand incorporated registered banks have been required to comply with the following minimum capital ratios, which are calculated as the amount of capital that must be held in relation to risk-weighted exposures (including market and operation risk):

- A Common Equity Tier 1 capital ratio of 4.5%;
- A Tier 1 capital ratio of 6%;
- A total capital ratio of 8%.

Additionally, since 1 January 2014, a bank that does not maintain a common equity buffer ratio of 2.5% above these minimum ratios has faced restrictions on the distributions it can make.

The Reserve Bank is undertaking a comprehensive review of the capital adequacy framework applying to New Zealand incorporated registered banks. The Capital Review aims to apply an appropriate approach to setting capital requirements for New Zealand banks, taking into account how the current framework has operated and international developments in bank capital requirements. The purpose of the External Experts' Reports is to provide an external perspective on the Reserve Bank's analysis and methodology underpinning the Reserve Bank's capital proposals.

The Capital Review has been carried out within the context of New Zealand as a small open economy, with external imbalances and an economic and financial system that is disproportionately subject to external economic and financial shocks and changes in offshore sentiment:

- The New Zealand banking sector is dominated by four New Zealand incorporated banks that operate as wholly-owned subsidiaries of their Australian-owned parents, which cover around 85% of the banking system.
- The banking system obtains a sizeable share of its funding from offshore wholesale markets.
- Much of New Zealand's private debt is concentrated in the household and agricultural sectors, and has been steadily climbing over recent decades.
- New Zealand households have high debt levels, with household debt around 160% of nominal disposable income. Household debt is concentrated in housing loans from banks.

The Reserve Bank's current supervisory approach is non-intrusive and seeks to enhance self-discipline and market discipline where possible. Likewise, the New Zealand approach to supervisory review is light-handed. Where necessary, the Reserve Bank does use tools that directly constrain market choices, for example, through governance and incorporation requirements or restrictions on high loan to value ratios. This relatively non-intrusive approach is complemented by simple-yet-conservative prudential requirements. As part of the current proposals in the Capital Review, the Reserve Bank's supervisory approach would grow in intensity if a bank's capital ratio fell below 16%. The precise details of how this would work will be developed during the next stages of the Capital Review. The External Experts are asked to focus on the role of capital, given the overall prudential regime operating in New Zealand.

The Reserve Bank has powers under the Reserve Bank of New Zealand Act 1989 to impose capital requirements on registered banks through conditions of registration. The Reserve Bank exercises these powers to promote the maintenance of a sound and efficient financial system, and to mitigate against significant damage to the financial system that could result from the failure of a registered bank.

The Reserve Bank has designed and calibrated a risk appetite framework that, in conjunction with other information, contributed to its analysis of the appropriate level of capital for banks operating in New Zealand. This process has been underpinned by an evolving picture of the significant and sometimes long-lasting economic and social costs of financial system crises, and the Reserve Bank's conclusion, drawn from international research and analysis, that society is risk averse in the face of these risks.

The risk appetite framework is centred on the concept of ensuring that systemically-important banks can survive large unexpected losses – i.e. losses that have a likelihood of occurring only once in every 200 years. This is a higher degree of risk aversion than is implicitly built into the New Zealand system at the moment, reflecting the Reserve Bank's judgement that the economic and social impacts of financial crises are large and more wide-ranging than previously realised.

Minimum capital requirements help to promote the maintenance of a sound financial system and, by reducing the probability of bank failures, also help to protect the financial system from the wider costs that can arise from bank failures.

In setting capital requirements the Reserve Bank recognises the need to balance the benefits of higher capital against the costs. It is expected that a higher level of capital would reduce the probability of bank failures, and would smooth out credit cycles. Banks typically argue that capital is a costly source of funding and that if they had to operate with a higher level of capital they would seek to preserve their returns on capital by passing these higher costs on to customers, leading to reduced investment and economic growth.

Capital Review Principles

The Reserve Bank began a review of the capital adequacy framework applying to New Zealand incorporated registered banks in 2017.

The Reserve Bank has had regard to six high-level principles through the Capital Review:

1. Capital must readily absorb losses before losses are imposed on creditors and depositors.

2. Capital requirements should be set in relation to the risk of bank exposures.

3. Where there are multiple methods for determining capital requirements, outcomes should not vary unduly between methods.

4. Capital requirements of New Zealand banks should be conservative relative to those of international peers, reflecting the risks inherent in the New Zealand financial system and the Reserve Bank's regulatory approach.

5. The capital framework should be practical to administer, minimise unnecessary complexity and compliance costs, and take into consideration relationships with foreign-owned banks' home country regulators.

6. The capital framework should be transparent, to enable effective market discipline.

These principles have underpinned the analysis, advice and decisions made during the Capital Review so far.

Scope of Work

The External Experts Report will cover:

- Is the problem that the Capital Review seeking to address well specified?
- Has the Reserve Bank adopted an appropriate approach to evaluate and address the problem? For example, is the range of information considered, and the analytical approach appropriate?
- Do the inputs and cited pieces of evidence used by the Reserve Bank in its approach appropriately capture the relationship between bank capital and financial system soundness and efficiency?
- Has the analysis and advice taken into account all relevant matters, including the costs and benefits of the different options?[1]

[1] A full assessment of costs and benefits will be carried out in a Regulatory Impact Statement (RIS) as part of final decisions in the Capital Review. The material published during the Capital Review so far has included an overview of a range of costs and benefits, with the consultation papers seeking further input about costs and benefits from affected parties, and the public more widely. The External Experts Reports and consideration of all relevant information will be expected to feed into the Bank's assessment of the costs and benefits. The cost

- Have the issues raised in submissions been assessed fairly and adequately? The External Experts will only consider the Reserve Bank's assessment of issues raised in the submissions on the first three consultation papers.[2]
- Have the key risks been adequately considered across the proposals in the Capital Review?
- Was the advice and analysis underpinning the Capital Review reasonable in the New Zealand-specific context?

The Capital Review has generated internal analysis covering a wide range of issues. This analysis has formed the basis of four public consultation papers and a much larger number of internal reports. This analysis has covered all aspects of the capital requirements, including the definition of capital ("the numerator"), the calculation of risk-weighted assets ("the denominator") and the capital ratio itself.

The Report should cover all aspects of the review that the External Reviewers consider relevant, however, the Reserve Bank is particularly interested in the following two topics:

- the definition of what qualifies as regulatory capital in the New Zealand system, and
- the overall calibration of capital requirements, including the assessment of costs and benefits.

The Reserve Bank has made background information relating to the proposals publicly available on its website:

https://www.rbnz.govt.nz/regulation-and-supervision/banks/consultations-and-policy-initiatives/active-policy-development/review-of-the-capital-adequacy-framework-registered-banks

Out of Scope

The Reserve Bank is not seeking information from the External Experts that covers:

- Undertaking new modelling exercises focused on estimating the impacts of alternative capital proposals. However, reviewers should identify whether there are developments in modelling, or other analytical exercises, that have not been appropriately considered during the Capital Review.
- An assessment of other prudential regulation tools, such as deposit insurance or the Reserve Bank's approach to supervision.

These topics are important but the Reserve Bank is not seeking information from the External Experts on these topics:

- For the first point, the External Experts are asked to focus on whether the overall approach taken was reasonable given the range of different sources of evidence drawn on during the Capital Review, not whether the exact capital ratio is "right" or whether alternative model specifications would generate a different number. The External Experts should also consider whether other relevant information or analysis has been overlooked.
- For the second point, Phase 2 of the Reserve Bank Act Review is considering these issues. Phase 2 is a wide-ranging review of the financial policy provisions of the

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and benefit assessment will be finalised alongside final Capital Review decisions.

[2] Submissions on the fourth consultation paper close on 17 May and will be considered by the Reserve Bank during the next stages of the Capital Review. The Reserve Bank has not yet assessed or responded to the issues raised in the consultation that closes on 17 May.

Reserve Bank of New Zealand Act that provide the legislative basis for prudential regulation and supervision. Phase 2 of the Reserve Bank Act Review will also consider broader governance arrangements for the Reserve Bank. Work on Phase 2 is being led by a joint review team of Reserve Bank and Treasury staff.[3]

Any lack of clarity about the scope should be clarified with the Reserve Bank as soon as possible.

Deliverable

Each reviewer will complete their own independent report, to be provided for the consideration of the Reserve Bank Governor and Deputy Governor, and the Reserve Bank Board. The reports will be an input into final decisions made in the Capital Review.

Each reviewer should provide an independent view and produce their own report. The Reserve Bank will not attempt to consolidate the reports – each Expert's Report will be considered as a separate stand-alone report.

The Reserve Bank will publish the External Experts' Reports prepared by each Expert (but not draft reports).

Proposed Contract

The Reserve Bank intends to use a New Zealand Government Model (Services) Contract (GMC) for contracting with each External Expert. The GMC reflects the New Zealand Government's default terms and conditions of contract. The GMC is in two parts – GMC Form 2 SERVICES (2nd edition) and GMC Form 2 SERVICES – Schedule 2 (2nd edition). These are available at https://www.procurement.govt.nz/procurement/templates/#government-model-contract-templates

Reviewers will be asked to declare any possible conflicts of interest, and how these will be managed, prior to commencing their contract.

Consultation

It is not expected that the External Experts will carry out extensive consultation as part of their work. Any external consultation should be agreed in advance with the Reserve Bank.

Timing

The final reports should be provided to the Reserve Bank by the end of August 2019. A draft report should be provided by 15 July 2019.

[3] https://treasury.govt.nz/news-and-events/reviews-consultation/reviewing-reserve-bank-act/phase-2-reserve-bank-act-review