

## Financial Stability Oversight Committee Paper for Decision 2.1

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<b>Approved by</b>	Angus McGregor, Acting AG/GM Financial Stability
<b>Date</b>	3 April 2025
<b>Subject</b>	Review of key capital settings: Project plan and terms of reference
<b>For</b>	Decision
<b>Value(s)</b>	Integrity/Tauira   Innovation/Wānanga
<b>Strategic Theme(s)</b>	Strengthening efficiency and competition, Promoting understanding and trust

### 1. Purpose

This paper seeks approval from FSOC of the scope and timing of the recently announced review of key capital settings.

The proposed a scope meets the objective of announcing substantive policy positions within six months for public feedback and reaching final decisions by the end of year, provided that:

- the scope and deliverables are agreed, and there is no scope creep;
- there is no additional policy and legal work added to the work programme;
- the governance structure proposed is endorsed;
- we proceed with engagement of international experts promptly and there is adequate availability; and
- we carefully manage external and internal stakeholders' input and expectations; including through regular and structured communications.

### 2. Recommendations

That FSOC:

1. **Note** that on 27 March 2025 the Board delegated authority to FSOC to approve the terms of reference for the review of key capital settings.
2. **Approve** the Deputy Secretary, Macroeconomics and Growth from the Treasury being invited to future FSOC meetings on this review as an observer.
3. **Approve** the:
  - a. terms of reference set out in **Appendix 1**;
  - b. the approach to communications set out in paragraphs 4.18-4.20; and
  - c. the criteria for appointing and the next steps in the selection and procurement of international experts set out in paragraphs 4.24-4.27.

### 3. Background

3.1 In 2019, decisions were made to amend our capital adequacy framework following the 2017-2019 review (the **2019 Capital Review**). A multi-year work programme is currently underway to implement the Deposit Takers Act 2023 (the **DTA**). A Capital Standard will be required under the DTA to replace the existing prudential capital requirements for banks and NBDTs.

3.2 On 27 March the Board approved the Reserve Bank undertaking a review of regulatory capital settings for deposit takers, with this to be announced publicly at hearing of the Finance and Expenditure Committee's (**FEC's**) inquiry into banking competition on 31 March. At the meeting, the Board delegated to FSOC decisions around scope, methodology, timing, and the use of external international experts.

### 4. Discussion

4.1 **Appendix 1** sets out a draft terms of reference for the review of key capital settings for your feedback. This paper provides additional information about our proposed approach.

#### Purpose

4.2 We propose that the terms of reference set out that the purpose of the review is to assess whether the Reserve Bank's prudential capital requirements for deposit takers are set at the optimal level to effectively meet the Reserve Bank's financial stability objective.

4.3 This reflects the need to reassess our capital settings in light of developments since the 2019 Capital Review and the new information/evidence presented through submissions on the Capital Standard, the Commerce Commission market study, and the FEC banking inquiry. This includes developments in some other jurisdictions' capital settings.

#### Scope

4.4 The proposed scope in the terms of reference is focused on key elements of the capital framework where stakeholders have raised concern. Specifically:

- An assessment of key developments since the 2019 Capital Review, including findings of the Commerce Commission's market study into personal banking services, the Finance and Expenditure Committee's inquiry into banking competition and developments in regulatory and supervisory settings.
- An assessment of how our capital settings compare internationally and a consideration of whether our capital settings are appropriate, given the risks that the New Zealand financial system faces.
- A reassessment of the appropriate risk appetite for capital settings in New Zealand.
- Reviewing the degree of proportionality in the framework and considering any changes in capital ratios for different groups of deposit takers.
- Considering the balance between going concern and gone concern capital (including the share of CET1), the appropriateness of any Total Loss Absorbing Capacity (TLAC) requirements, and if we should continue to have 'Additional Tier 1 capital' as part of the

New Zealand capital framework. It will also consider the interrelationship between capital and the crisis management framework.

- Utilise international experts to undertake research that will inform the options, review the Reserve Bank’s options and recommendations, and support the Reserve Bank’s decision makers in reaching decisions.

**4.5** This builds on existing work to review options for more granular risk weights for residential mortgages and corporate (including rural) lending; and lending for housing for community housing providers, housing co-operatives and whenua Māori.

**4.6** We propose keeping the review targeted by not rebuilding analytical frameworks, having some targeted exclusions and seeking to minimise the impact on areas that require detailed technical drafting in the Capital Standard. This should help provide certainty sooner and meet the requested timeframe. It also limits the impact on the drafting process of the rest of the Capital Standard and avoids substantively pushing back the implementation of the DTA.

**4.7** Therefore, we propose the following elements are out of scope:

**Table 1: Out of scope topics**

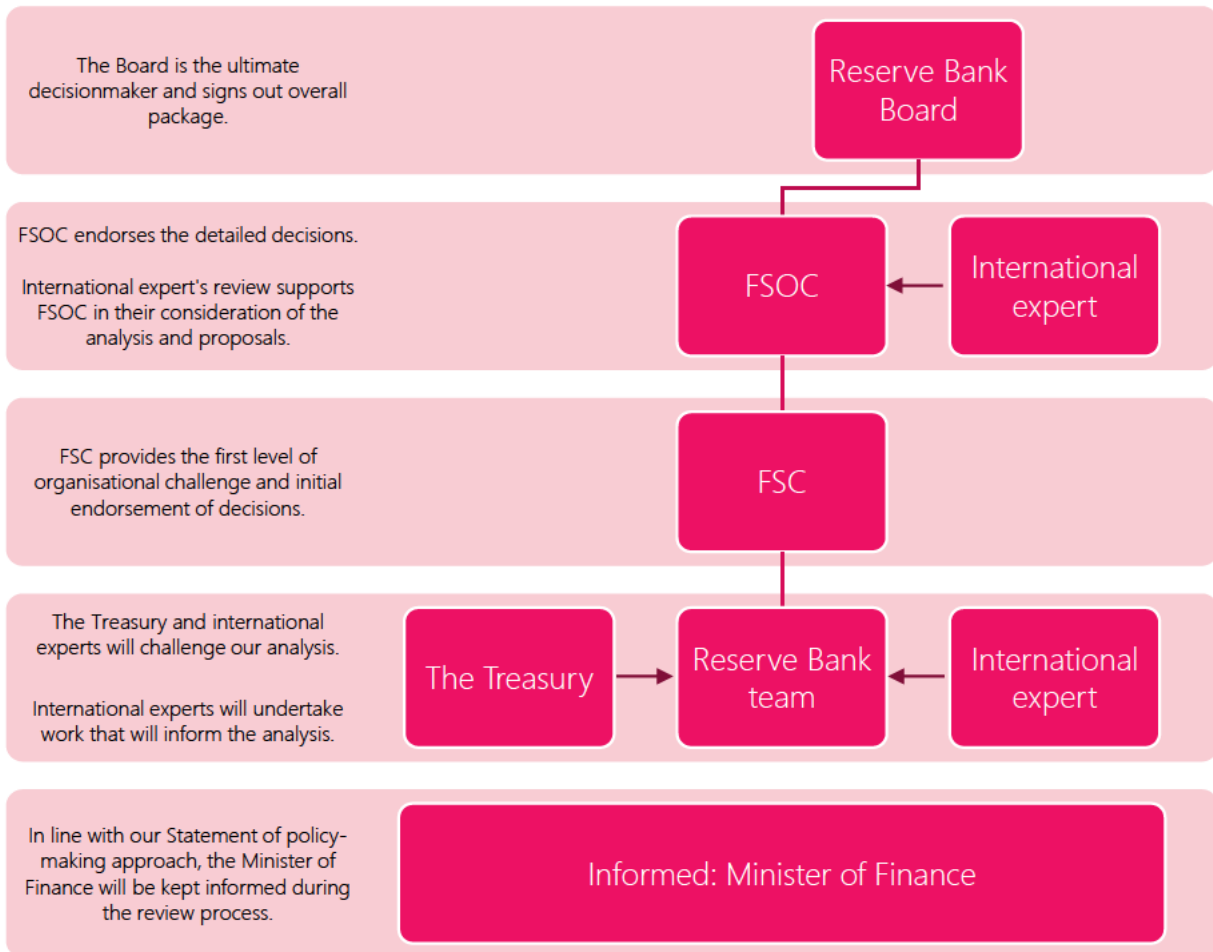
Out of scope	Rationale
Rebuilding the analytical framework used to assess evidence on costs and benefits of capital	While we will be informed by reviewing new evidence (including that submitted to FEC) and assessing the key developments since the 2019 review, a full first-principles rethink of our analytical approach or underlying evidence is not achievable in the timeline. If there are specific assumptions underpinning the analytical approach that have materially changed since the original review, we will revisit these as time permits.
The use of internal ratings-based (IRB) modelling	We want to maintain incentives for good credit risk management and modelling, so propose the option of removing the option of IRB modelling (or removing the possible benefits by having a 100% output floor) is out of scope. Changes to the output floor, scalar and domestic-systemically important bank buffer – which help determine the difference between the IRB and standardised approach – are in scope.
Detailed redesign of existing capital instruments	Excluding the detailed redesign of existing capital instruments avoids significant market disruption and risk to the delivery of the DTA Capital Standard exposure draft.  Removing AT1 as an instrument is in scope, as is the possibility of adding TLAC as an instrument. Any adoption of a TLAC requirement or other changes to capital instruments would be done in a phased way at a later date, to allow the capital standard to progress.
Changes to risk weights beyond the scope of current review	We are already looking at the majority of lending. We only collected data on key areas. Current scope already addresses key concerns raised by the Minister of Finance, Commerce Commission and stakeholders.

Out of scope	Rationale
Role of the Counter-cyclical Capital Buffer (CCyB)	Nothing has changed our view on the benefits of having a CCyB. There is international consensus and stakeholder support for having a CCyB.
Climate, financial inclusion, fintechs, CBDC, detailed changes consulted on in DTA consultation beyond the core calibration.	We propose to exclude these matters to avoid scope creep and keep the review targeted.

## Roles and responsibilities

4.8 Figure 1 provides an overview of roles and responsibilities for the review.

Figure 1: Overview of roles and responsibilities



4.9 The Treasury has various roles which inform its interests in prudential regulation: it is the steward of the Reserve Bank's institutional framework, lead advisor to the government on economic and financial performance and is responsible for management of risks to the Crown balance sheet.

4.10 In the Memorandum of Understanding between the Treasury and the Reserve Bank states that "the Treasury will provide second opinion advice to the Minister on prudential regulation and supervision where this impacts on the wider economy" and that "the Treasury and Bank

*may undertake joint work in areas of joint interest which may include areas such as the financial stability framework and crisis resolution policy issues".*

- 4.11** Therefore, we intend to work closely with the Treasury, especially on issues related to crisis management such as bail-in and considerations of the appropriate risk appetite for capital settings - given the impacts and risks to the Crown balance sheet. We intend to have weekly catchups with the Treasury, and share emerging thinking and findings of the international experts with them. We have sought their high-level feedback on the Terms of Reference and reflected it in this paper.
- 4.12** At your meeting on 27 March, you expressed an interest in inviting the Deputy Secretary, Macroeconomics and Growth from the Treasury to be an observer for the FSOC discussions on capital. We can follow up on this if you wish to proceed with this approach.
- 4.13** We intend to provide roughly monthly updates to the Minister of Finance on progress of the review. Any decisions that are required from the Minister of Finance to support elements of the review, for example legislative changes needed for crisis management, will be sought on a case-by-case basis. The Treasury has recommended that we give the Minister of Finance an opportunity to comment on the terms of reference before they are finalised.
- 4.14** We will consult Council of Financial Regulator colleagues before reaching final decisions of the review.

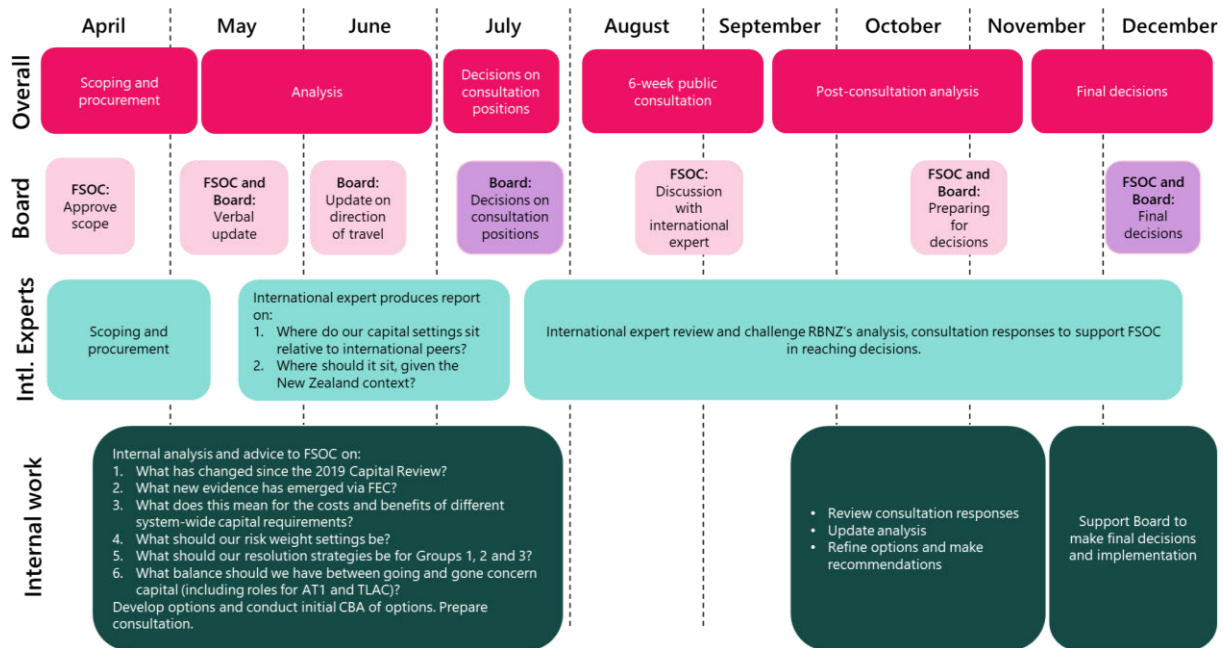
## Timeline

- 4.15** Figure 2 below proposes a timeline for the review over 2025. It allows for a short public consultation (6 weeks) and delivery of final decisions before the end of the year.<sup>1</sup> We think this balances the need to move quickly with the need to hear from our stakeholders to ensure the outcomes are credible. It also ensures there is adequate time to engage international experts. The Treasury supports public consultation to maximise benefits from the review for legitimacy of the settings and institutional framework.
- 4.16** We intend to have standing items at FSOC meetings in 2025 to provide updates on the review and test FSOC's comfort with our policy direction. We will also engage with the Board on key policy issues. We will ensure the Board is appropriately engaged ahead of decision-making meetings by seeking feedback at the indicated Board meetings and/or via Te Kete papers.

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<sup>1</sup> On 27 February, the Board agreed to consult on implementation of the CCyB. We initially intend to publish the consultation document in March. However, given we are reviewing our broader capital settings, we delayed publication. We now intend to consult alongside the wider consultation on capital settings. The wider capital consultation will also cover some detailed settings for market risk and risk weights to support the development of the Capital Standard.

Figure 2: Timeline for the reassessment of key capital settings



4.17 Concurrently, the team will:

- Progress the drafting of all unaffected aspects of the Capital Standard. Following decisions in late 2025, the Capital Standard drafting will be finalised and the exposure draft released for consultation in mid-2026.
- Support the Government and Parliamentary Counsel Office to update non-bank deposit taker regulations, to allow for the early adoption of key capital settings for Group 3 deposit takers (as requested by the Minister of Finance).<sup>2</sup> We will also update the current Banking Prudential Requirements for Group 1 and Group 2 deposit takers.

### Communications approach

4.18 At a high level our communications plan is focussed on transparency, credibility, and engagement, emphasising the independence and expertise of the internal reviewers. At the same time, we will reinforce our commitment to inclusivity, accountability, and best practice in carrying out this work.

4.19 Our tone will be clear, professional and reassuring – positioning the review as a positive step forward in our transparency while proactively addressing stakeholder concerns.

4.20 Some key deliverables from this plan include:

- Establishing a webpage to act as the main update mechanism for the review (which will include the finalised terms of reference and be updated following key decisions).
- Providing an overview of the review in the upcoming May Financial Stability Report.

<sup>2</sup> See the 12 March memo from Jess Rowe and Nick McBride titled 'Update on Ministerial advice on prudential matters'.

- Carrying out a 6-week public consultation, with supporting webinars with stakeholders to gain further feedback.
- Publishing the views of international experts we commission to support transparency and credibility.

## Resourcing

### Internal

- 4.21** Internally, the work will be resourced by reprioritisation within the Prudential Policy Department. We are in the process of setting up a core team of around 6 FTEs to work on the capital reassessment. We will also ensure there are 1.5 FTEs progressing the Capital Standard to limit knock on implications for the DTA timeline, and assign 1 FTE to progressing the changes in the NBDT regulations.
- 4.22** In order to achieve this, we have paused work on a range of work that is lower priority and is able to be re-sequenced. The details of this will be included in the annual prudential policy work programme report considered by FSOC and provided to the Board.
- 4.23** We anticipate that we will need to delay the intended date for issuing some of the DTA standards, with potential flow on implications for the wider DTA implementation programme. We are working through the details for the implementation programme and will provide an update to the Board when we seek decisions on the non-core standards in June. We do not anticipate that this will impact on the ultimate legislative backstop, but may require a shift to the current July 2028 go live date.

### International experts

- 4.24** We propose engaging two international experts. We propose they have two main roles:
- **Produce credible independent reports.** In particular, on where New Zealand's current requirements sit relative to comparable jurisdictions' capital requirements and should sit relative to other countries based on our risk profile and how risk has changed since the 2019 Capital Review.
  - Act as **independent advisers** across the team's analysis, options and recommendations – providing challenge and supporting FSOC and the Board in reaching decisions.
- 4.25** The three international experts that provided independent analysts of the 2019 Capital Review cost approximately \$200,000 (not including travel and other costs). We estimate that it will cost at least as much as last time for two international experts to provide independent analysis as part of this review. However, this cost may increase given the tight procurement timeframe, and if a third expert is needed in order to meet the deliverables within the agreed timeline.
- 4.26** We need people with a deep understanding of the banking system, regulation, and policy. To ensure that the contributions of the experts are seen as credible to stakeholders we are looking for internationally recognised experts. Appendix 2 sets out a long list of possible candidates, which we are continuing to work on and can provide an oral update at the

meeting. We seek your feedback on this list and welcome additional suggestions or feedback on candidates you recommend we prioritise contacting.

**4.27** We propose the following high-level considerations that we will use to prioritise the contacting and shortlisting of potential candidates:

- **Professional capability and credibility.** Demonstrated by senior academic and regulatory experience, and strong references. An ability to provide robust and challenging perspectives to support the credibility of the review.
- **Strong interpersonal skills, ability to work under pressure, time constraints and deal with differences of views in a pragmatic and constructive way, including in situations with high ambiguity.**
- **Diverse perspectives and experience.** Ability to provide a wide range of perspectives, and knowledge of approaches in different jurisdictions. Expertise in the effects of regulation on competition, innovation, economic efficiency – as well as financial stability.
- **Independence and objectivity.** In particular, avoiding people with overly strong, entrenched policy positions, whilst recognising that the academic and regulatory experience that makes someone suitable for this role may have seen them express some views on relevant matters in the past.
- Availability during the required time period.
- Cost that can be managed within the budget.
- Confirmation that there are no conflicts of interest.

## 5. Next Steps

Following FSOC's feedback, the team will:

- Send the finalised terms of reference to the full Board via a Te Kete paper.
- Begin procurement of international experts and test their availability.
- Begin analytical work as set out in the scope in **Appendix 1**, subject to FSOC's feedback.

As outlined in Figure 2 above, we will keep FSOC and the Board involved as the review progresses.

## Appendix 1: Draft Terms of Reference

### Purpose

The purpose of the review of key capital settings is to assess whether the Reserve Bank's prudential capital requirements for deposit takers are set at the optimal level to effectively meet the Reserve Bank's financial stability objective.

### Approach

The review will be informed by relevant findings of the Commerce Commission's market study into personal banking services and the Finance and Expenditure Committee's inquiry into banking competition.

We will consult publicly on key proposals. Responses to this consultation process, alongside a cost and benefit analysis and the use of independent international experts, will inform decisions made by the Reserve Bank Board.

As we consider feedback and options under this review, we will operate consistently with our legislative requirements (e.g. the purposes and principles of the Deposit Takers Act 2023), including having regard to the Financial Policy Remit and the Proportionality Framework.

### Scope

This is an evidence-based review that will build on existing work to review options for more granular risk weights for residential mortgages and corporate (including rural) lending; and lending for housing for community housing providers, housing co-operatives and whenua Māori.

To achieve the purpose within the stated timeframe, the review will be limited to:

- An assessment of key developments since the 2019 Capital Review, including findings of the Commerce Commission's market study into personal banking services, the Finance and Expenditure Committee's inquiry into banking competition and developments in regulatory and supervisory settings.
- An assessment of how our capital settings compare internationally and a consideration of whether our capital settings are appropriate, given the risks that the New Zealand financial system faces.
- A reassessment of the appropriate risk appetite for capital settings in New Zealand.
- Reviewing the degree of proportionality in the framework and considering any changes in capital ratios for different groups of deposit takers.
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## Appendix 2: Long-list of possible international experts

International expert

Short bio

9(2)(a)

International expert

Short bio

9(2)(a)

International expert

Short bio

9(2)(a)

International expert

Short bio

9(2)(a)