8 May 2012

LETTER TO CHIEF EXECUTIVES OF LOCALLY INCORPORATED NEW ZEALAND BANKS

Basel III implementation in New Zealand - update

The purpose of this letter is to update you on the Reserve Bank's implementation of Basel III in New Zealand.

We have now completed two Basel III consultations. The November 2011 consultation was on capital ratios, the definition of capital, and the leverage ratio. The March 2012 consultation was on the operation of the conservation buffer; the countercyclical buffer; and minimum requirements to ensure that all classes of capital instruments fully absorb losses at the point of non-viability ("loss absorbency"). The March consultation paper also proposed transitional arrangements and set out interim arrangements for new capital instruments issued prior to our Basel III standards being finalised.

We appreciated the response to both consultations from banks and other submitters. While we have yet to consider all issues arising through the consultation process, we have recently taken decisions on some key elements of Basel III. These decisions took into account submissions received and developments in APRA's Basel III proposals. We consider it is important to communicate these decisions now to assist banks with their Basel III capital planning. Details of these decisions are provided in the appendix to this letter.

Many of the submissions received argued that the Reserve Bank's Basel III requirements should align more closely with APRA's planned standards. Our approach to Basel III implementation is guided by a set of principles that includes a principle to coordinate with APRA. While this is an important principle, it is not the only principle and we also intend to adapt the Basel III standards as necessary to ensure a suitable fit for New Zealand conditions. Also, where the Basel III standards are less conservative than our existing standards, our prior is to retain our existing standards. However we have taken into account concerns raised in submissions and have concluded that, on balance, more alignment with APRA is appropriate in some areas.

Overall, we are adopting almost all of the Basel III standards and in doing so are generally well aligned with APRA's proposals in most areas. The two most notable departures from the Basel standard and from APRA's requirements are:

- Our intention not to impose a minimum "one-size-fits-all" leverage ratio.
- Earlier implementation of the conservation and countercyclical buffer (this departure is explained in the appendix).

We plan to release a full summary of submissions and the Reserve Bank's response, together with a cost benefit analysis in a few weeks time. Changes also need to be made to the Banking

Supervision Handbook to incorporate our Basel III policy. We plan to release proposed changes in July for consultation, and will invite submissions at that stage.

I am sending this letter to all locally-incorporated New Zealand banks. Also, in order to keep other stakeholders informed, a copy of the letter will be available on our website from 9 May 2012.[1]

Yours sincerely

Toby Fiennes
Head of Prudential Supervision

[1] The Basel III page on our website is: http://www.rbnz.govt.nz/finstab/banking/4572979.html.

Appendix

This appendix provides a summary of recent decisions taken by the Reserve Bank on Basel III requirements. The main reason for communicating these decisions now is to assist banks with their Basel III capital planning. These decisions – along with our response to other issues raised by submitters, and the details of how we propose to apply our Basel III policies - will be incorporated into the Reserve Bank's proposed changes to the Banking Supervision Handbook, and we will invite submissions on these proposed changes.

<u>Call-ability of additional Tier 1 instruments.</u>

One of the Basel III criteria for Additional Tier 1 (AT1) instruments is that they may be callable at the initiative of the bank after a minimum of five years (subject to various conditions). In our November 2011 consultation paper we proposed not to adopt this criterion as doing so would represent a lowering of our standards given we do not allow Tier 1 shares to be redeemable.

After taking into account submissions we now plan to adopt the Basel III criterion and allow AT1 instruments to be callable at the initiative of the bank after a minimum of five years, subject to the conditions set out in the Basel III framework as follows:

i) To exercise a call option a bank must receive prior supervisory approval;
ii) A bank must not do anything which creates an expectation that the call will be exercised; and
iii) Banks must not exercise a call unless:
   a. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank; or
   b. The bank demonstrates that its capital position is well above the minimum capital requirement after the call option is exercised.

In coming to this decision we took into account that the conditions set out above are tighter than our current requirements and once adopted will, in our view, provide sufficient prudential safeguards in respect of callable instruments.

<u>Operation of the capital conservation buffer.</u>

In our March 2012 consultation we proposed that a bank operating within the buffer must <u>fully</u> restrict distributions to the extent necessary to restore the buffer. This differs from the Basel III standard that envisages only <u>partial</u> restrictions on distributions unless a bank's common equity tier 1 ratio is as low as 5.125%. We also proposed to restrict distributions to the extent they would result in a bank moving into the buffer.

Most submissions commented on this proposal and did not agree with our proposal to depart from the Basel III standard. Submitters consider that our proposal was too restrictive and were concerned about the impact of the proposal on the market for additional tier 1 instruments.

We remain of the view that a bank operating within the buffer should restore the buffer as soon as possible. However we accept that in many circumstances banks will be incentivised to do so through market discipline. While there may be merit in *requiring* banks to restore the buffer as soon as possible, on balance, we accept the concerns raised by industry and now intend to adopt the Basel III 'partial restriction' requirements without modification.

The Reserve Bank remains of the view that prudent management of staff bonuses is appropriate when banks are operating within the conservation buffer.

Loss absorbency at the point of non-viability.

In the March 2012 consultation paper, we proposed to adopt the Basel III requirements that ensure all forms of regulatory capital are capable of absorbing losses to support the viability of a distressed bank. In particular we proposed to require banks to convert into common equity all non-common equity regulatory capital instruments upon the occurrence of a trigger event.

Taking into account submissions received and further development of APRA's plans in this area, we now plan to require either write-off or conversion of non-common equity regulatory capital instruments upon the occurrence of a trigger event. We need to undertake further work on the details of the loss absorbency requirement, but we note submitters' concern that requirements be compatible with APRA's requirements if possible.

Transitional arrangements.

In the March 2012 consultation paper, we proposed a three-year phase-out for existing capital instruments that are not recognised under Basel III. Some banks consider more time is needed to replace non-qualifying instruments. Also we note that APRA are now prepared to adopt the Basel III transitional arrangements for capital instruments issued out of subsidiaries and held by third parties, and that these arrangements are relevant to some capital instruments issued by New Zealand banks.

We therefore intend to adopt the following timetable for de-recognition of all non-qualifying capital instruments issued by New Zealand banks.

Year commencing	Percentage of instruments that may be included in regulatory capital
1 January 2014	80
1 January 2015	60
1 January 2016	40
1 January 2017	20
1 January 2018	0

We also intend to require that instruments with call and step-up on or after 12 September 2010 and before 1 January 2013 will not be recognised for transitional arrangements from 1 January 2013, and instruments with a call and step-up after 1 January 2013 be fully derecognised from the date the call and step-up apply.

In the March 2012 consultation paper, we proposed implementation of the capital conservation buffer in full from 1 January 2014. We intend to retain this requirement. In coming to this decision the Reserve Bank took into account: that banks are reasonably well placed to meet this requirement; that for some banks the phase-out decisions noted above will make it easier to comply with the 1 January 2014 date; and our long-held expectation that unless there are good reasons to delay we will implement elements of Basel III ahead of the Basel Committee's timetable as some other jurisdictions are planning.

Interim arrangements.

The interim arrangements relate to new instruments issued prior to our Basel III standards being finalised. Consistent with our March 2012 consultation paper we are prepared to allow newly issued instruments to qualify for transitional arrangements in certain circumstances, but a shorter phase-out period will apply in the event they do not comply with our final standards. We have now adjusted the details of these arrangements, mainly as a consequence of the new transitional timetable described above.

In particular, capital instruments issued prior to release of our final Basel III standards may qualify for grand-parenting (in the event they are not compliant with our final standards) on the following basis:

- The Reserve Bank determines, on a case-by-case basis that the instrument can qualify for grand-parenting (taking into account the consistency of the instrument's characteristics with the Basel III framework).
- If the instrument is not consistent with our final Basel III standards, the grand-parenting arrangement that will apply is that it will be recognised in 2013, partly recognised in 2014 (80%) and not recognised from 2015 onwards.
- Banks will be permitted to call instruments issued during the interim period that do not qualify with our final standards.