

BPR100

Capital Adequacy

Purpose of document

This document summarises the capital adequacy requirements that normally apply to New Zealand-incorporated registered banks. It sets out the standard conditions of registration by which the Reserve Bank imposes those requirements. It sets out the high-level definitions for capital ratios, and refers to the other BPR documents which provide the detail of the methods for calculating those capital ratios. This document also deals with other aspects of the capital adequacy framework, including the required actions when certain “trigger” events occur, the minimum requirements for banks using the internal modelling approach, and the internal processes that banks must have for assessing capital adequacy.

Document version history

[1 July 2021]	First issue date
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Conditions of registration

The Reserve Bank of New Zealand Act 1989 (the **Act**) permits the Reserve Bank to impose conditions of registration (**conditions**) on registered banks¹.

This document BPR100: Capital Adequacy forms part of the requirements for the following conditions:*

- A New Zealand-incorporated registered bank is normally subject to a condition requiring it to maintain capital ratios above specified minimum levels, and also to two conditions, imposing restrictions on distributions on CET1 and AT1 capital instruments respectively, when its prudential capital buffer ratio falls below specified levels.² This document sets out the methodology for calculating the capital ratios and the capital buffer ratio, to allow such a bank to calculate its day-to-day values for those ratios, and hence monitor its compliance with these capital adequacy conditions.

Guidelines

The Act permits the Governor of the Reserve Bank to issue guidelines for the purpose of interpreting any of the matters referred to in sections 78(1)(c) to (g) of the Act.

Part D of this document BPR100: Capital Adequacy includes guidelines within the scope of the following matters in section 78(1):

78(1)(c): Capital in relation to the size and nature of the business; and

78(1)(d): Loan concentration and risk exposures; and

78(1)(fa): Risk management systems and policies.

** All of the material set out in this document forms part of the requirements of the applicable condition, except material that is expressly identified as guidance by being included in a shaded box like this.*

¹ The conditions can relate to any of the matters referred to in sections 73 – 73B, 78 and 81. The standard conditions are contained in Appendix 1 of document BS1: Statement of Principles.

² These conditions of registration relate to the matter referred to in: section 78(1)(c) (capital in relation to the size and nature of the business).

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Part A: Capital adequacy framework

A1 Overview

A1.1 Requirements and relationship with Basel recommendations

- (1) This document–
- (a) summarises the capital adequacy requirements that normally apply to New Zealand-incorporated registered banks (“**locally-incorporated banks**”); and
 - (b) sets out the standard conditions of registration that the Reserve Bank uses to impose those requirements on banks; and
 - (c) defines the minimum capital adequacy ratios that are imposed on banks; and
 - (d) refers to other documents that set out the detailed calculation methodology to be used by banks for calculating those ratios; and
 - (e) sets out the conditions of registration that–
 - (i) require a bank to follow specified processes when certain trigger events occur; and
 - (ii) impose minimum system requirements, which a bank must meet to use internal modelling approaches for credit risk and operational risk, and the process requirements around the maintenance of internal models; and
 - (iii) require banks to have their own internal processes for assessing capital adequacy, and includes guidelines on how banks should satisfy that condition.

Guidance: To avoid doubt, the capital adequacy requirements that apply to locally-incorporated banks do not apply to overseas-incorporated banks. For overseas-incorporated banks, the applicable minimum capital requirements are set and administered by the home country regulator.

- (2) These requirements and conditions are based on Pillars 1 and 2 of the Basel Committee on Banking Supervision’s (**Basel**) recommendations in its *International Convergence of Capital Measurement and Capital Standards* (June 2006, and as amended).
- (3) The “First Pillar” of Basel refers to the minimum capital ratio requirements that banking supervisors internationally are recommended to impose on banks. Based on those recommendations, the Reserve Bank requires a bank to hold minimum amounts of different tiers of regulatory capital, expressed as percentages of the bank’s total risk-weighted asset equivalents (**total RWA equivalents**). The ratio of total capital to total RWA equivalents must be no lower than 8%.

*Guidance: For full definitions of the different tiers of capital, see **BPR110**.
The Reserve Bank plans to increase the minimum ratio of total capital to RWAs from 8% to 9%, as noted in guidance after section B1.2.*

- (4) Basel’s “Second Pillar” is a framework intended to ensure that banks have internal processes that will ensure that they maintain adequate capital to cover all risks: the Reserve Bank has implemented this in New Zealand by means of the standard Internal Capital Adequacy Assessment Process (**ICAAP**) condition and the guidelines on ICAAP, which are set out in Part D.

A1.2 Two approaches to calculation of minimum capital ratios

- (1) There are two general approaches to calculating regulatory minimum capital ratios: the standardised approach and the internal models approach.
- (2) A bank must use the standardised approach unless it has been accredited by the Reserve Bank to use the internal models approach.

Guidance: Reserve Bank accreditation to use the internal models approach means that a bank has been accredited by the Reserve Bank to use both the Internal Ratings Based (IRB) approach for credit risk capital requirements and the Advanced Measurement Approach (AMA) for operational risk capital requirements. A bank using this approach is known as an “IRB bank”, while a bank using the standardised approach is known as a “standardised bank”.

A1.3 Applicability of BPR documents to standardised and IRB banks

The BPR documents that make up the capital adequacy framework are listed in the first column of the following table, and the banks to which those documents apply is specified in the second column.

BPR document	Application
BPR100: Capital adequacy	Standardised and IRB banks
BPR110: Capital definitions	Standardised and IRB banks
BPR120: Capital adequacy process requirements	Standardised and IRB banks
BPR130: Credit risk RWAs overview	Standardised and IRB banks
BPR131: Standardised credit risk RWAs	Standardised and IRB banks (see guidance, below)
BPR132: Credit risk mitigation	Standardised and IRB banks
BPR133: IRB credit risk RWAs	IRB banks only
BPR134: IRB minimum system requirements	IRB banks only
BPR140: Market risk exposure	Standardised and IRB banks
BPR150: Standardised operational risk	Standardised banks only
BPR151: AMA operational risk	IRB banks only
BPR160: Insurance, securitisation, and loan transfers	Standardised and IRB banks
BPR001: Glossary	Standardised and IRB banks

Guidance: The application of BPR131 and BPR132 to IRB banks is limited to the specific circumstances set out in those documents and in BPR133.

Source for all of Part A: new text.

Part B: Capital ratio requirements and calculation

B1 Minimum capital ratio requirements

B1.1 Regulatory minimum capital requirements (Basel Pillar 1)

- (1) All locally-incorporated banks are subject to minimum capital requirements, as set out in their conditions of registration (see section B1.2).
- (2) These requirements take the form of minimum capital ratios: that is, capital as a percentage of total RWA equivalents.
- (3) In addition to the minimum capital requirements, locally-incorporated banks are subject to buffer ratio conditions, which restrict a bank's distribution of earnings if its capital buffer (the amount of Common Equity Tier 1 (**CET1**) capital it has above the minimum requirement) falls below a defined level (see sections B1.3 and B1.4).

Source: BS1, para 102B.

B1.2 Standard capital requirements

- (1) The Reserve Bank imposes a condition of registration:

That–

- (a) *the Total capital ratio of the banking group is not less than 8%; and*
- (b) *the Tier 1 capital ratio of the banking group is not less than 6%; and*
- (c) *the Common Equity Tier 1 capital ratio of the banking group is not less than 4.5%; and*
- (d) *the Total capital of the banking group is not less than \$30 million.*

Source: from BS1, Appendix 1.

Guidance: A locally incorporated bank is required to have a minimum of NZD \$30m in capital from when it is first registered, to ensure that the bank has sufficient substance to carry on business as a registered bank and to demonstrate that the owners have made a reasonable commitment to the business.

Source: BS1, para 43.

- (2) The terms referred to in the condition of registration in subsection (1), including **Total capital ratio**, **Tier 1 capital ratio**, **Common Equity Tier 1 capital ratio**, and **Total capital**, are defined in the bank's conditions of registration by reference to subpart B2.

Guidance: The minimum ratio requirements shown in subsection (1) apply until the last day of year 2 of the buffer transition period. From the first day of year 3 of the buffer transition period, the minimum CET1 capital ratio is unchanged and the minimum Tier 1 capital ratio and minimum total capital ratio will increase to 7% and 9% respectively. These changes will be implemented by revisions to locally-incorporated banks' conditions of registration.

Source: new text.

B1.3 Buffer ratio CET1 dividend restrictions

- (1) The Reserve Bank imposes a condition of registration on a locally-incorporated bank that restricts its CET1 capital distributions by varying amounts when its prudential capital buffer (PCB) ratio falls below a specified level, which is referred to as the **buffer trigger ratio**).

- (2) The level of the buffer trigger ratio, and the values of the PCB ratio below the buffer trigger ratio at which increasing dividend restrictions apply, is subject to a phase-in period (the **buffer transition period**).
- (3) Once the buffer transition period starts, the buffer trigger ratio that applies to banks that are designated as Domestic Systemically Important Banks (**D-SIBs**) will be higher than that applying to other banks.

Guidance: The list of banks designated as D-SIBs, and the framework for determining that designation, are set out on the Reserve Bank website at [[LINK to be added once webpage is live](#)].

- (4) The wording of the condition that normally applies before the start date of the buffer transition period is the following:

*That, if the Prudential Capital Buffer (**PCB**) ratio of the banking group is 2.5% or less, the bank must, according to the following table, limit the aggregate distributions of the bank's earnings payable to holders of CET1 capital to the percentage limit to distributions that corresponds to the banking group's PCB ratio:*

Banking group's PCB ratio	Percentage limit to distributions of the bank's earnings
0% – 0.5%	0%
>0.5 – 1%	30%
>1 – 2%	60%
>2 – 2.5%	100%

Guidance: Different dividend restrictions may be applied across the banking sector in the event of systemic events, as they have been in response to the COVID-19 pandemic.

- (5) The terms referred to in the condition of registration in subsection (4) above, including **PCB ratio**, **distributions**, **earnings**, and **CET1 capital** are defined in the bank's conditions of registration by reference to subpart B2.
- (6) The condition of registration in subsection (4) will continue to apply to all locally-incorporated banks during the buffer transition period and thereafter, with the same wording and with the same ranges of distribution limits, but with the ranges of PCB ratios at which those limits apply being revised at regular intervals by variations in banks' conditions of registration.
- (7) For the purpose of the capital buffer response framework (CBRF) provided in Subpart D1 of BPR120, the CBRF stage applying to a bank is determined by the percentage limit applying to the bank's CET1 distributions under its conditions of registration, in accordance with the following table:

Table B1.3 – Definition of CBRF stages

Percentage limit to distributions of the bank's earnings	Capital buffer response stage
0%	Stage 3
30%	Stage 2
60%	Stage 1
100%	None

Guidance: Subpart D1 of BPR120 sets out remedial actions the Reserve Bank will require a bank to take, and actions the Reserve Bank will itself take, in response to a bank's PCB ratio falling to the point where the bank is in one of the CBRF stages. The CBRF stages are based on the distribution restrictions that a bank may have become subject to at any point, regardless of what point in the buffer transition period has been reached.

Source: adapted from standard bank CoRs, and new text.

- (8) Appendix 1 sets out the planned transition path for the bands of buffer ratios that determine the levels of CET1 distribution restrictions and the CBRF Stages, for each year during the transition period and at the end-point of the transition, and separately for D-SIBs and non D-SIBs.

Guidance: The buffer trigger ratio comprises the following common equity capital buffer ratio components:

- (a) *the conservation buffer is designed so that banks can absorb losses during periods of economic and financial stress without breaching minimum capital requirements;*
- (b) *the D-SIB buffer is set so that banks designated as D-SIBs have additional capital (in addition to the conservation buffer) to withstand severe losses; and*
- (c) *the countercyclical capital buffer is set to accommodate a system-wide build-up of risk.*

After the transitional period is finished, the buffer trigger ratio will consist of the following:

- (a) *5.5% conservation buffer, to apply to all locally-incorporated banks:*
- (b) *the countercyclical capital buffer, normally set at 1.5%, to apply to all locally-incorporated banks. (1.5% is the neutral setting for the countercyclical buffer. However, on occasions it may be set at higher or lower levels, for example, it may be increased in times of excessive credit build-up, or decreased during post-recession recovery):*
- (c) *2% D-SIB buffer, to apply only to D-SIBs.*

Source: BS1, paras 102C and 102D (Guidance).

B1.4 Buffer ratio AT1 distribution restrictions

- (1) From the end-date of the buffer transition period, the Reserve Bank will impose a condition of registration on a locally-incorporated bank that is designated as a D-SIB:

That, if the Prudential Capital Buffer (PCB) ratio of the banking group is 3% or less, the bank must make no discretionary distributions payable to holders of Additional Tier 1 capital instruments.

- (2) From the end-date of the buffer transition period, the Reserve Bank will impose a condition of registration on a locally-incorporated bank that is not designated as a D-SIB:

That, if the Prudential Capital Buffer (PCB) ratio of the banking group is 2% or less, the bank must make no discretionary distributions payable to holders of Additional Tier 1 capital instruments.

- (3) The terms referred to in the condition of registration in subsections (1) and (2) above, including **PCB ratio**, **distributions**, and **Additional Tier 1 capital instrument** are defined in the bank's conditions of registration by reference to subpart B2.

Source: new text.

B2 Calculation of capital ratios

B2.1 Introduction

- (1) This subpart sets out the method to be used for calculating–
- the CET1 capital ratio for the bank and the banking group; and
 - the Tier 1 capital ratio for the bank and the banking group; and
 - the total capital ratio for the bank and the banking group; and
 - the PCB ratio for the banking group.
- (2) This subpart also sets out the definitions relevant to the operation of the PCB ratio.
- (3) This methodology is to be used for the purposes of determining the bank's compliance with conditions of registration relating to capital, as set out in subpart B1, and for disclosing information about capital.

Source: BS2A, para 1 and 11: BS2B, paras 1.1 and 3.1.

B2.2 Questions regarding status of particular transactions

Where a bank is unsure whether or not a particular transaction or financial arrangement falls within the scope of the relevant requirements in any of the documents referred to in section A1.3, the bank should refer the question to the Reserve Bank for guidance.

Source: adapted from BS2A, para 2: BS2B, para 1.2.

B2.3 Scope of capital ratio calculations

- (1) The minimum capital ratios and buffer trigger ratio imposed on a bank by the conditions of registration in subpart B1 are defined in terms of the bank's banking group.

*Guidance: For the purpose of calculating capital ratios for the bank on a consolidated basis, **banking group** has the meaning given to it in the bank's conditions of registration.*

- (2) As part of the Reserve Bank's disclosure requirements, a bank is required to disclose its capital ratios on a solo basis as well as on a group basis and, for that purpose, the bank must carry out the capital ratio calculations specified in this subpart using the scope of consolidation defined in section B2.4.

Guidance: The Reserve Bank may impose minimum capital ratio requirements on a bank on a solo as well as a group basis, if circumstances require.

- (3) BPR160 sets out—
- (a) the conditions under which a bank must consolidate an SPV with its banking group for the purpose of the group capital ratio calculations, as a result of the bank’s involvement with securitisation or funds management activity; and
 - (b) the conditions for the “clean transfer” of a loan or loan commitment, which allow the loan or loan commitment to be excluded from both the group and solo capital ratio calculations.

Source: BS2A, para 3(1); BS2B, para 1.4.

B2.4 Consolidation of subsidiaries for solo capital ratio calculations

- (1) Subsections (2) and (3) apply for the purposes of calculating capital ratios for the bank on a solo basis.
- (2) Subject to subsection (3), a subsidiary—
- (a) must be consolidated with the bank if—
 - (i) it is funded exclusively by the bank; and
 - (ii) it is wholly owned by the bank; or
 - (b) may otherwise be consolidated with the bank only if there is a full, unconditional, and irrevocable cross-guarantee between the subsidiary and the bank.
- (3) A subsidiary must not be consolidated with the bank—
- (a) other than in accordance with subsection (2); or
 - (b) if a subsidiary above it in the chain of ownership is not exclusively funded by the bank.
- (4) In this section—
- funded exclusively by the bank**, in respect of a subsidiary, means that the subsidiary has no liabilities (including off-balance sheet obligations) other than to—
- (a) the bank; or
 - (b) the Inland Revenue Department; or
 - (c) trade creditors, but only if the aggregate exposure of the subsidiary to trade creditors does not exceed 5% of the subsidiary’s shareholders’ funds
- wholly owned by the bank**, in respect of a subsidiary, means that the subsidiary is 100% owned by—
- (a) the bank; or
 - (b) another subsidiary that is ultimately owned by the bank through a chain of ownership where each entity is 100% owned by its immediate parent.

Guidance: This means that the “solo” basis of calculation goes beyond the bank as a single legal entity, but only includes entities that in practice are not subject to any interests separate from those of the bank.

Source: BS2A, para 3(2) to (4); BS2B, para 1.5-1.8.

B2.5 Calculation of total RWA equivalents

- (1) In this section and in section B2.6, **total RWA equivalents** means the sum of the following components:
- total RWAs for credit risk; and
 - 12.5 x (total capital requirement for market risk exposure); and
 - 12.5 x (total capital requirement for operational risk); and
 - supervisory adjustment.

Guidance: Total capital requirements for market risk exposure and operational risk are multiplied by 12.5 to derive total RWA equivalents to reflect the 8% minimum total capital ratio (12.5 = 1 / 0.08). When the minimum total capital ratio requirement is increased to 9%, effective 1 July 2022, the multiplier for the market risk and operational risk capital requirements will change from 12.5 to 11.11 (11.11 = 1 / 0.09).

- (2) In subsection (1), the value of the **supervisory adjustment** is either—
- the value specified by the Reserve Bank in the bank's condition of registration; or
 - if the Reserve Bank has not specified a value, nil.

Guidance: The value of the supervisory adjustment is normally set at nil unless the circumstances of an individual bank are such that the Reserve Bank imposes a different value.

Source: BS2B 3.4 and new text.

B2.6 Calculation of capital and buffer ratios

- (1) A bank must calculate the CET1 capital ratio in accordance with the following formula:

$$\text{CET1 capital ratio} = \frac{\text{CET1 capital}}{\text{Total RWA equivalents}}$$

- (2) A bank must calculate the Tier 1 capital ratio in accordance with the following formula:

$$\text{Tier 1 capital ratio} = \frac{\text{Tier 1 capital}}{\text{Total RWA equivalents}}$$

- (3) A bank must calculate the total capital ratio in accordance with the following formula:

$$\text{Total capital ratio} = \frac{\text{Total capital}}{\text{Total RWA equivalents}}$$

- (4) A bank must calculate the PCB ratio in accordance with the following formula:

$$\text{PCB ratio} = \frac{\text{Surplus CET1 capital}}{\text{Total RWA equivalents}}$$

- (5) For the purposes of calculating the PCB ratio in accordance with subsection (4), **surplus CET1 capital** means any amount of CET1 capital that is not required to meet the minimum capital ratio requirements set out in subpart B1.

Guidance: If minimum capital ratio requirements are not met, there will not be any Surplus CET1 capital.

Expressed as a formula, the PCB ratio is calculated as follows:

$$\text{PCB ratio} = \text{Minimum of } \{ (\text{CET1 capital ratio} - \text{minimum CET1 capital ratio}), \\ (\text{Tier 1 capital ratio} - \text{minimum Tier 1 capital ratio}), \\ (\text{Total capital ratio} - \text{minimum Total capital ratio}) \}$$

- (6) For the purposes of complying with the buffer ratio conditions of registration as specified in sections B1.3 and B1.4–

distributions–

- (a) means–
- (i) dividends; and
 - (ii) share buy-backs; and
 - (iii) discretionary payments made to holders of Additional Tier 1 capital instruments (including all payments of dividends); but
- (b) does not include–
- (i) distributions the bank is contractually obliged to make; or

Guidance: Such distributions will not exist in the case of CET1 or AT1 instruments.
 - (ii) payments that do not result in a depletion of CET1 capital; or

Guidance: This will include, for example, scrip payments.
 - (iii) share buy-backs that are part of a mechanism to convert an instrument to ordinary shares or write off an instrument in accordance with subpart D2 of BPR120.

earnings means current year distributable profits calculated–

- (a) prior to the deduction of distributions; and
- (b) net of the tax that would have been reported had none of the distributable items been paid.

Source: BS2A, paras 11a to 13b; BS2B, paras 3.1A. to 3.4E.

B2.7 Calculation of components of capital ratios

- (1) This section specifies how the capital, exposure, and risk components of the formulae in sections B2.5 and B2.6 are to be calculated.
- (2) CET1 capital, tier 1 capital, and total capital must be calculated in accordance with BPR110.
- (3) Total RWAs for credit risk must be calculated in accordance with BPR130.
- (4) Total capital requirement for market risk exposure must be calculated in accordance with BPR140.
- (5) Total capital requirement for operational risk must be calculated in accordance with BPR150 (for standardised banks) or BPR151 (for IRB banks).

Source: new text.

Part C: Other capital-related requirements

C1 Minimum process and system requirements

C1.1 Supervisory processes for capital

- (1) This part sets out standard conditions of registration that normally apply to a New Zealand-incorporated registered bank.
- (2) However, there are, in addition, other supervisory processes relating to capital, which are required as a result of a trigger event, as described in subsection (3).
- (3) A trigger event occurs in any of the following situations:
 - (a) a bank intends to include as regulatory capital a financial instrument it proposes to issue or has issued:
 - (b) a bank seeks to retire or repay an existing capital instrument:
 - (c) a standardised bank seeks to obtain accreditation to use internal models for credit and operational risk:
 - (d) an IRB bank seeks to obtain approval for an update of an existing model or for a new model:
 - (e) a bank's PCB ratio falls below any of the levels specified in its conditions of registration:
 - (f) conversion or write-off of a capital instrument issued on or before 30 June 2020 is triggered.
- (4) On the occurrence of any one or more of these trigger events, the bank must follow the process requirements set out in BPR120.

Source: new text.

C1.2 Process requirements for capital instruments

- (1) The Reserve Bank imposes a condition of registration on all New Zealand-incorporated banks:

~~That—~~

 - (a) *the bank must not include the amount of an Additional Tier 1 capital instrument or Tier 2 capital instrument issued on or after 1 July 2021 in the calculation of its capital ratios unless it has completed the notification requirements in Part B of BPR120: Capital Adequacy Process Requirements in respect of the instrument; and*
 - (b) *the bank meets the requirements of Part C of BPR120: Capital adequacy process requirements in respect of regulatory capital instruments.*
- (2) The terms referred to in the condition of registration in subsection (1), including **Additional Tier 1 capital instrument**, and **Tier 2 capital instrument** are defined in the bank's conditions of registration by reference to Part B of BPR110.

The requirements in Part C of BPR120 include that the bank must notify the Reserve Bank if the group CET1 ratio falls below 5.125%, or if the bank plans to make pay-outs that would reduce the group's CET1 ratio by specified amounts. It also includes that the bank must (in specified circumstances) not repay, purchase, or fund the purchase of the banking group's AT1 or Tier 2 capital instruments without the prior approval of the Reserve Bank.

C1.3 Accreditation to use capital models

A standardised bank may apply to the Reserve Bank to be accredited to use its own IRB model approach for calculating credit risk RWAs and its own AMA approach for calculating its operational risk capital requirement.

Guidance: The Reserve Bank has not specified any particular form of application or information requirements, so a bank will need to discuss what is required with the Reserve Bank. Among other things, the applicant will need to satisfy the Reserve Bank that it can meet the minimum requirements set out in BPR134 and BPR 151.

Source: new text.

C1.4 PCB and non-viability trigger points

- (1) If a bank's PCB ratio falls below any of the different levels specified in its conditions of registration that trigger the different stages of the CBRF specified in Table B1.3, the Reserve Bank may, among other things, take actions in regards to the bank or require actions from the bank in line with subpart D1 of BPR120.
- (2) If the Reserve Bank assesses that the bank's capital position is weak, it may take steps that will amount to a **non-viability trigger event**, resulting in the conversion or write-off of any of the bank's AT1 or Tier 2 capital instruments that were issued on or before 30 June 2020, as described in Part D2 of BPR120.

Source: new text.

C1.5 Requirements applying to IRB banks

The Reserve Bank imposes a condition of registration on all banks that have been accredited to use internal models:

That the bank must–

- (a) *comply with the minimum requirements for using the IRB approach set out in BPR134: IRB minimum system requirements; and*
- (b) *comply with the minimum requirements for using the AMA approach set out in Part B of BPR151: AMA operational risk; and*
- (c) *follow the process in Part E of BPR120: Capital adequacy process requirements for obtaining Reserve Bank approval for any changes to any IRB credit risk model or AMA operational risk model; and*
- (d) *maintain a compendium of approved models with the Reserve Bank that meets the requirements of section E1.5 of BPR120: Capital adequacy process requirements.*

Source: standard IRB bank CoRs, updated.

Part D: Internal Capital Adequacy Assessment Process (ICAAP)

D1 Overview

D1.1 ICAAP requirements

- (1) The Reserve Bank ordinarily imposes a condition of registration on every New Zealand-incorporated bank:

That—

- (a) *the bank has an internal capital adequacy assessment process (ICAAP) that accords with the guidelines set out in Part D of BPR100); and*
 - (b) *under its ICAAP, the bank must identify and measure its other material risks; and*
 - (c) *the bank must determine an internal capital allocation for each identified and measured other material risk.*
- (2) For the purposes of the condition in subsection (1), **other material risk** means any material risks of the banking group that is not explicitly captured in the calculation of total RWA equivalents in Part B.

Guidance: Other material risk is defined in a bank's conditions of registration by reference to subsection (2).

Source: BS1, para 102E.

D1.2 ICAAP guidelines

- (1) Parts D2 and D3 set out ICAAP guidelines, which are issued under section 78(3) of the Act.
- (2) These guidelines apply to any bank that is subject to the condition of registration set out in section D1.1(1).
- (3) The purpose of these guidelines is to provide guidance on how a bank should establish, operate, and maintain its ICAAP.

Source: BS12, para 4.

D1.3 Relationship with international standards

- (1) Pillar 1 of Basel II (the revised capital adequacy framework issued by the Basel Committee on Banking Supervision) sets out minimum capital requirements for credit, operational, and market risks.
- (2) Pillar 2 of Basel II is intended to ensure that a bank has adequate capital to support all the risks in its business, and includes the requirement on a bank to have an ICAAP.

Source: BS12, para 5.

D1.4 Reason for ICAAP

A bank must have an ICAAP that enables the bank to ensure that it has adequate overall capital in relation to its risk profile.

Source: BS12, para 6.

D2 Responsibility for ICAAP

D2.1 Bank's responsibility for ICAAP

- (1) Each bank is responsible for its own ICAAP.
- (2) If a bank is a member of a larger banking group, the bank may base its approach on group-wide methodologies.
- (3) In all cases, the bank's board of directors retains the ultimate responsibility for ensuring the overall capital adequacy of both the New Zealand banking group and the bank on a solo basis.

Source: BS12, para 7.

D2.2 Board and senior management oversight of risk

- (1) A sound risk management framework is a pre-requisite for the effective assessment of a bank's overall capital adequacy position.
- (2) This framework should include robust board and senior management oversight, risk monitoring and reporting processes, and regular independent review.
- (3) There should be credible and consistent policies and procedures to identify, measure, and report all material risks that the bank faces.

Source: BS12, para 9.

D2.3 Board's responsibility

- (1) The board is responsible for setting the bank's tolerance for risk, and ensuring that the bank's business remains within that risk tolerance.
- (2) To achieve this, the board should ensure that management establishes a framework for assessing the various risks, develops a system to relate risk to the bank's capital level, and sets up a method for monitoring compliance with internal risk management policies.

Source: BS12, para 10.

D2.4 Bank management's responsibility

- (1) Bank management should understand the nature and level of risk that the bank takes.
- (2) The management are responsible for–
 - (a) ensuring that internal risk management processes are appropriately sophisticated and formal for the size and nature of the bank's business; and
 - (b) establishing strong internal processes that state capital adequacy goals with respect to risks.

Source: BS12, para 11.

D3 Expectations of bank's ICAAP

D3.1 Proportionality

The level of detail and sophistication of the analysis required in a bank's ICAAP depends on the size, nature, and complexity of the bank's business.

Source: BS12, para 8.

D3.2 Documentation of, and responsibility for, ICAAP

- (1) The bank's ICAAP should be fully specified (including its methodologies, assumptions, and procedures) and formally documented.
- (2) The board or its appropriately delegated sub-committee should approve the ICAAP and its components, review them on a regular basis, and approve any revisions, as appropriate.
- (3) Senior management are responsible for the detailed development of the bank's ICAAP.

Source: BS12, para 12.

D3.3 Comprehensive coverage

A bank's ICAAP should capture all material risks that the bank faces, including the following:

- (a) risks not fully captured under Pillar 1; and

Guidance: Such risks could include underestimation of credit risk in the Pillar 1 standardised credit approach, risks of internal ratings migrations in the Pillar 1 internal model-based approach to credit risk, and residual risk stemming from credit risk mitigation. Also under this heading, the bank should have in place policies and systems to both monitor and control concentrated exposures to credit and other risks, and in turn consider whether additional capital is a suitable risk mitigant.

- (b) risks not taken into account by Pillar 1 processes; and

Guidance: That is, all other material risks arising from the bank's business such as reputation risk, strategic risk and liquidity risk.

- (c) risk factors external to the bank.

Guidance: That is, risks that have not already been covered arising from the regulatory, economic or business environment in which the bank operates.

Source: BS12, para 13.

D3.4 Relationship between capital and risk

- (1) The ICAAP should include a consistent approach to deriving capital requirements from the bank's risk measurement, in line with its established level of risk tolerance.

Guidance: For instance, when calibrating its capital needed against other risks, a bank that uses internal models for Pillar 1 risks should aim to achieve confidence levels for those other risks that are no lower than the Pillar 1 assumed confidence levels. Depending on proportionality considerations and industry developments over time, banks may design their ICAAP in various ways.

- (2) To assess overall capital adequacy, a bank should consider not only quantitative techniques but should also include an element of qualitative assessment or management judgment of both capital model inputs and outputs.
- (3) A bank is likely to ascertain that some risks it faces are easier to measure than others.

Guidance: An ICAAP can hence involve a mixture of rigorous risk capital estimates and more judgment-based estimates.

- (4) Risks should be included if they are material, even if they are hard to quantify.
- (5) However, there could be a trade-off between the importance of allocating capital to such risks, and the robustness of the bank's approach to mitigating and managing these risks.

Source: BS12, paras 14 to 16.

D3.5 ICAAP to be forward-looking

- (1) The ICAAP should take into account forward-looking factors such as changes in the bank's strategic plans.

Guidance: It is important for both the board and senior management to examine a bank's current and future capital requirements in relation to its strategic business objectives.

- (2) The strategic plan should clearly delineate the bank's near- and longer-term capital needs, capital expenditures required for the foreseeable future, target capital levels, and external capital sources.
- (3) Capital planning and budgeting should be a key feature in the strategic planning process.
- (4) For ICAAP purposes, bank management should—
 - (a) ensure that the capital adequacy would be appropriate for a range of business conditions at different points in the business cycle; and
 - (b) perform rigorous and forward-looking stress tests that identify plausible severe loss events or adverse changes in market conditions, and assess their impact on the bank's capital adequacy.

Source: BS12, paras 17 and 18.

D3.6 Risk monitoring and reporting

- (1) The bank should establish an adequate system for monitoring and reporting risk exposures
- (2) The monitoring system should help the bank assess how changes in its risk profile affect its capital needs.
- (3) The board and senior management should receive regular reports or updates on the bank's risk profile and capital needs, that enable senior management to carry out the following tasks:
 - (a) evaluate the level and trend of material risks and their effect on capital requirements; and
 - (b) evaluate the sensitivity and reasonableness of central assumptions used in the capital measurement system; and
 - (c) determine that the bank holds sufficient capital against various risks; and
 - (d) determine that the bank meets its internal capital adequacy goals; and
 - (e) assess its future capital requirements based on the bank's reported risk profile and in turn make necessary adjustments to the bank's strategic plan accordingly.

Source: BS12, paras 19 and 20.

D3.7 Regular review of ICAAP

- (1) The bank should review its ICAAP with sufficient frequency to ensure that it continues to cover the bank's risks, and that its capital coverage reflects the actual risk profile.
- (2) The bank should also review its ICAAP in response to any changes in the bank's strategic focus, business plan, operating environment, or other factors that materially affect assumptions or methodology.

Source: BS12, para 21.

D3.8 Independent review of ICAAP

- (1) The ICAAP and its review process should be subject to periodic independent internal review to ensure its integrity, accuracy, and reasonableness.

Guidance: Where appropriate, this review may involve internal or external audits.

- (2) The outcomes of these reviews should be reported to the board in ensuring the bank's prudent conduct of business.
- (3) These reviews should cover, at a minimum,—
 - (a) whether the ICAAP is appropriate for the nature, scale, and complexity of the bank's activities; and
 - (b) whether the data inputs into the capital assessment are accurate and complete; and
 - (c) whether the severe loss scenarios used in the ICAAP are both reasonable and valid; and
 - (d) stress-testing and analysis of assumptions and inputs.

Source: BS12, para 22.

Appendix 1

Transitional path for buffer ratio bands

These tables set out the bands of PCB ratios that will be included in banks' CET1 dividend restriction condition of registration (see section B1.3) in each year of the transition period. The bands differ between D-SIB and non-D-SIB banks.

Transitional path for D-SIBs

Pre-transition	Transition phase 1			Transition phase 2			Final	Outcomes	
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6		Year 7	Limit on CET1 distributions
0-0.5%	0-0.5%			0-0.5%			0-3%	0%	Stage 3
0.5-1%	0.5-1%			0.5-3.5%			3-6%	30%	Stage 2
1-2%	1-2%			3.5-5%			6-7.5%	60%	Stage 1
2-2.5%	2-3.5%	2-4.5%	2-4.5%	5-5.5%	5-6.5%	5-7.5%	7.5-9%	100%	None

Transitional path for Non-D-SIBs

Pre-transition	Transition phase 1			Transition phase 2			Final	Outcomes	
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6		Year 7	Limit on CET1 distributions
0-0.5%	0-0.5%			0-0.5%			0-2%	0%	Stage 3
0.5-1%	0.5-1%			0.5-2%			2-4%	30%	Stage 2
1-2%	1-2%			2-3%			4-5.5%	60%	Stage 1
2-2.5%	2-2.5%	2-2.5%	2-2.5%	3-3.5%	3-4.5%	3-5.5%	5.5-7%	100%	None

Note: There is no change in the buffer ratio bands in Year 3. The 1% increase in the minimum Tier 1 and total capital ratios is planned to take place in Year 3.