Basel III implementation in New Zealand

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Off the record...

... and this presentation is not financial advice.

Basel III reforms

Key considerations for New Zealand include:

- Explicit liquidity requirements.
- Tougher capital requirements.
- The leverage ratio.
- Macro-prudential framework.

Liquidity

The Reserve Bank's prudential liquidity policy was introduced in April 2010:

Two mismatch ratios (over 1 week and over 1 month).

- Aim is to increase the likelihood that a bank will survive an acute bank specific loss of confidence.
- Policy specifies cash inflow and outflow assumptions under stress.
- Banks must hold liquid assets to meet the calculated net outflows (more types of assets are counted as liquid for the 1 month than the 1 week ratio).

Core Funding Ratio (CFR).

- Aim is to promote resilience over longer term.
- Creates incentives for banks to fund their activities with more stable sources of funding, and to limit reliance on short-term wholesale funding during times of buoyant market liquidity.

Liquidity (cont)

- The Basel III Liquidity Coverage Ratio (LCR) is similar in aim and design to RBNZ one month mismatch ratio.
  - But LCR would require liquid assets to be mainly government securities, which does not suit NZ circumstances.
- The Basel III Net Stable Funding Ratio (NSFR) is likewise similar to our CFR, including the one year focus.
  - But NSFR has more detailed categories, and calibration of the NSFR (at 100%) may be somewhat stricter than CFR (at 75%).
- Basel is still working on some details of the LCR and NSFR.
- As our liquidity policy is similar in substance (if not detail) to Basel III, we do not intend to modify it in the near future.

The purpose of capital

- Capital serves as a buffer against a bank's unexpected losses, protecting creditors (including depositors), and guarding against potential spill-over or system-wide effects resulting from a bank failure.

- The failure of a major bank would have the immediate effect of reducing the availability of credit within the economy, would limit people's access to funds, could put other banks into difficulty, and could lead to a system-wide crisis.

- System wide bank crises can have disastrous real and financial affects for an economy, including potentially large fiscal costs.

- The key benefit of higher capital requirements (as delivered by Basel III) is a reduction in the likelihood of a banking crisis.

- However higher capital requirements can create additional costs, for example potentially higher bank lending rates.

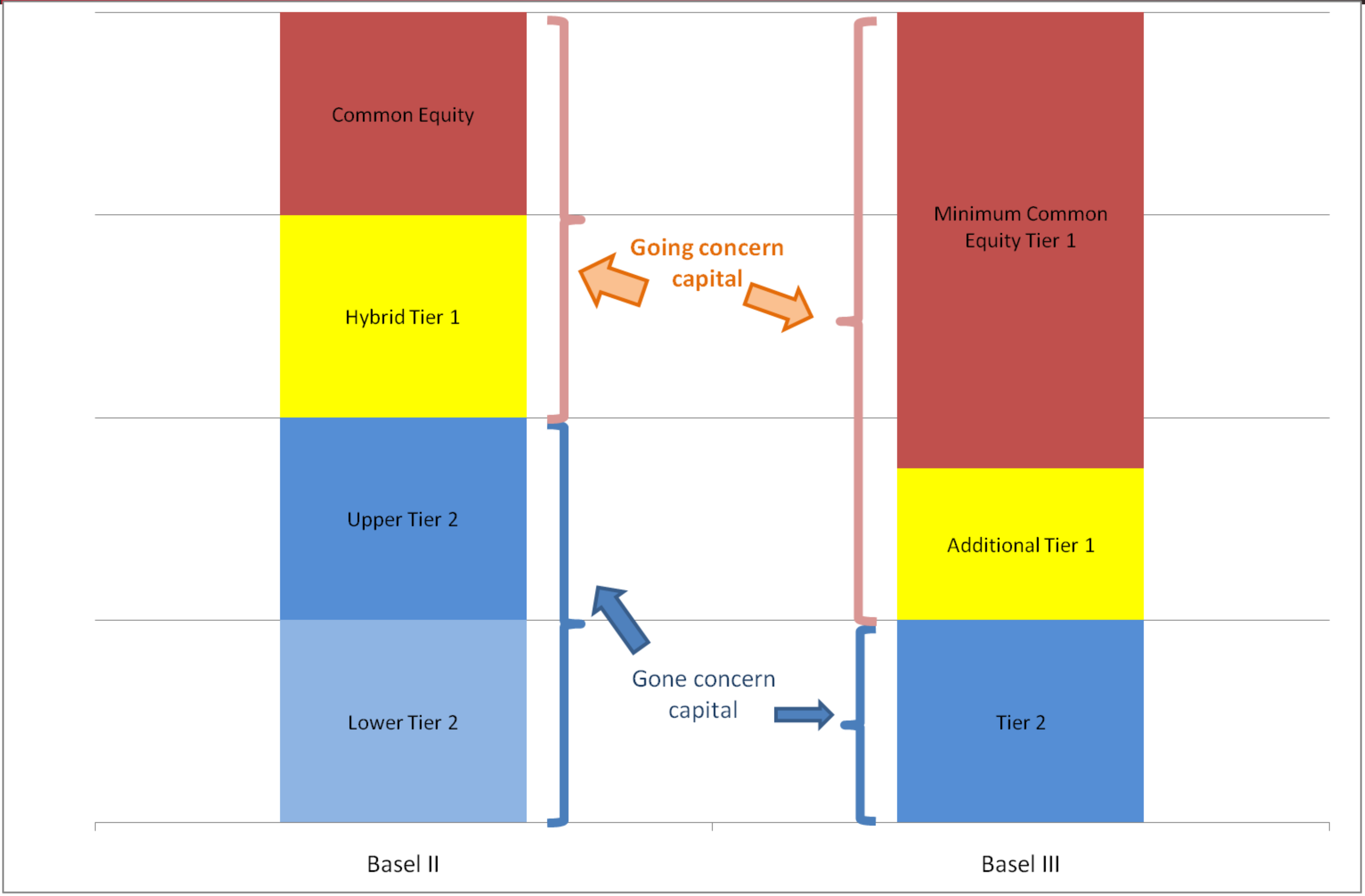
Development of international capital adequacy standards

- 1988: “Basel I” - Basel Capital Accord.

- 2006: “Basel II” – more sophisticated measurement of risk.

- 2010: “Basel III” – more conservative capital requirements and enhanced risk coverage.

Composition of minimum capital requirements



Reserve Bank approach to Basel II and Basel III

General approach:

- Adopt international standards.
- Align with APRA.
- Some adjustment for NZ conditions may be necessary (e.g. adjustments to Basel II to account for housing and farm lending risk).

Basel III approach:

- Adopt most of the Basel III capital standards where they are more conservative than existing standards and fit NZ conditions.
- We remain committed to ensuring the Basel II capital risk framework is used and calibrated appropriately.
- We expect to implement the new capital requirements ahead of the Basel Committee's timetable.

Basel III capital ratios

	Common equity	Tier 1 capital	Total capital
Existing minimum ratios	-	4.0%	8.0%
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%
Countercyclical buffer range	0-2.5% +		

Loss absorbency at the point of non-viability

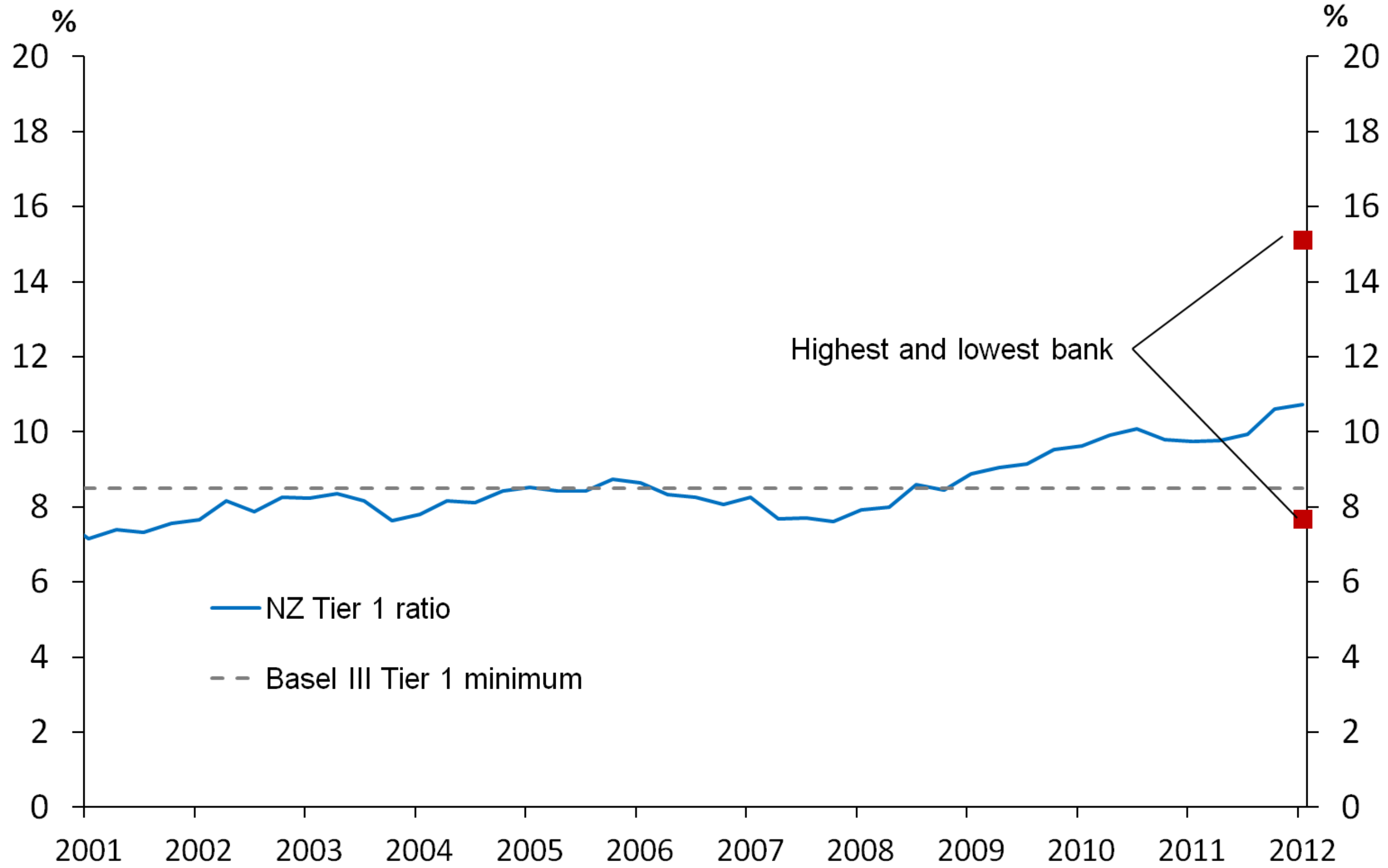
- Consistent with Basel III, we will require that all forms of regulatory capital are capable of absorbing losses to support the viability of a distressed bank:

    The terms and conditions of all non-common equity regulatory capital instruments must therefore include a provision that requires the instrument to be written off or converted to common equity upon the occurrence of a trigger.

- The trigger event would be when a bank is, in the opinion of the Reserve Bank, non-viable. Also, for a bank in statutory management, the statutory manager could trigger the requirement.

- Existing mechanisms within the Reserve Bank of New Zealand Act 1989 will be used to put this requirement in place.

NZ banks generally well placed to meet the Basel III capital requirements



Implementation of the Basel III capital requirements

NZ banks generally well placed

- Tier 1 ratios gradually rose consistent with market and regulatory expectations during the crisis and are now near or exceed the Basel III minimum (base on Basel II capital definition).
- Early implementation is therefore justified and is consistent with our principle to implement ahead of the Basel timetable as several jurisdictions are planning.
- The quality of NZ banks' capital has always been relatively conservative, but some existing instruments will not qualify and will need to be replaced (e.g. to meet the loss absorbency requirements).

Implementation details

- Full implementation of most aspects from 1 January 2013, ahead of the Basel timetable and in line with APRA's plans.
- Policy is largely aligned with the Basel III/APRA framework.

Key differences between RBNZ and APRA Basel III proposals

RBNZ policy is largely aligned with the Basel III/APRA framework. However, based on decisions to date there are some areas of difference. The main ones are described below.

Basel III area	RBNZ	APRA	Reason for difference / comments
Leverage ratio.	Not adopt	Adopt	One size fits all can give misleading picture of risk.
Countercyclical buffer.	0-2.5%, could be higher	0-2.5%	The Basel III framework provides for a buffer in excess of 2.5%.
Implementation of conservation buffer.	1 Jan 2014	1 Jan 2016	NZ banks reasonably well placed and we see no good reason to delay (some other jurisdictions are planning early implementation of some Basel III requirements).
Phase-out of non-qualifying instruments.	By 2018	By 2022	Six years is sufficient and aligns with APRA treatment of instruments issued to third parties by NZ subsidiaries.

RBNZ exploring macro-prudential tools

- RB likely to adopt a discretionary or judgemental rather than rules-based approach.
- Trigger likely to be a credit fuelled asset boom.
- Potential counter-cyclical capital and liquidity buffers.
- Prime purpose is financial system stability – but should also assist monetary policy.

Cost benefit and impact

- Cost benefit analysis (CBA) supports tightening of capital ratios to the Basel III standards.
- Most banks' capital ratios comply or are near to the new standards. Some banks will need to replace non-common equity capital instruments that do not comply with Basel III.
- CBA took into account the financial stability benefits of higher capital requirements and the costs in terms of potentially higher bank lending rates.
- Any increase in lending rates small as overall balance sheet risk is unchanged.

Questions?