RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Geoff Bascand
Deputy Governor
General Manager Financial Stability

11 November 2020

Dear Chief Executive,

At 8:30am this morning the Reserve Bank published a regulatory update announcement covering four areas:

- Capital Review Implementation Timing
- Capital Review Implementation Consultation
- Loan-to-Value Ratio Restrictions
- Dividend Restrictions

Given the market sensitivity of this information we were unable to share it with industry ahead of the announcement. This letter provides a summary of the key aspects of the announcement, and some additional supporting information that banks may find useful. Banks should contact their Reserve Bank supervisors in the first instance for any follow-up questions.

This letter also provides guidance on the Reserve Bank's approach to returning the Core Funding Ratio (CFR) minimum requirement back to 75 percent.

Capital Review Implementation Timing

The Reserve Bank will further delay the start of increases in the Prudential Capital Buffer (PCB) until 1 July 2022. This will allow banks further headroom to respond to the effects of the COVID-19 pandemic and continue to support the economic recovery. The increase in the scalar applied to Risk-Weighted Assets (RWA) calculations by IRB banks will also be delayed by a year to 1 October 2022. We will reconfirm the timing of these changes before the end of 2021, and will consider making further amendments to the timing if the economic conditions warrant it. These changes do not affect the required increases in capital by the end of the transition period, only the timing of when the changes are to take place.

Other aspects of the Capital Review will proceed as scheduled from the middle of 2021 onwards. An updated Capital Review implementation timeline showing these changes is included in Annex 1.

Capital Review Implementation Consultation

We intend to release detailed consultation materials on the implementation of the Capital Review on 17 November 2020. This will cover all of the changes necessary to implement the December 2019 Capital Review decisions, as well as some small consequential policy changes arising from the Capital Review process.

We will be seeking input on the way the changes are being implemented. We will not be seeking feedback on the December 2019 decisions. Consultation will run until 31 March 2021.

Loan-to-Value Ratio Restrictions

In December, the Reserve Bank will consult about re-instating loan-to-value ratio (LVR) restrictions on high-risk lending with effect from 1 March 2021.

LVR restrictions are used to reduce the risks to financial stability from higher-risk lending. The restrictions were removed in May to best ensure credit could flow, and that they did not have an undue impact on the mortgage deferral scheme implemented in response to the COVID-19 pandemic.

Circumstances in the lending market have since improved and we are now observing rapid growth in higher-risk investor lending. We will consult about re-instating the restrictions we had in place pre-COVID, which limited the amount of high-risk lending banks could make.

We are committed to providing an adequate consultation period – keeping in mind the summer holiday shutdown period. We will announce the consultation launch date alongside the 25 November *Financial Stability Report.*

Dividend Restrictions

The Reserve Bank will maintain the restrictions on dividends and redeeming non-Common Equity Tier 1 (CET1) capital instruments put in place in April 2020 until 31 March 2021, or later if required. This decision has been made to support financial stability and the provision of credit in the economy.

In the medium term, the Reserve Bank intends to return to the usual approach to distributions, where banks make decisions about dividends based on their own assessments of risks and the circumstances they face.

When deciding whether to lift dividend restrictions, we will look for movement in the following indicators (along with other relevant information):

- A fall in the volatility of general economic data.
- Greater certainty about the level of impairments that banks face, including assessing any trends that emerge as the mortgage deferral programme ends.
- Capital adequacy levels relative to regulatory minimums.
- Credit growth remains positive.

While the restrictions announced in April 2020 will remain in place, and no changes will be made to existing conditions of registration, the Reserve Bank is open to considering instances where banks want to replace capital instruments with higher quality capital, or other financial restructuring arrangements where the spirit and intent of the April 2020 dividend restrictions is met. Banks wishing to undertake such transactions should approach the Reserve Bank in the first instance.

Core Funding Ratio Normalisation

As you are aware, the minimum requirement for the Core Funding Ratio was reduced from 75 percent to 50 percent, effective 2 April 2020. The Reserve Bank is committed to maintaining the CFR minimum requirement at 50 percent until at least 31 March 2021. Additionally, the CFR minimum requirement will only return to 75 percent once all of the following conditions have been met:

- Wholesale funding markets are functioning similarly to pre-COVID-19 and are expected to remain so; or, in the absence of this condition, banks are able to source stable long-term funding through Reserve Bank facilities, which can be included as 'core funding' for CFR purposes (so long as requirements for inclusion are met).

- The Reserve Bank is satisfied that there is sufficient credit availability for credit-worthy borrowers.

- The Reserve Bank is comfortable that any increase to the CFR minimum requirement will not adversely affect credit availability.

The Reserve Bank also commits to providing banks with adequate time to transition back to the previous 75 percent minimum requirement.

Please contact your bank's supervisor at the Reserve Bank if you wish to discuss any aspect of this letter in more detail.

Yours sincerely

Geoff Bascand
Deputy Governor / General Manager Financial Stability

Annex 1: Updated Capital Review Implementation Timeline

As at 11 November 2020

These are the elements that the Reserve Bank is proceeding with implementing during 2021 and the beginning of 2022:

H2 2020	• Consultation on exposure drafts of revised Banking Supervision Handbook, including revised definition of capital instruments, and a framework for distribution restrictions and supervisory actions once a bank enters its prudential capital buffers.
2021	• Consultation on exposure drafts closes 31 March 2021 • Revised Banking Supervision Handbook issued before 1 July 2021 • Consultation on Standardised Measurement Approach for Operational Risk (H1 or H2 2021)
1 July 2021	• Banks can apply for recognition of new qualifying AT1 and Tier 2 capital instruments • Derecognition of non-qualifying AT1 and Tier 2 instruments begins
1 January 2022	• IRB banks required to report IRB and Standardised capital calculations (dual reporting) • Output floor on IRB exposures set at 85% • For IRB banks, Sovereign and Bank exposures move to Standardised approach
H1 2022	• Consultation on the operational framework for the countercyclical capital buffer

Below is an indicative phasing of the implementation of the increase in capital buffers and the IRB scalar. The exact dates for implementing these increases will be confirmed by the Reserve Bank in 2021.

1 July 2022[1]	• D-SIB buffer set at 1%
1 October 2022	• IRB scalar increases from 1.06 to 1.2
1 July 2023	• D-SIB buffer increases from 1% to 2%
1 July 2024	• Minimum Tier 1 capital requirement increases from 6% to 7% • Minimum Total capital requirement increases from 8% to 9%
1 July 2025	• Conservation buffer increases from 2.5% to 3.5%
1 July 2026	• Conservation buffer increases from 3.5% to 4.5%
1 July 2027	• Conservation buffer increases from 4.5% to 5.5%
1 July 2028	• Countercyclical capital buffer set at 1.5% • Non-qualifying AT1 and Tier 2 instruments fully derecognised

[1] Changes take effect from this date, meaning the 1% D-SIB buffer would be reflected in D-SIB banks' reporting, e.g. on the RBNZ Dashboard, for 30 September 2022 (not 30 June 2022). This logic also applies to the IRB scalar and other capital ratio changes.