Reserve Bank of New Zealand
Te Pūtea Matua

Proportionality Framework

For Developing Standards Under the Deposit Takers Act

31 July 2023

CONSULTATION PAPER

Contents

Submission Contact Details

The Reserve Bank of New Zealand – Te Pūtea Matua invites submissions on this consultation paper by 5pm on 25 September 2023. Please note the disclosure on the publications of submissions below.

Address for Submissions and Enquiries

Email

dta@rbnz.govt.nz

Subject line: Proportionality Framework Submission

Hard Copy

Shoko Seta
Prudential Policy Department
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

Publication of Submissions

Your submission will be published on the Bank's website.

All information in your submission will be published unless you indicate good reason for withholding it (e.g. to protect the privacy of an individual).

If you would like information in your submission withheld, you should provide a copy of your submission suitable for publication. The copy should be identical to your submission except for the redaction of the text to be withheld. You should ensure any redacted text is not recoverable.

Your submission may be made available to a person under the Official Information Act 1982. The Bank will consider any reasons you have provided for withholding information in your submission in its decision whether to make that information available.

The Bank may also publish on its website an anonymised submissions summary.

Executive Summary

In this consultation paper, the Reserve Bank of New Zealand – Te Pūtea Matua (the Reserve Bank) sets out its proposed proportionality framework – that is, how we balance the costs and benefits of prudential standards for different groups of deposit takers, based on their assets – as required by the Deposit Takers Act 2023 (the Act). The draft framework itself has been published alongside this consultation paper.

Under the Act, the Reserve Bank will regulate and supervise deposit takers within a single regulatory regime. Deposit takers comprise a range of entities including banks, building societies, credit unions and finance companies. These entities are currently regulated separately as banks and licenced non-bank deposit takers (NBDTs) under separate regulatory regimes.

The Act Modernises the Regulatory Regime for Deposit Takers

The Act provides a single, coherent framework for regulating and supervising both banks and non-bank deposit takers. The main purpose of the Act is to promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy *by protecting and promoting the stability of the financial system.*

A sound and well-functioning financial system provides a public benefit shared by society in much the same way that physical infrastructures – such as roads, water, and power systems – provide benefits felt much more widely than by individual users of these networks.

The Act represents increased expectations on the Reserve Bank and deposit takers to ensure the financial system is sound and well-functioning, so that New Zealanders can be confident that the deposit takers they rely on are robust.

Operating within the system comes with responsibilities. Deposit takers must meet minimum standards, so that financial stability is not compromised. However, this does not mean the Reserve Bank will take a 'one-size-fits-all' approach to prudential regulation. Taking a proportionate approach – that is, balancing the costs and benefits of regulation – is important, as it means the public can benefit from a safe, sound, and stable deposit-taking sector, but also one that can be diverse, innovative, and inclusive.

The Proportionality Framework Sets out Our Approach When Developing Standards

The Act requires the Reserve Bank to publish a proportionality framework setting out how it takes into account the proportionality principle when developing standards under the Act. The proportionality framework will assist us to consistently and transparently balance the costs and benefits of regulation in relation to different types of deposit takers, when tailoring requirements in the standards.

Consistent with the legislative requirements, the purpose of our framework is to group similar deposit takers together by carefully considering these factors:

- the size and nature of business of different deposit takers;
- their relative importance to the stability of the financial system; and

- the extent to which a range of regulatory requirements are necessary or desirable to promote the safety and soundness of each deposit taker.

We define proportionality for developing standards as looking at either the strength and/or the comprehensiveness of standards. We will calibrate the strength and/or comprehensiveness of standards based on the purpose of the Act and the appropriate principles.

We propose grouping deposit takers into three broad categories based on their total assets to simplify the process of tailoring standards in a proportionate manner. However, we intend to retain a degree of flexibility in the treatment of individual deposit takers – for example, to account for firm-specific risks faced by particular deposit takers.

The three broad categories proposed are outlined in the table below.

Group	Types of deposit takers	Likely application of standards
Group 1	The Domestic Systemically Important Banks (D-SIBs)	Comprehensive prudential requirements
Group 2	Most other locally-incorporated banks	Enhanced prudential requirements
Group 3	Mostly non-bank deposit takers (NBDTs)	Baseline prudential requirements

The Application of the Framework to Prudential Standards will be Key

While the framework signals the broad approach to standard setting, it does not provide specific details of how any particular standard will apply. The next phase of work is the application of the framework in developing specific standards, e.g., on capital, liquidity, and governance. It is the calibration of these specific standards – using the criteria outlined in this framework – that will have the most meaningful impact on deposit takers.

There is a significant forward work programme to develop, consult on and issue new prudential standards. This will commence in 2024 following the finalisation of the proportionality framework. We look forward to on-going input and engagement from stakeholders as we begin to develop the standards themselves.

This will Not Represent an Overall Lowering of Prudential Standards

The framework will not represent an overall lowering of prudential requirements compared to existing regulatory requirements. There will be minimum standards to ensure the safety and soundness of each deposit taker.

For most existing banks (Groups 1 and 2) it is likely that standards will be designed and tailored in a similar way to the current Banking Prudential Requirements, amended as necessary to take into account the new legislative framework under the Act and the shift in expectations on the Reserve Bank as a modern prudential regulator. For non-bank deposit takers (Group 3) in some cases requirements will be strengthened under the Act relative to the status quo. This reflects the overall shift to a more intensive regulatory and supervisory regime in New Zealand, which has been underway since the IMF's Financial Sector Assessment Program (FSAP) report in 2017.[1] It also reflects the forthcoming introduction of the Depositor Compensation Scheme (DCS), which socialises the cost of entity failures.

Some deposit takers may need to modify their business model to meet the minimum standards. Others may need to assess their viability in line with operating in a well-regulated competitive marketplace.

Give Us Your Feedback and Shape the Proposed Framework:

We are seeking your feedback on our proposed framework and any relevant information by 5pm on 25 September 2023. Details on how to make a submission can be found on page two of this document. Your feedback and information will help us to shape the final version of the framework, which we intend to publish by March 2024. The finalised proportionality framework will inform the development of the standards under the Act.

1 New Zealand: Financial Sector Assessment Program: Financial System Stability Assessment (imf.org)

1 Introduction

In this consultation paper, the Reserve Bank of New Zealand – Te Pūtea Matua (the Reserve Bank) sets out its proposed proportionality framework. The draft framework itself has been published alongside this consultation paper. The framework outlines how we propose to take a proportionate approach when developing standards under the Deposit Takers Act 2023 (the Act).[2] Our proposal clarifies that we do not intend to take a one-size-fits-all approach when designing standards.

The draft framework itself has been published alongside this consultation paper. The contents of this consultation paper correspond with those in the framework paper. Corresponding sections in the framework are stated at the beginning of each section in the consultation paper below.

Legislative Background

Under the Act, the Reserve Bank will regulate, supervise and set standards for all deposit takers within a single regulatory regime. Deposit takers comprise a range of entities including banks, building societies, credit unions and finance companies. These entities are currently regulated separately as banks and licenced non-bank deposit takers (NBDTs) under separate regulatory regimes.

The main purpose of the Act is to protect and promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy by protecting and promoting the stability of the financial system (section 3(1)). To that end, the Act has the following additional purposes:

- promote the safety and soundness of each deposit taker (section 3(2)(a));
- promote public confidence in the financial system (section 3(2)(b));
- avoid or mitigate the adverse effects of risks:
    - to the stability of the financial system;
    - from the financial system that may damage the broader economy (section 3(2)(c)); and
- to the extent not inconsistent with the above purposes, support New Zealanders having reasonable access to financial products and services (section 3(2)(ba)).

The Act also sets out a number of decision-making principles that the Reserve Bank must take into account (as relevant) in achieving the purposes of the Act. One principle is the desirability of taking a proportionate approach to regulation and supervision ('proportionality principle').

2 The Deposit Takers Act and its updates are available here. rbnz.govt.nz/about-us/responsibility-and-accountability/our-legislation/proposed-deposit-takers-act

The Act requires us to prepare, consult on, publish, and keep up to date a proportionality framework setting out how we will take into account the proportionality principle when developing standards. In preparing the framework, the Act requires us to have regard to the size, nature, and relative importance to financial stability of each different kind of regulated entity, and the extent to which a range of different requirements are necessary to promote the safety and soundness of each deposit taker.

Relevant sections of the Act are replicated in Annex 2.

The Act requires the proportionality framework to be published within nine months of royal assent. Once the proportionality framework is finalised, it will inform the development of the standards applicable to deposit takers that are incorporated and carrying out business in New Zealand. We plan to start consultation from 2024 on the core standards needed for licensing - Capital, Liquidity, DCS and Disclosure. Consultation on other standards will follow.

2 Our Proposed Proportionality Framework

2.1 Proportionality Framework Aims to Balance the Costs and Benefits of Standards While Promoting the Purposes of the Act

Please read this section along with Section 2 of the accompanying framework paper.

What do We Want to Achieve with the Proportionality Framework?

Taking a proportionate approach is a part of good regulatory practice. The Reserve Bank already takes a proportionate approach in the design of our prudential policies recognising that deposit takers differ in their size, the nature of their business, and their relative importance to financial stability (i.e., systemic importance).

As outlined above, the Act formalises this approach both by requiring the Reserve Bank to:

- take into account the proportionality principle when exercising the Reserve Bank's functions, powers and duties and pursuing its main and additional purposes; and
- publish this proportionality framework setting out how we will take into account the proportionality principle when developing standards.

The proportionality framework will assist us in providing consistency and transparency in our proportionate approach. That is, we balance the costs and benefits of regulation so that the public can benefit from a safe, sound, and stable deposit-taking sector, but also one that can be diverse, innovative and inclusive.

What does Proportionality Actually Mean?

The concept of proportionality can have different meanings or interpretations in different contexts.

In the context of prudential regulation, the Bank for International Settlements (BIS) has articulated that effective proportionate approaches strive to be both conservative and simple to understand and implement. Similarly, the Bank of England has described its approach to applying proportionality in prudential regulation as 'strong and simple'.[3]

The BIS reinforced the proportionality concept in its review of Core Principles in 2011. The revised Core Principles acknowledge the benefits of a regulatory approach that is proportionate to the risk profile and systemic importance of a broad spectrum of entities, ranging from large internationally active banks to small, non-complex deposit-taking institutions.[4]

The approach of BIS and the Bank of England is broadly in line with our current approach to prudential regulation in New Zealand. For example, we exempt some smaller non-bank deposit takers from the requirement to have a credit rating, but an exempted entity must maintain a higher capital ratio than NBDTs who have a credit rating. Under our capital adequacy framework, we also allow smaller entities to calculate their risk-weighted assets using simplified methodologies, but we require them to use more conservative multipliers to compensate for the simplification.

3 CP 5/22 The Strong and Simple Framework: a definition of a Simpler-regime Firm (bankofengland.co.uk)
FS1/21 – 'Responses to DP1/21 'A strong and simple prudential framework for non-systemic banks and building societies' | Bank of England
4 bis.org/basel_framework/standard/BCP.htm

Scope

We will use our proposed proportionality framework as a guide for developing standards for deposit takers that are incorporated and licenced to carry out business in New Zealand.

Branches of overseas-incorporated deposit takers will be subject to a different set of standards. Standards for branches will be designed and tailored separately.

The Reserve Bank also takes a proportionate approach to regulatory supervision. Our supervisory approach is developed separately from the proportionality framework proposed in this consultation paper which is required to focus on the design of standards. Our Statement of Prudential Policy outlines our risk-based approach to prudential supervision.[5]

1

Consultation question

Do you have any comments on our interpretation of the meaning of proportionality?

2

Consultation question

Do you have any comments on the proposed scope of the proportionality framework?

2.2 Tailoring Standards into Baseline, Enhanced and Comprehensive

Please read this section along with the Sections 2.1 and 3 of the accompanied framework paper.

What Dimensions do We Consider When Tailoring Requirements?

For tailoring requirements under the proportionality framework, we propose to look at either or both of these two dimensions:

- strength (e.g., higher vs lower capital requirements); and/or
- comprehensiveness (e.g., using detailed and precise vs simple and approximate methodologies to calculate capital ratios).

These dimensions will assist us to tailor individual standards consistently, subject to necessary case by case variations. In addition, these dimensions can guide us in considering which standards should apply to which entities. In general we expect that the majority of our standards will apply to all deposit takers, with the design of individual standards tailored in a proportionate manner. However, there may be cases where particular standards are not needed for certain deposit takers or groups of deposit takers e.g., due to their small size and/or business model.

We intend the proportionality framework to balance the costs and benefits of regulations in relation to different size and business of deposit takers. We therefore propose to classify deposit takers into three groups based on their size and business model, and then tailor requirements for each group. Our method for identifying the three groups is described in more detail below, but in broad terms the three groups comprise:

5 Our Statement of Prudential Policy - Reserve Bank of New Zealand - Te Pūtea Matua (rbnz.govt.nz)

- Group 1: the Domestic Systemically Important Banks (D-SIBs),
- Group 2: most other locally-incorporated banks, and
- Group 3: mostly current non-bank deposit takers (NBDTs).

We have termed the regulations likely applicable to each group as ‘Comprehensive’, ‘Enhanced’ and ‘Baseline’, respectively.

What Factors do We Consider When Tailoring Standards?

When we adjust the strength and comprehensiveness of individual standards to balance the costs and benefits of regulations, we will consider the elements below to achieve the purposes of the Act and factor in the appropriate principles:

- **The systemic importance of the deposit taker** (sections 3(2)(b) and (c))
- **The need to promote the safety and soundness of each deposit taker** (section 3(2)(a))
- **The need to promote public confidence in the financial system** (section 3(2)(b))
- **The need to support New Zealanders having reasonable access to financial products and services,** to the extent this is not inconsistent with our financial stability objectives (section 3(2)(ba))
- **Deposit takers’ operational complexity and ability to comply with comprehensive prudential requirements** (sections 3(2)(ba) and 4(a))
- **The business model and risk profile of the deposit taker** (sections 3(2)(a), (b), and (c)).

Group 1 deposit takers (the D-SIBs) are large, systemically important and interconnected with other financial service providers. They also have high capacity to manage detailed comprehensive regulatory requirements. All six of the elements above are relevant, which means that prudential requirements applicable to Group 1 would be tailored towards the higher end in both the strength and comprehensiveness dimensions.

Group 2 deposit takers mostly comprise medium and smaller sized domestic banks. They are less systemically important compared to D-SIBs, but have the potential for sectoral or regional importance and/or servicing specific markets. They are likely to have moderate capacity to manage detailed comprehensive regulatory requirements. For the smaller banks in Group 2, systemic importance is likely to be relevant primarily in terms of potential concentration in the relevant sector, region or market served. However, even smaller deposit takers can pose contagion risks for the wider financial sector during a crisis. Overall, the requirements for Group 2 may not need to be as strong across the board as those for Group 1, and can be slightly simpler. This is evident in our existing regulatory framework, for example Group 1 D-SIBs are required to hold higher capital than Group 2 banks.

Group 3 deposit takers are mostly current non-bank deposit takers (NBDTs) and very small banks. Current NBDTs consist of building societies, credit unions and finance companies. Their systemic importance is much less than deposit takers in the other Groups. They have lower operational capability to manage detailed requirements or to absorb additional regulatory burden. However, they still play an important role, along with larger deposit takers, in serving New Zealanders and promoting access to a diverse range of financial services.

Because of their role in society and the economy, regardless of size, all deposit takers need to be safe and sound, and all promote public confidence in the financial system (i.e. the second and third elements in the list above). The prudential requirements applicable to Group 3 therefore still need to meet prudential baselines. We do not intend to dilute prudential baseline requirements relative to the status quo, and in some areas requirements are likely to be strengthened under the new standards. We would however make every effort to simplify requirements for Group 3 deposit takers. This includes examining which requirements are relevant to the nature of the business of Group 3 deposit takers.

In some cases, simpler requirements in some areas may need to be offset by increased strength in others. For example, we currently require deposit takers who are exempt from obtaining a credit rating to hold more capital. Also, the current deposit taker regulations for NBDTs require higher risk weights for assets that are categorised in a simplified way, and a higher flat surcharge for operational risk calculated based on credit risk. BIS's "High-level considerations on proportionality" provides further hypothetical examples such as de-risking.[6]

What does That Mean for the Deposit-Taking Sector?

For most existing banks (Groups 1 and 2) it is likely that standards will be designed and tailored in a similar way to the current Banking Prudential Requirements, amended as necessary to take into account the new legislative framework under the Act. In some areas (e.g. governance and resolution practices) requirements may be strengthened or clarified under the Act relative to the status quo.

For non-bank deposit takers (Group 3) requirements are likely to be strengthened overall under the Act relative to the status quo. This reflects the overall shift to a more intensive regulatory and supervisory regime in New Zealand, in line with the statutory purposes under the Act. It also reflects the forthcoming introduction of the Depositor Compensation Scheme (DCS)[7], which socialises the cost of entity failures. Some deposit takers may need to modify their business model to meet the minimum standards. Others may need to assess their viability in line with operating in a well-regulated competitive marketplace.

3

Consultation question

Do you have any comments on our proposed three tier grouping approach for designing proportionate standards?

4

Consultation question

Do you have comments on the relevant factors we have identified for tailoring standards proportionately?

6 BIS's "High-level considerations on proportionality" bis.org/bcbs/publ/d534.pdf

7 The DCS provides each eligible depositor up to $100,000 for their covered deposits in New Zealand dollars at each deposit-taking institution. Further information can be found on the Reserve Bank's website.

Box 1: Indicative examples – Liquidity Requirements

This section intends to provide an indicative design example of prudential requirements that may potentially be applicable to deposit takers in the future.

As part of our ongoing Liquidity Policy Review (LPR), we are considering whether to move to the Basel liquidity metrics that are now widely used internationally – the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). The alternative would be to retain our existing metrics, the Mismatch Ratio (MMR) and Core Funding Ratio (CFR). These issues are discussed in the second consultation paper (C2) for the LPR.[8]

Our proposed assessment framework in C2 is designed to support a proportionate approach. It consists of four steps:

Step 1: Apply the most appropriate metrics to our domestic systemically important deposit takers (D-SIBs) – i.e. Group 1 deposit takers under our proposed proportionality framework.

Step 2: Assess the appropriateness of those D-SIB metrics for the remaining locally incorporated banks (Group 2 deposit takers under our proposed proportionality framework). For example, if we adopt the LCR and NSFR for D-SIBs, we could decide to either require Group 2 deposit takers to also adopt these metrics, or retain the existing MMR and CFR metrics for this group.

Step 3: Apply proportionate (simplified) metrics to smaller deposit takers, which we expect may include some/all NBDTs (or Group 3 under our proposed proportionality framework). It should be noted that our LPR principles state that 'we do not wish to see an overall material weakening in liquidity requirements relative to the qualitative and quantitative liquidity requirements currently in place'.

Step 4: Check that the outcomes of steps 1-3 are consistent with the LPR principles.

C2 sets out potential examples of simplified quantitative liquidity requirements that could be applied to smaller deposit takers.

2.3 We Group Deposit Takers Based on Total Assets and then Fine Tune

Please read this section along with Sections 4.1 to 4.3 of the accompanying framework paper.

What Metrics are Used?

We propose to use a deposit taker's total assets[9] as the basis for classifying deposit takers into groups. We propose this approach as our analysis found the size of a deposit taker's total assets to be a simple and transparent indicator of sophistication, complexity of business, interconnectedness and systemic importance. A simple and transparent measure will help deposit takers to easily foresee prudential requirements and plan for their future growth.

8 Liquidity Policy Review Consultation Paper #2 (Significant Policy Issues) (rbnz.govt.nz)

9 The sum of all assets of the deposit taker. Assets of a deposit taker represent the amounts owed by debtors or economic resources it owns, at a specific point in time. Assets will comprise various types of resources like cash, securities and loans and can also include intangible assets like goodwill and trademarks. We would use Reserve Bank held data sourced from the Bank Balance Sheet Survey and the Non-bank Deposit Takers Survey to calculate the total assets for each deposit taker.

We also examined whether a more complex set of indicators could be used to capture sophistication, operational complexity, interconnectedness with other financial institutions, operational capacity, and systemic importance. However, our analysis found that the grouping of deposit takers was overall very similar in either a simple asset-based approach or a more complex approach. This was because the total asset measure is so influential across the current spread of the deposit taking sector. Therefore, we propose to use the simple and transparent measure of total asset size.

BIS's "*High-level considerations on proportionality*" also guides us that, when the criteria used for grouping are simple to understand and calculate, the grouping framework is more effective, robust and transparent.

How are Thresholds Set Between Groups?

Placing thresholds requires an element of judgement. Our proposed thresholds are placed at 'natural breakpoints' after ranking all deposit-takers based on total assets. Natural breakpoints are noticeable and there are distinct gaps between deposit takers' total assets. The distinct gap helps to prevent frequent transitions from one group to another.

We found two 'natural breakpoints' in the ranking, thereby creating these three groups:

- **Group 1 –** Those deposit takers with total assets of NZ$100 billion or more;
- **Group 2 –** Those deposit takers with total assets of NZ$2 billion or more, but less than NZ$100 billion; and
- **Group 3 –** Those deposit takers with total assets less than NZ$2 billion.

As noted earlier, these groups largely align with current D-SIBs, most remaining locally-incorporated banks and NBDTs.

We also considered whether more than three groups should be established. However, we consider that an additional group would increase a deposit taker's regulatory costs to transition between different sets of requirements without providing any additional benefits in terms of how standards are likely to be tailored between groups.

When designing the standards, we will consider each group separately and tailor standards accordingly. However, it is not necessarily the case that all standards will be tailored into three different tiers. For example, some standards could apply the same requirements to deposit takers in Groups 1 and 2 combined, or to Groups 2 and 3 combined. The desirable or necessary level of requirements will be assessed when we tailor each individual standard.

Furthermore, some standards are likely to use a principles-based approach rather than a rules-based approach, or combination of the two. In circumstances where we use a principles-based approach we might apply the same prudential requirements to all deposit takers. An example of a principle-based requirement in relation to risk management could be "a firm must ensure that its risk management framework is adequate, effective and appropriate for the scale and nature of its business". By design, principles-based requirements can allow for a proportionate approach to each individual deposit taker.

Finally, it is important to note that the framework is not applied rigidly. The Reserve Bank is required to retain some discretion to consider individual cases on their merits and to deal with firm-specific risks.

Our proposed grouping approach is not an unusual approach within the context of other regulatory regimes in New Zealand. For example, the Financial Reporting Act 2013 also uses groups for setting requirements for financial reporting standards.

We Aim for Smooth Transition Between Groups and Reasonable Foreseeability

In allocating deposit-takers to groups, we propose to use average total asset size over a period of time of at least one year. This will help deposit takers smoothly transition between groups and have reasonable foreseeability of their future regulatory requirements.

We assessed the stability of the resultant groups by changing the data lengths used to calculate average asset size. We found that a one-year average was the minimum length of period needed to smooth out monthly/quarterly fluctuations in total assets.

We are however open to use longer periods than one year to increase industry's predictability for their smooth transition between groups. We are seeking feedback on this point from stakeholders.

We Fine Tune Applicable Requirements for Better Matches

We aim to provide reasonable foreseeability of applicable requirements. We however also need to acknowledge that none of the deposit takers is identical. Therefore, there may be circumstances where a deposit taker's risk profile does not match with the requirements applicable to its allocated group based on its asset size (refer to Box 2 for example).

To deal with firm-specific circumstances, we propose that our proportionality framework will retain flexibility to fine tune requirements. Variations to prudential requirements for individual deposit takers could be actioned in three ways:

- **Variations to standard requirements incorporated as a part of the design of individual standards.** In such circumstances a standard may prescribe the circumstances in which a variation may be applied.
- **Variations to licence conditions for individual deposit takers.** Where either the standard requirements or the variations described above are not appropriate for a particular individual deposit taker, a variation may be applied through a condition of license. This could include variation of requirements for individual standards or lifting a deposit taker into a higher group for all requirements. We expect situations such as this to be rare, but it is important we do not fetter our discretion.
- **'Opt-in' to higher prudential requirements.** There may also be circumstances where a deposit taker assesses that it is desirable to opt into higher prudential requirements (for example, due to their growth strategy or the nature of their business model). In such circumstances, in addition to the transition arrangements outlined, a deposit taker could also choose to opt in to the standards applied to a higher group. Such an opt-in would be reflected as a variation of a condition of license.

5

Consultation question

Do you have any comments on our proposed approach to grouping deposit takers? In particular we would welcome comments on the following:

- the metric for establishing groups (total assets of a deposit taker);
- the basis for assessing this metric (average total assets over a one year period);
- the thresholds for each of the groups;
- the situations for applying variation from the grouping approach.

Box 2: How will We Manage Firm Specific Circumstances?

There are advantages and disadvantages of our proposed 'total assets'- based grouping approach. The approach is simple, consistent, and transparent. However, in some specific circumstances it could provide less flexibility with respect to addressing firm-specific risks. Firm-specific risks could include an exposure to certain assets or sectors, the ownership of a deposit taker and its jurisdiction, or a deposit taker's governance structure (for example). The example below illustrates how such a situation would be addressed through our proposed approach to variations from a group-based design of standards.

A specific example could be a deposit taker who falls within Group 3 (under the asset-based metric) and has significant exposure to interest rate or exchange rate movements. NBDTs are not currently required to use the actual size of risks in relation to these types of market movements when calculating their minimum capital levels. If the same approach were to be adopted for Group 3 under the new capital standard, the capital calculations may not be appropriate for a deposit taker with significant exposure to these market risks. However, we may not want to adjust requirements for all Group 3 deposit takers if only a single deposit taker or a small subset of deposit takers are exposed to these firm-specific risks.

We have considered two possible options to deal with this type of scenario:

- **Option 1: variations to standard requirements incorporated as a part of the design of individual standards.** In this option, the capital standard could be designed to specify specific additional metrics to identify a Group 3 deposit taker that has significant exposure to interest rate or exchange rate movements. For example, if a deposit taker had more than a certain percentage of interest rate exposures, the deposit taker that met this criterion could then have more comprehensive requirements put in place to manage their specific risks (which could be aligned with the requirements of group 2). This option would allow the requirements applicable to most Group 3 deposit takers to be simpler.

- **Option 2: Variations to licence conditions for individual deposit takers.** In this option, the capital standard could be designed to specify requirements only for the full group (i.e. not tailored for specific scenarios as outlined in option 1). In this circumstance, the way in which the deposit taker's specific exposure to interest rate movements could be addressed would be to apply specific requirements to that deposit taker as a condition of license. This option would also allow the requirements applicable to most Group 3 deposit takers to be simpler.

The choice between which of these two approaches is most appropriate will vary depending on the specific issue and standard involved.

2.4 Transition Arrangements for New and/or Growing Deposit Takers

Please read this section along with the Section 4.4 of the accompanied framework paper.

We expect that some deposit takers may need to transition between Groups, when their size changes due to business growth or reorganisations. We also expect new deposit takers to enter the market, and mergers or acquisitions may happen from time to time. This section outlines our proposed mechanism for transition and new entrants.

We think it is desirable that requirements applicable to individual deposit takers change only gradually. This helps prevent unnecessary adjustment costs and uncertainty for deposit takers. It will also ensure that deposit takers are subject to adequate standards regardless of where they are in their growth cycle.

We therefore propose that in such circumstances deposit takers should be given an appropriate period of time to transition to higher standards that may apply to a new group. Our approach of using a multi-period average will help to increase predictability for deposit takers about any forthcoming transition. Should change be required, the implementation of any new prudential requirements will be completed consistent with the requirements outlined in relevant standards and/or in agreement with supervisors.

Deposit takers could also opt into higher prudential requirements (not lower requirements), if they have sufficient capability to be subject to the requirements. We could also consider transition arrangements (e.g. a gradual transition starting from several requirements and expanding scope through years), and a mechanism for transitioning deposit takers to remain in their new group for a reasonable period of time before any further movement including swinging back to their previous group.

Prospective new deposit takers will be assigned to a group based on their existing asset base. If they have not yet generated sufficient data for us to determine their group, we might use their business plans submitted to the Reserve Bank as part of their license application. We would look into prospective new deposit takers' anticipated size after an initial period of growth, and how they expect to meet regulatory requirements. For example, new entrants often incur losses during their start-up period, and need capital from owners in order to meet those losses and regulatory requirements as the balance sheet grows. As part of that licensing discussion, the Reserve Bank would likely determine the group the new deposit taker will be in after an initial growth period and consider whether the deposit taker has a realistic path to compliance with those regulatory requirements.

6

Consultation question

Do you have comments on our proposed approach for transitioning deposit takers between groups?

7

Consultation question

Do you have any other elements that you think we should clarify in the proportionality framework?

3 Next Steps

Consultation on this framework closes on 25 September 2023. We plan to publish the finalised framework and resultant grouping on the Reserve Bank's website by March 2024. The finalised framework will inform the development of the standards. We plan to consult on the standards following finalisation of the proportionality framework. The standards can be divided into core standards, which are needed for licensing purposes, and other standards. We plan to consult on core standards in the first instance. The core standards include those relating to capital, liquidity, disclosure and Depositor Compensation Scheme (DCS).

Annex 1: Financial Policy Remit

The Minister of Finance issued the Financial Policy Remit (FPR) on 30 June 2022. It emphasises that the Minister of Finance considers a strong, efficient and inclusive financial system, with a low incidence of failure of regulated entities, is desirable. It also signals that the Board of the Reserve Bank should have regard to a competitive financial system and have regard to Government priorities on climate change, financial inclusion, cyber resilience and supporting sustainable house prices in the circumstances outlined in section 49 of the Reserve Bank of New Zealand Act 2021.

This table shows how we have had regard to the Financial Policy Remit in the policy proposals in this Consultation Paper. The full text of the Remit is available on the website of the New Zealand Gazette.[10]

Component of the Financial Policy Remit	Summary of analysis and relevance to proposals in this paper
"It is desirable to have a financial system that is strong, efficient and inclusive, with a low incidence of failure of entities regulated by the Reserve Bank."	Our proposed proportionality framework is intended to provide for the consistent application of standards for deposit takers of a similar size and nature of business, while: • allowing for a range of different requirements that may be necessary or desirable to promote the safety and soundness of each deposit taker, and; • having regard to the relative importance to financial stability of different deposit takers. Standards will be tailored based on the proportionality framework balancing the costs and benefits of varying the strength and/or comprehensiveness of requirements. This underpins our prudential regulation to maintain and promote a strong, efficient and inclusive financial system, with a low incidence of failure of regulated entities.
"Within the appetite of a low incidence of failure, a competitive financial system should be encouraged so as to best ensure ongoing financial efficiency and inclusion."	While the proportionality framework itself will not prescribe how individual standards balance the costs and benefits of the relative strength and/or comprehensiveness of a prudential requirement, it will allow individual standards to be tailored consistently to meet the purposes of the Act and the FPR. This in turn will help to ensure ongoing financial efficiency and inclusion. Low probability of deposit-takers getting into trouble with the minimum standards increases the likelihood that people can stably access, and have trust in, the products and services they rely on. Also, standards can be designed to help deposit takers wind down in an orderly manner, which would help to prevent a deposit taker (particularly one providing a critical service to their customers) from abruptly ceasing service provision, resulting in the disconnection of their customers from the financial system (financial inclusion). This

10 The text of the Financial Policy Remit is available here in the NZ Gazette: gazette.govt.nz/notice/id/2022-go2497

Component of the Financial Policy Remit	Summary of analysis and relevance to proposals in this paper
	would also help open up space for new entrants and for more-efficient deposit takers to grow (financial efficiency).
"imposing regulatory and supervisory costs that are proportionate to the expected risks and benefits to the financial system and society"	This component is addressed directly by the proportionality framework itself. The proportionality framework classifies deposit takers based on the risks that deposit takers pose to the financial system and society, and is intended to ensure consistent design of individual standards having regard to the benefits of deposit takers to the system and society.
"encouraging new investment and financial innovation that raise the productive potential of the economy"	The proportionality framework allows for individual standards to be calibrated according to the risks and benefits that deposit takers bring to the financial system and society. This helps in the design of regulation so as to avoid imposing excessive compliance costs, and opens up capacity for deposit takers (including new entrants) to explore new investment and financial innovation.
"encouraging the allocation of financial resources in a way that maximises the sustainable long-term growth of the New Zealand economy"	Based on the proportionality framework, individual standards can be designed to encourage the allocation of financial resources in a way that maximises the sustainable long-term growth of the New Zealand economy.
Sustainable house prices	This component is of low relevant importance to the design of the proportionality framework.
Building resilience and facilitating adaption to climate change	This component is of low relevant importance to the design of the proportionality framework.
Improving financial inclusion	Proportionate tailoring of prudential requirements can support financial inclusion by avoiding a one-size fits all approach in favour of a framework that is more suitable for smaller deposit takers. Provided they meet minimum standards, this better ensures small deposit takers have a role in the sector. In turn, this supports financial inclusion if those deposit takers serve a particular sector of New Zealanders not served by larger deposit takers.
Improving cyber resilience	This component is of low relevant importance to the design of the proportionality framework.

Annex 2: The Statutory Framework

The Deposit Takers Act 2023 (the Act) requires the Reserve Bank to prepare, consult, publish and keep up to date a proportionalty framework. It also sets out that proportionality principle and the proportionality framework needs to be considered in the context of the purposes and relevant principles in the Act. Relevant sections of the Act are replicated below.

3 Purposes

(1) The main purpose of this Act is to promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy by protecting and promoting the stability of the financial system.

(2) To that end, this Act has the following additional purposes:

- (a) to promote the safety and soundness of each deposit taker:
- (b) to promote public confidence in the financial system:
- (c) to the extent not inconsistent with **subsection (1)** and **paragraphs (a), (b),** and **(d),** to support New Zealanders having reasonable access to financial products and services provided by the deposit-taking sector:
- (d) to avoid or mitigate the adverse effects of the following risks:
  - (i) risks to the stability of the financial system:
  - (ii) risks from the financial system that may damage the broader economy.

4 Principles to be taken into account under this Act

In achieving the purposes of this Act, the Bank must take into account the following principles that are relevant to the performance or exercise of the functions, powers, and duties conferred or imposed on the Bank:

- (a) the desirability of—
  - (i) taking a proportionate approach to regulation and supervision; and
  - (ii) consistency in the treatment of similar institutions; and
  - (iii) the deposit-taking sector comprising a diversity of institutions to provide access to financial products and services to a diverse range of New Zealanders:
- (b) the need to maintain competition within the deposit-taking sector:
- (c) the need to avoid unnecessary compliance costs:
- (d) the desirability of maintaining awareness of, and responding to,—
  - (i) the practices of overseas supervisors that perform functions in relation to any licensed deposit taker or any holding company of any licensed deposit taker; and
  - (ii) guidance or standards of international organisations:
- (e) the desirability of ensuring that the risks referred to in **section 3(2)(d)** are managed (including long-term risks to the stability of the financial system):
- (f) the desirability of sound governance of deposit takers:
- (g) the desirability of deposit takers effectively managing their capital, liquidity, and risk:
- (h) the desirability of depositors having access to timely, accurate, and understandable information to assist them to make decisions relating to debt securities issued by deposit takers.

77 Bank must prepare and publish framework for taking proportionality principle into account when developing standards

(1) The Bank must—

(a) prepare and keep up to date a proportionality framework; and

(b) publish a copy of the framework on the Bank’s Internet site.

(2) The proportionality framework must set out how the Bank takes into account, or proposes to take into account, the principle under **section 4(a)(i)** when it is developing standards.

Guidance note

The principle under **section 4(a)(i)** relates to the desirability of taking a proportionate approach to regulation and supervision.

(3) When preparing the proportionality framework, the Bank must have regard to the following:

(a) the size and nature of the businesses of different deposit takers:

(b) the extent to which a range of different requirements are necessary or desirable to promote the safety and soundness of each deposit taker:

(c) the relative importance of different deposit takers to the stability of the financial system.

(4) Before publishing the proportionality framework, the Bank must consult the persons, or representatives of the persons, that the Bank considers will be substantially affected by the framework.