

7 October 2009

Dear CEO

Implementation of the Reserve Bank's liquidity policy

I wrote to you and other New Zealand-incorporated banks on 30 June 2009 proposing new conditions of registration to bring into effect the Reserve Bank's prudential liquidity policy, and enclosing the new Banking Supervision Handbook documents "Liquidity Policy" (BS13) and "Liquidity Policy Annex: Liquid Assets" (BS13A).

I asked for feedback on the proposals by 31 August, and said at that point that we would be bringing the new conditions formally into effect on 30 September 2009. Since I sent that letter, we have had valuable discussions about the quantitative requirements of the policy with all of the locally-incorporated banks including yours, and have received useful data to enable us to refine the calibration of those requirements. I wrote to you again on 10 July and on 24 August to update you as we refined our thinking on the calibration of the policy and the process for implementing it. We appreciate this constructive dialogue that has helped us to finalise the policy, and would also like to thank you for your formal written response to the proposals.

As foreshadowed in my letter of 24 August, I am now writing to you again to set out revised proposed new conditions of registration.

Proposed new conditions of registration

Subsection 74(2) of the Reserve Bank of New Zealand Act 1989 (the Act) states that the Reserve Bank of New Zealand (the Bank) may, by notice in writing to a registered bank,

- (a) impose conditions of registration (whether or not the registration of the bank is subject to conditions); or
- (b) vary, remove, add to or substitute any conditions of registration.

Subsection 74 (3) states that the Bank must not exercise a power referred to in subsection (2) unless-

- (a) the Reserve Bank gives the registered bank not less than 7 days' notice in writing of the Bank's intention to do so; and
- (b) the notice contains, or is accompanied by, a statement of the Bank's reasons; and
- (c) the registered bank has a reasonable opportunity to make submissions to the Bank; and
- (d) the Bank has regard to those submissions.

Accordingly I am writing to you to advise you of the new liquidity conditions of registration we intend to impose on your bank.

The proposed new conditions are as follows:

1. That the banking group complies with the following quantitative requirements for liquidity-risk management with effect from 1 April 2010:
 - (a) the one-week mismatch ratio of the banking group is not less than zero per cent at the end of each business day;
 - (b) the one-month mismatch ratio of the banking group is not less than zero per cent at the end of each business day; and
 - (c) the one-year core funding ratio of the banking group is not less than 65 per cent at the end of each business day.

For the purposes of this condition of registration, the ratios identified must be calculated in accordance with the Reserve Bank of New Zealand documents entitled “Liquidity Policy” (BS13) dated October 2009 and “Liquidity Policy Annex: Liquid Assets” (BS13A) dated October 2009.
2. That, with effect from 1 April 2010, the registered bank has an internal framework for liquidity risk management that is adequate in the registered bank’s view for managing the bank’s liquidity risk at a prudent level, and that, in particular:
 - (a) is clearly documented and communicated to all those in the organisation with responsibility for managing liquidity and liquidity risk;
 - (b) identifies responsibility for approval, oversight and implementation of the framework and policies for liquidity risk management;
 - (c) identifies the principal methods that the bank will use for measuring, monitoring and controlling liquidity risk; and
 - (d) considers the material sources of stress that the bank might face, and prepare the bank to manage stress through a contingency funding plan.

Where relevant to the bank, given its nature and risks, the bank should apply the guidelines given in Section D.2 of the Reserve Bank of New Zealand document entitled “Liquidity Policy” (BS13) dated October 2009 when determining its approach to liquidity risk management.

The above conditions of registration will be added at the end of your existing conditions of registration, numbered accordingly.

I enclose the revised versions of documents BS13 and BS13A referred to in the above conditions.

Please let us have any submissions you wish to make on the proposed new conditions of registration by no later than 15 October 2009.

Once we have finalised the new conditions of registration, taking into account any submissions we receive, we propose to impose them formally with effect from 21 October 2009. In addition we will be amending the Statement of Principles (BS1) issued pursuant to section 75 of the Act to incorporate the new liquidity requirements.

Planned and potential future changes to quantitative requirements

The proposed conditions of registration attached to my letter of 30 June would have imposed a minimum one-year core funding ratio of 65% initially, increasing to 70% from 1 October 2010 and to 75% from 1 October 2011. Our intention now is that we will increase the minimum to 70% from 1 July 2011 and to 75% from 1 July 2012.

However, you will note from the above that the initial liquidity conditions of registration that we are now proposing no longer include these two future increases in the minimum ratio. Over the coming months we will keep under review the state of the term funding markets and banks' experiences in implementing the one-year core funding ratio. In the light of that, we will be in touch again in good time before the proposed step-up to 70% with new conditions of registration to bring that into effect.

More generally, I understand that the Basel Committee on Banking Supervision is planning to publish new proposals for minimum liquidity standards by the end of this year, which may be more prescriptive than previous Basel liquidity guidance, for instance on what should qualify as liquid assets. I note also that APRA have recently published a Discussion Paper on replacing their current liquidity policy. The final implementation dates arising from either set of proposals will likely be some way off, but in due course we will need to consider whether they make revisions to our ratio requirements desirable. If we do update the ratio requirements, we expect that we will do so as far as possible within the measurement framework we have now established, and you will be consulted on any changes.

Other steps to full implementation of the policy

There remain a number of other elements of the liquidity policy that we are still planning to implement. We have had to defer these until now, as our first priority has been to get the quantitative and qualitative policy requirements in place for the New Zealand-incorporated banks. The future steps to complete the policy remain largely as set out in my letter of 30 June, but a brief summary follows.

First, we will shortly begin discussions with the branches of overseas-incorporated banks to determine how the requirements of the policy should be adapted for them.

Secondly, we will then turn our attention to finalising our proposals for banks' regular reporting of liquidity-related data to the Reserve Bank. As I noted previously, we aim

to minimise as far as possible any duplication between what the subsidiaries of Australian banks have to report to the Reserve Bank and what they may need to report to APRA. Before we formally impose the reporting requirement by means of a notice issued under Section 93 of the Act, we will allow sufficient time for you to discuss with us any concerns about the content of the reporting, or about your ability to begin reporting by the proposed date.

And finally, we still plan eventually to make changes to the disclosure Orders in Council to add information about liquidity. However, we will include any such changes alongside other changes that we are likely to make as a result of the major review of the Reserve Bank's disclosure regime as a whole, which is now under way. That process will not be completed before the second half of next year.

In the meantime, existing disclosure requirements mean that banks will need to disclose the new Conditions of Registration relating to liquidity once they are in place, and any breaches of those conditions. Existing financial reporting standards also require a certain amount of information on liquidity risk to be disclosed in financial statements. Appendix 3 of BS13 summarises these requirements.

If you have any questions or you require any additional information please contact the analyst for your bank or Jeremy Richardson (jeremy.richardson@rbnz.govt.nz, 04-471-3667).

Yours sincerely

Grant Spencer
Deputy Governor, Head of Financial Stability