Consultation Paper:

Implementation of Basel III capital adequacy requirements in New Zealand

The Reserve Bank invites submissions on this Consultation Paper by 27 January 2012.

Submissions and enquiries about the consultation should be addressed to:

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Please note that a summary of submissions may be published. If you think any part of your submission should properly be withheld on the grounds of commercial sensitivity or for any other reason, you should indicate this clearly.

November 2011

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Background

1. In December 2010 the Basel Committee on Banking Supervision (the Basel Committee) released the new global regulatory standards for bank capital adequacy and liquidity as endorsed by G20 leaders at their November 2010 summit.[1] These standards are commonly known as Basel III standards.[2]

2. The Basel III standards for bank capital distinguish between *Tier 1* and *Tier 2* capital. Tier 1 capital is permanently and freely available to absorb losses without the bank being obliged to cease trading, while Tier 2 capital generally only absorbs losses in a winding up. Within Tier 1 capital, Common Equity Tier 1 (CET1) has greater loss absorbing capability than the other Tier 1 instruments referred to as Additional Tier 1 (AT1) capital.

3. Capital ratios are used to define minimum capital requirements for each of: common equity, tier 1 capital (CET1 plus AT1), and total capital (tier 1 plus tier 2), as a percentage of risk-weighted assets. Table 1 below contains the ratios set out in the Basel III standards.

Table 1: Basel III capital ratio requirements
(as a percentage of risk weighted assets)

	Common equity	**Tier 1 capital**	**Total capital**
New minimum ratios	4.5%	6.0%	8.0%
Conservation buffer	2.5%		
New minimum ratio plus conservation buffer	7.0%	8.5%	10.5%

[1] The Basel III package is available on the website of the Bank of International Settlements here: http://www.bis.org/publ/bcbs188.htm.

[2] Where this document refers to 'Basel III standards' or 'Basel III', it is referring the Basel Committee's new regulatory standards for bank capital adequacy. For the purposes of this document the 'Reserve Bank's standards' or 'our requirements' refer to our capital adequacy requirements for locally incorporated banks and in particular the documents "Capital Adequacy Framework (Standardised Approach) – BS2A" and "Capital Adequacy Framework (Internal Models Based Approach) – BS2B" that are part of the Reserve Bank's Banking Supervision Handbook.

4. The key comparisons between our current requirements and Basel III capital standards outlined above are:
   - The total minimum capital requirement remains unchanged at 8%.
   - The Tier 1 minimum capital requirement has increased from 4% to 6%.
   - The quality of Tier 1 capital has increased – a larger portion of common equity is required (CET1), and the criteria for inclusion in Tier 1 capital have been tightened.
   - The quality of Tier 2 capital has increased – the criteria for inclusion in Tier 2 capital have been tightened.
   - Basel III requires that most capital deductions be applied to CET1 rather than 50% from Tier 1 and 50% from Tier 2 as is often the case under Basel II.

5. Within Basel III a new measure called the conservation buffer is being introduced to ensure banks maintain a buffer of capital over the minimum ratio requirements that can be used to absorb losses during periods of financial and economic stress. While banks will be able to draw on this buffer during such periods of stress, constraints on earnings distributions will be applied as their capital ratios get closer to the minimum requirement (excluding the buffer).

6. A countercyclical buffer of common equity is also introduced and to be implemented according to national circumstances. The purpose of this buffer is to achieve the broader macro-prudential goal of protecting the banking sector from periods of extraordinary excess aggregate credit growth.[3] For any given country, it is expected that this buffer will only be in effect when there is excess credit growth that results in a system-wide build up of risk.

7. In addition to strengthened quality of the capital base, Basel III strengthens rules for the calculation of risk-weighted assets, primarily in the area of counterparty credit risk. Basel III also includes minimum requirements to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss.[4]

8. The new capital requirements are supplemented by a non-risk based leverage ratio, initially calibrated at 3 percent for Tier 1 capital. This leverage ratio is intended to serve as a backstop to the risk-based measures.

9. Basel III also incorporates new disclosure requirements.

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[3] The Basel Committee envisages that jurisdictions are likely to only need to deploy the countercyclical buffer on an infrequent basis, perhaps as infrequently as once every 10 to 20 years.

[4] The Basel III minimum requirements to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss were released by the Basel Committee in January 2011 and are available on the website of the Bank of International Settlements here: http://www.bis.org/press/p110113.htm

Reserve Bank implementation of Basel III

10. This consultation paper sets out the Reserve Bank's proposals for implementing core Basel III capital measures relating to capital ratios, the definition of capital and the leverage ratio. The Reserve Bank welcomes comments on these proposals by 27 January 2012.

11. The Reserve Bank intends to consult on other elements of Basel III capital in 2012. This will include a policy on restrictions that apply to banks operating within the Basel III 'conservation buffer', as well as the countercyclical buffer and counterparty credit risk requirements. The Reserve Bank has yet to reach a position on the Basel III minimum requirements designed to reduce potential tax-payer losses noted in paragraph 7 above, but expects to form a view on this in 2012. The Reserve Bank will also consult on any Basel III related changes to its disclosure requirements in 2012.

12. We expect New Zealand's locally incorporated banks to be relatively well positioned to meet the proposals set out in this paper. However, further information from banks will provide us with greater clarity on this matter. The Reserve Bank therefore requests that locally incorporated banks complete and submit a quantitative impact assessment of the proposals as set out in Appendix E.

13. Following this consultation we will draft new capital adequacy requirements taking into account submissions received, and plan to release these draft requirements for consultation in the first quarter of 2012. Further changes to capital adequacy requirements may also be necessary once the other elements of Basel III are consulted on in 2012.

14. Our starting position is that the proposals in this consultation paper will take effect from 1 January 2013, rather than being phased in over a period of time from 1 January 2013 as the Basel Committee contemplates, unless there are compelling reasons for a phased approach.[5]

15. The remaining sections of this paper set out the Reserve Bank's proposals in relation to the core Basel III capital measures. In developing these proposals the Reserve Bank has been guided by the following main principles:[6]

    - Adoption of the Basel III standards as a starting point, except where the standards are not appropriate for New Zealand circumstances.

[5] Our expectation that we would implement Basel III ahead of the Basel Committee's timeline was noted in the May 2011 edition of the *Financial Stability Report* (chapter 6).

[6] The May 2011 edition of the *Financial Stability Report* (chapter 6) set out the general principles that the Reserve Bank would use to guide its implementation of Basel III. The principles noted above are the same in substance but are narrower in scope as they relate only to the core Basel III capital measures.

- Where the Basel III standards are less conservative than our existing standards, retain existing standards.
- Have regard to international consistency and comparability (especially consistency with Australia), subject to the other principles above.

Capital ratios

16. The Reserve Bank's initial cost benefit analysis of the Basel III capital ratios suggests that tightening existing requirements to the Basel III standards is easily justified. Our analysis took into account the key benefit of higher capital requirements (a reduction in the expected cost of a banking crisis, including fiscal cost), and the potential costs of higher capital requirements including the impact on bank lending rates. The Reserve Bank is proposing to adopt the Basel III minimum ratios and the conservation buffer as set out in Table 1 above.

17. Our proposal to adopt the Basel III minimum ratios was made in the context of ongoing instability in international financial markets and plans by some other jurisdictions to adopt more conservative ratios. We have not ruled out revisiting our decision at a later time if the net benefits of more conservative ratios become more compelling although we have no plans to move beyond the minimum ratios at this point.

Definition of capital

18. As noted above there are three components of capital within the Basel III framework. This section addresses each component separately and also separately discusses regulatory adjustments.

Common equity Tier 1 capital

19. The Basel III definition of CET1 capital consists of the sum of the following elements:
    - Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes, or the equivalent for non-joint stock companies;
    - Share premium resulting from the issue of instruments included in CET1;
    - Retained Earnings;
    - Accumulated other comprehensive income and other disclosed reserves;
    - Common shares issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in CET1(i.e. minority interests); and
    - Regulatory adjustments applied in the calculation of Common Equity Tier 1 capital (see separate section below).

Common shares

20. The Basel III requirements set out a list of 14 criteria that instruments must meet for inclusion as common shares. These criteria are set out in Appendix A. The Reserve Bank proposes to adopt all but the last two of these criteria. Our reasoning for the two exceptions is set out in the table below.

Criteria	Comment
(13) It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.	This requirement could result in a process problem if a New Zealand subsidiary bank needed to recapitalise in a crisis situation. We therefore propose not to adopt this criterion as it is not appropriate for New Zealand circumstances.
(14) It is clearly and separately disclosed on the bank's balance sheet.	We plan to review our disclosure requirements in response to Basel III as a separate exercise.

21. Our existing requirements do not permit recognition of the part of partially paid in shares that has been paid in (i.e. our requirements recognise only fully paid up ordinary shares). Our view is that because such funds have been paid in and are available to absorb losses, they should be recognised. This view is consistent with Basel III requirements and while in theory adopting this approach would represent a relaxation of our standards, we do not expect this tidy-up would have any material impact.

Share premium

22. Following changes made to corporations law with the enactment of the Companies Act 1993, share premiums are no longer recognised in New Zealand. However, since there could be some share premium accounts outstanding, we propose to retain recognition of share premium.

Retained earnings

23. We propose to retain recognition of retained earnings in CET1. Basel III allows national discretion on audit, verification and review procedures with regard to the interim profit or loss included in retained earnings.

24. Our existing standards require retained earnings recognised in Tier 1 capital to be audited or reviewed. In effect this means that 'on-quarter' retained earnings can be recognised in tier 1 (because on quarter disclosure information is required to be audited) but that 'off-quarter' retained earnings cannot be recognised in tier 1. We consider that this creates an unnecessary distinction between the recognition of off-quarter retained earnings and the other off-quarter elements included in CET1. We therefore propose to alter our existing requirements and no

longer require retained earnings to be audited or reviewed as a condition of recognition in CET1.

Accumulated other comprehensive income and other disclosed reserves

25. The Basel III standards permit accumulated other comprehensive income and other disclosed reserves to be counted towards CET1. The Reserve Bank proposes to recognise these items, except where current treatment of these reserves is more conservative than Basel III. The Reserve Bank proposes to continue to recognise in CET1 cumulative gains and losses on cash flow hedges which have been recognised directly in equity if the cash flow hedge is against an available-for-sale item. However, the current treatment of changes in revaluation reserves and foreign currency translation reserves, as well as for defined benefit superannuation schemes will be retained.

Minority interests that meet the criteria for inclusion in CET1

26. The Basel III requirements state that a minority interest arising from the issue of common shares by a fully consolidated subsidiary of the bank may receive recognition in Common Equity Tier 1 only if: (1) the instrument giving rise to the minority interest would, if issued by the bank, meet all of the criteria for classification as common shares for regulatory capital purposes; and (2) the subsidiary that issued the instrument is itself a bank (or subject to the same minimum prudential standards and level of supervision as a bank).

27. The Reserve Bank is not aware of any minority interest that would meet criterion (2) set out above. Consequently we propose not to recognise CET1 minority interests.

Regulatory adjustments

28. Regulatory adjustments are discussed separately below.

Additional criteria for classification and common shares

29. A Basel III criterion for inclusion in Additional Tier 1 capital is:

> Any repayment of principal (e.g. through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given (see criterion #6 in Appendix B below).

30. The Reserve Bank proposes to include this criterion as an additional criterion for classification as common shares. In our view repayment restrictions for common shares should be at least as conservative as those that apply to AT1 instruments given that common shares are intended as higher quality capital. However, we intend to give more consideration to the role of supervisory approval in relation to this criterion for both CET1 and AT1 as it represents a more hands-on approach to repayment compared to our existing requirements.

Additional Tier 1 capital

31. The Basel III definition of AT1 capital consists of the sum of the following elements:
    - Instruments issued by the bank that meet the criteria for inclusion in AT1 capital (and are not included in CET1);
    - Share premium resulting from the issue of instruments included in AT1 capital;
    - Instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in AT1 capital and are not included in CET1 (i.e. Minority interests); and
    - Regulatory adjustments applied in the calculation of AT1 capital (see also separate section below).

32. The Reserve Bank proposes to adopt this definition in line with the principles set out in paragraph 15 but to retain its restriction on the extent to which perpetual non-cumulative preference shares may contribute to total tier 1 capital. This is discussed below.

Instruments issued by banks that meet the criteria for inclusion in AT1 capital

33. The only hybrid instrument specified in our existing Tier 1 requirements is perpetual non-cumulative fully-paid up preference shares. We propose continuing with this approach, rather than allowing other instruments that may meet the Basel III AT1 criteria as this would allow a deterioration in the quality of capital currently being held.

34. The Basel III requirements set out a list of 14 criteria that instruments must meet for inclusion in AT1 capital. These criteria are set out in Appendix B. The Reserve Bank proposes to adopt all but three of these criteria. The table below provides an explanation of criteria the Reserve Bank does not propose to adopt.

Criteria	**Comment**
(5) May be callable at the initiative of the issuer only after a minimum of five years (subject to various conditions).	As noted above, we propose to only recognise perpetual non-cumulative preference shares in AT1. Within our existing standards these shares are not redeemable (i.e. not callable). We do not propose to relax our standards by allowing a bank to call AT1 instruments (even if only after 5 years).
(10) The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.	We propose not to adopt this criterion as we are only allowing perpetual non-cumulative preference shares to count towards AT1. Such shares are not counted as liabilities.
(11) Instruments classified as liabilities for accounting purposes must have principal loss	As above.

absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point.	

Share premium

35. We propose to retain recognition of share premium.

Minority interests that meet the criteria for inclusion in AT1

36. The Basel III criteria for AT1 minority interests are as follows:

Tier 1 qualifying capital issued by consolidated subsidiaries

Tier 1 capital instruments issued by a fully consolidated subsidiary of the bank to third party investors may receive recognition in Tier 1 capital only if the instruments would, if issued by the bank, meet all of the criteria for classification as Tier 1 capital. The amount of this capital that will be recognised in Tier 1 will be calculated as follows:

- Total Tier 1 of the subsidiary issued to third parties minus the amount of the surplus Tier 1 of the subsidiary attributable to the third party investors.
- Surplus Tier 1 of the subsidiary is calculated as the Tier 1 of the subsidiary minus the lower of: (1) the minimum Tier 1 requirement of the subsidiary plus the capital conservation buffer (ie 8.5% of risk weighted assets), and (2) the portion of the consolidated minimum Tier 1 requirement plus the capital conservation buffer (ie 8.5% of consolidated risk weighted assets) that relates to the subsidiary.
- The amount of the surplus Tier 1 that is attributable to the third party investors is calculated by multiplying the surplus Tier 1 by the percentage of Tier 1 that is held by third party investors.

37. The Reserve Bank proposes to adopt the Basel III requirements for AT1 minority interests.

Restriction of the extent to which perpetual non-cumulative preference shares may contribute to total tier 1 capital

38. The Reserve Bank's existing standards do not allow perpetual non-cumulative preference shares without full voting rights to constitute more than 25% of tier 1 capital. The Reserve Bank proposes to retain this requirement as it will limit the extent to which a bank that only just meets the minimum common equity requirement can report a strong tier 1 capital ratio.

Tier 2 capital

39. The Basel III definition of Tier 2 capital consists of the sum of the following elements:
    - Instruments issued by the bank that meet the criteria for inclusion in Tier 2 capital (that are not included in Tier 1 capital);
    - Share premium resulting from the issue of instruments included in Tier 2 capital;
    - Instruments issued by consolidated subsidiaries of the bank and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital (i.e. minority interests);
    - Certain loan loss provisions; and
    - Regulatory adjustments applied in the calculation of Tier 2 capital (see also separate section below).

Instruments issued by the bank that meet the criteria for inclusion in Tier 2 capital

40. The Basel III requirements set out a list of 9 criteria that instruments must meet for inclusion in Tier 2 capital. These criteria are set out in Appendix C. The Reserve Bank proposes to adopt all these criteria, although in the case of criterion 5, we propose to adopt only part of it.

41. Criterion 5 states that a Tier 2 instrument:

> May be callable at the initiative of the issuer only after a minimum of five years:
> **a.** To exercise a call option a bank must receive prior supervisory approval;
> **b.** A bank must not do anything that creates an expectation that the call will be exercised; and
> **c.** Banks must not exercise a call unless:
>
> > **i** 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
> >
> > **ii.** The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised

42. We propose to adopt the five year minimum requirement and part (a) and (b) of criterion 5, but not part (c). This approach should give the Reserve Bank suitable flexibility in forming a view on whether or not to grant supervisory approval for a call option.

Share premium

43. We propose to retain recognition of share premium.

Minority interests that meet the criteria for inclusion in Tier 2 capital

44. The Reserve Bank does not currently recognise Tier 2 minority interests and does not propose to recognise them as part of its Basel III implementation.

Certain loan loss provisions

45. For standardised banks Basel III recognises in Tier 2 provisions or loan-loss reserves held against future, presently unidentified losses. We do not propose to adopt this standard as it is not consistent with current New Zealand accounting standards.

46. For internal models banks the Basel III standard is that where the total expected loss amount is less than total eligible provisions, banks may recognise the difference in Tier 2 capital up to a maximum of 0.6% of credit risk weighted assets calculated under the internal models approach. At national discretion, a lower limit than 0.6% may be applied. The Reserve Bank already implements this requirement and does not propose to exercise its discretion to lower the 0.6% limit.

Regulatory adjustments

47. The Basel III requirements set out 13 regulatory adjustments. These adjustments are set out in Appendix D. The Reserve Bank proposes to adopt all but three of the Basel III regulatory deductions. The table below provides an explanation of the adjustments the Reserve Bank does not propose to adopt.

Regulatory adjustment	**Comment**
(5) De-recognise in CET1 any increase in equity capital resulting from a securitisation transaction, such as that associated with expected future margin income resulting in a gain-on-sale.	The Reserve Bank does not propose to adopt this regulatory adjustment because our existing standards do not allow securitisation transactions to be taken off banks' balance sheets (so no gain on sale can occur).
(12) Threshold deductions. Instead of a full deduction, certain items may receive limited recognition in CET1(this is a matter for national discretion).	The Reserve Bank does not propose to exercise its discretion to allow concessional deductions.
(13) Items which under Basel II were deducted 50% from Tier 1 and 50% from Tier 2	The Reserve Bank does not propose to adopt this regulatory adjustment because the affected items are not included in our existing standards.

48. The Reserve Bank proposes to adopt the regulatory adjustment relating to defined benefit pension fund assets and liabilities only in part (this is identified as regulatory adjustment #7 in Appendix D). In Basel III, this regulatory adjustment is described as follows:

    a. Defined benefit pension fund liabilities, as included on the balance sheet, must be fully recognised in the calculation of CET1 (i.e. CET1cannot be increased through de-recognising these liabilities). For each defined benefit pension fund that is an asset on the balance sheet, the asset should be deducted in the calculation of CET1 net of any associated deferred tax liability which would be extinguished if the asset should become impaired or de-recognised under the relevant accounting standards.

b. Assets in the fund to which the bank has unrestricted and unfettered access can, with supervisory approval, offset the deduction

49. The Reserve Bank does not propose to adopt the second part of this regulatory adjustment (part 'b') as this would reduce the conservativeness of our standards.

50. Under Basel III almost all of the deductions are applied to CET1. The exception is a set of three regulatory adjustments (those identified as adjustments 9, 10 and 11 in Appendix D). These regulatory adjustments are intended to remove the double counting of capital in the banking sector and limit the degree of double counting in the wider financial system. For these deductions, banks must apply a "corresponding deduction approach". This means the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself.

51. The Reserve Bank proposes that the corresponding deduction approach should also be applied to its existing requirements relating to equity investments in unconsolidated subsidiaries of the registered bank and equity investments in subsidiaries of the registered bank other than those which are both wholly owned and wholly funded by the bank.

Leverage ratio

52. The Reserve Bank does not propose to implement the leverage ratio requirement. In our view the one-size-fits-all aspect of the leverage ratio is poorly targeted and can give a misleading picture of risk in some situations. It would also undermine the value of the existing risk-based approach to the calculation of required capital. If properly applied, the risk-based approach renders a leverage ratio unnecessary.

Consultation questions

53. To assist the consultation process the Reserve Bank has put forward a series of consultation questions below. However submissions should not necessarily be limited to addressing these questions and are not required to address all (or any) of these questions. The Reserve Bank welcomes all relevant comments on the proposals outlined above.

- Do you envisage any practical difficulties meeting the proposed quality of capital requirements?

- Do you consider that any of the proposed requirements could be adapted further to NZ circumstances based on materiality or issues of relevance?

- What challenges are there for non-joint stock company banks in meeting the proposed CET1 requirements?

- The Basel III criteria #6 for Additional Tier 1 capital requires that any repayment of principal must be with prior supervisory approval. Should this criterion also apply in respect of ordinary shares within CET1?

- Basel III contains a formula for determining what proportion of minority shares can be recognised in AT1. Is this formula appropriate for New Zealand banks' circumstances?

- Do agree with the Reserve Bank's view on the Basel III leverage ratio?

Appendix A: Proposed adoption of criteria for classification as common shares

Criterion	
1. Represents the most subordinated claim in liquidation of the bank.	√
2. Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).	√
3. Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).	√
4. The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled, nor do the statutory or contractual terms provide any feature that might give rise to such an expectation.	√
5. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).	√
6. There are no circumstances under which the distributions are obligatory. Non-payment is therefore not an event of default.	√
7. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.	√
8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.	√
9. The paid in amount is recognised as equity capital (ie not recognised as a liability) for determining balance sheet insolvency.	√
10. The paid in amount is classified as equity under the relevant accounting standards.	√
11. It is directly issued and paid-in and the bank can not directly or indirectly have funded the purchase of the instrument.	√
12. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim.	√
13. It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.	X

14. It is clearly and separately disclosed on the bank's balance sheet.	n/a

Appendix B: Proposed adoption of criteria for inclusion in Additional Tier 1 capital

Criteria	
1. Issued and paid-in.	√
2. Subordinated to depositors, general creditors and subordinated debt of the bank.	√
3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors.	√
4. Is perpetual, ie there is no maturity date and there are no step-ups or other incentives to redeem.	√
5. May be callable at the initiative of the issuer only after a minimum of five years: a. To exercise a call option a bank must receive prior supervisory approval; and b. A bank must not do anything which creates an expectation that the call will be exercised; and c. Banks must not exercise a call unless: i. 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 ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.	X
6. Any repayment of principal (e.g. through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given.	Likely
7. Dividend/coupon discretion: a. the bank must have full discretion at all times to cancel distributions/payments b. cancellation of discretionary payments must not be an event of default c. banks must have full access to cancelled payments to meet obligations as they fall due d. cancellation of distributions/payments must not impose restrictions on the bank except in relation to distributions to common stockholders.	√
8. Dividends/coupons must be paid out of distributable items.	√
9. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organisation’s credit standing.	√
10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.	X
11. Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified	X

trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects: a. Reduce the claim of the instrument in liquidation; b. Reduce the amount re-paid when a call is exercised; and c. Partially or fully reduce coupon/dividend payments on the instrument.	
12. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.	√
13. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.	√
14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital	√

Appendix C: Proposed adoption of criteria for inclusion in Tier 2 capital

Criteria	
1. Issued and paid-in.	√
2. Subordinated to depositors and general creditors of the bank.	√
3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general bank creditors.	√
4. Maturity: a. minimum original maturity of at least five years. b. recognition in regulatory capital in the remaining five years before maturity will be amortised on a straight line basis. c. there are no step-ups or other incentives to redeem.	√
5. May be callable at the initiative of the issuer only after a minimum of five years: a. To exercise a call option a bank must receive prior supervisory approval; b. A bank must not do anything that creates an expectation that the call will be exercised; and c. Banks must not exercise a call unless: i 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 ii. The bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.	√ (but not ‘c’)
6. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.	√
7. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organisation’s credit standing.	√
8. Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument.	√
9. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (eg a special purpose vehicle – “SPV”), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital.	√

Appendix D: Regulatory adjustments

1. Goodwill and other intangibles must be deducted in the calculation of CET1. The full amount is to be deducted net of any associated deferred tax liability that would be extinguished if the intangible assets became impaired or derecognised under the relevant accounting standards.	√
2. Deferred tax assets that rely on future profitability of the bank to be realised are to be deducted in the calculation of CET1.	√
3. Cashflow hedge reserves. The amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet (including projected cash flows) should be derecognised in the calculation of Common Equity Tier 1.	√
4. Shortfall of the stock of provisions to expected losses. The deduction from capital in respect of a shortfall of the stock of provisions to expected losses under the IRB approach should be made in the calculation of Common Equity Tier 1 (rather than 50% T1 and 50% T2).	√
5. Derecognise in CET1 any increase in equity capital resulting from a securitisation transaction, such as that associated with expected future margin income resulting in a gain-on-sale.	X
6. Derecognise in CET1 all unrealised gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the bank's own credit risk.	√
7. Defined benefit pension fund assets and liabilities. a. Defined benefit pension fund liabilities, as included on the balance sheet, must be fully recognised in the calculation of CET1 (i.e. CET1 cannot be increased through de-recognising these liabilities). For each defined benefit pension fund that is an asset on the balance sheet, the asset should be deducted in the calculation of CET1 net of any associated deferred tax liability which would be extinguished if the asset should become impaired or de-recognised under the relevant accounting standards. b. Assets in the fund to which the bank has unrestricted and unfettered access can, with supervisory approval, offset the deduction.	√ ('a' only)
8. Investments in own shares (treasury stock). All the bank's investments in its own common shares whether held directly or indirectly will be deducted in the calculation of Common Equity Tier 1 (unless already derecognised under the relevant accounting standards). Banks should look through holdings of index securities to deduct exposures to own shares.	√

<table>
<tr><td>9. Reciprocal cross holdings in the capital of banking, financial and insurance entities.

Reciprocal cross holdings of capital that are designed to artificially inflate the capital position of banks will be deducted in full. Banks must apply a “corresponding deduction approach” to such investments in the capital of other banks, other financial institutions and insurance entities. This means the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the bank itself.</td><td>√</td></tr>
<tr><td>10. Investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity.

In addition:

Investments include direct, indirect and synthetic holdings of capital instruments. For example, banks should look through holdings of index securities to determine their underlying holdings of capital.

Holdings in both the banking book and trading book are to be included. Capital includes common stock and all other types of cash and synthetic capital instruments (e.g. subordinated debt). It is the net long position that is to be included (i.e. the gross long position net of short positions in the same underlying exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year).

Underwriting positions held for five working days or less can be excluded.

Underwriting positions held for longer than five working days must be included.

If the capital instrument of the entity in which the bank has invested does not meet the criteria for CET1, AT1, or Tier 2 capital of the bank, the capital is to be considered common shares for the purposes of this regulatory adjustment.

National discretion applies to allow banks, with prior supervisory approval, to exclude temporarily certain investments where these have been made in the context of resolving or providing financial assistance to reorganise a distressed institution.

To the extent that these investments exceed 10% of the bank’s CET1 then the amount by which the 10% is exceeded is to be deducted according to the corresponding deduction approach.</td><td>√</td></tr>
<tr><td>11. Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation. Significant means where the bank owns more than 10% of common shares of the issuing entity or where the entity is an affiliate of the bank. These are generally to be deducted in full following the corresponding deduction approach.</td><td>√</td></tr>
</table>

12. Threshold deductions. Instead of a full deduction, certain items may receive limited recognition in CET1 (this is a matter for national discretion). These items are: • Significant investments in the common shares of unconsolidated financial institutions • Mortgage servicing rights • DTAs that arise from temporary differences.	X
13. The following items, which under Basel II were deducted 50% from Tier 1 and 50% from Tier 2 (or had the option of being deducted or risk weighted), will receive a 1250% risk weight: • Certain securitisation exposures; • Certain equity exposures under the PD/LGD approach; • Non-payment/delivery on non-DvP and non-PvP transactions; and • Significant investments in commercial entities.	n/a

Appendix E: Quantitative impact assessment

The Reserve Bank invites locally incorporated banks to submit a quantitative impact assessment as set out below. This template is available as an Excel spreadsheet on the Reserve Bank's website http://www.rbnz.govt.nz/finstab/banking/4572979.html

The Reserve Bank requests that as part of completing the quantitative impact assessment locally incorporated banks populate the spreadsheet with relevant numbers but also:

- Clearly identify any instruments that currently qualify for regulatory capital but will not qualify under the Reserve Bank's proposed Basel III standards (and in each case provide an explanation of why the instrument would not qualify).
- Clearly identify regulatory adjustments excluded from the calculation of the Capital ratios (i.e. those items that are excluded rather than deducted).

The Reserve Bank will not publish the quantitative impact assessment of individual banks.

Basel III Quantitative Impact Assessment			
Current capital position based on existing Basel II requirements	As at 30 Sep 2011 ($m)	**Capital position based on whether existing instruments meet proposed Basel III requirements (i.e RBNZ proposed implementation of Basel III including retaining existing requirements that are unaffected by Basel III)**	As at 30 Sep 2011 ($m)
Tier 1 Capital		**Common Equity Tier 1**	
Ordinary shares		Ordinary shares	
Retained earnings		Share Premium	
Revenue and similar reserves		Retained earnings	
Perpetual fully paid up non-cumulative preference shares		Accumulated other comprehensive income and other disclosed reserves (specify each category)	
Tier 1 minority interests		Less CET1 regulatory adjustments (specify each category)	
Less deductions from Tier 1 capital (specify each category)		**Total CET1 after regulatory adjustments**	
Total Tier 1 after deductions			
		Additional Tier 1	
Tier 2 Capital		Perpetual fully paid up non-cumulative preference shares	
Upper Tier 2 Capital		Share premium	
Unaudited retained profits		Minority interests	
Upper tier 2 capital instruments (specify each type of instrument)		Less AT1 regulatory adjustments (specify each category)	
Revaluation reserves		**Total AT1 capital after regulatory adjustments**	
Lower Tier 2 Capital			
Lower Tier 2 capital instruments (specify each type of instrument)		**Tier 2 Capital**	
Less deductions from tier 2 capital (specify each category)		Tier 2 capital instruments (specify each type of instrument)	
Total Tier 2 Capital after deductions		Share premium	
		Revaluation reserves	
		Less Tier 2 regulatory adjustments (specify each category)	
		Total Tier 2 capital after regulatory adjustments	
Total Capital		**Total capital**	
Basel II Capital Ratios		**Basel III Capital Ratios**	
Total risk weighted exposures		Total risk weighted exposures	
Tier 1 capital expressed as a percentage of total risk weighted exposures		CET1 capital expressed as a percentage of total risk weighted exposures	
Minimum tier 1	4%	Minimum CET1 (including conservation buffer)	7%
Total Capital Ratio		Total tier 1 capital ratio	
Minimum total capital	8%	Minimum Tier 1 (including buffer)	8.5%
		Total capital ratio	
		Minimum Total capital	10.5%