

FSO Committee

19 October 2018

The use of buffers in the Capital Review



Buffers set capital requirements on top of minimum ratios

Minimum capital ratios and buffers aim to ensure that:

- the banking sector can absorb shocks arising from financial and economic stress, reducing the risk of spillover from the financial sector to the real economy.
- The banking system can continue to supply credit during times of economic stress.

These slides consider additional buffers :

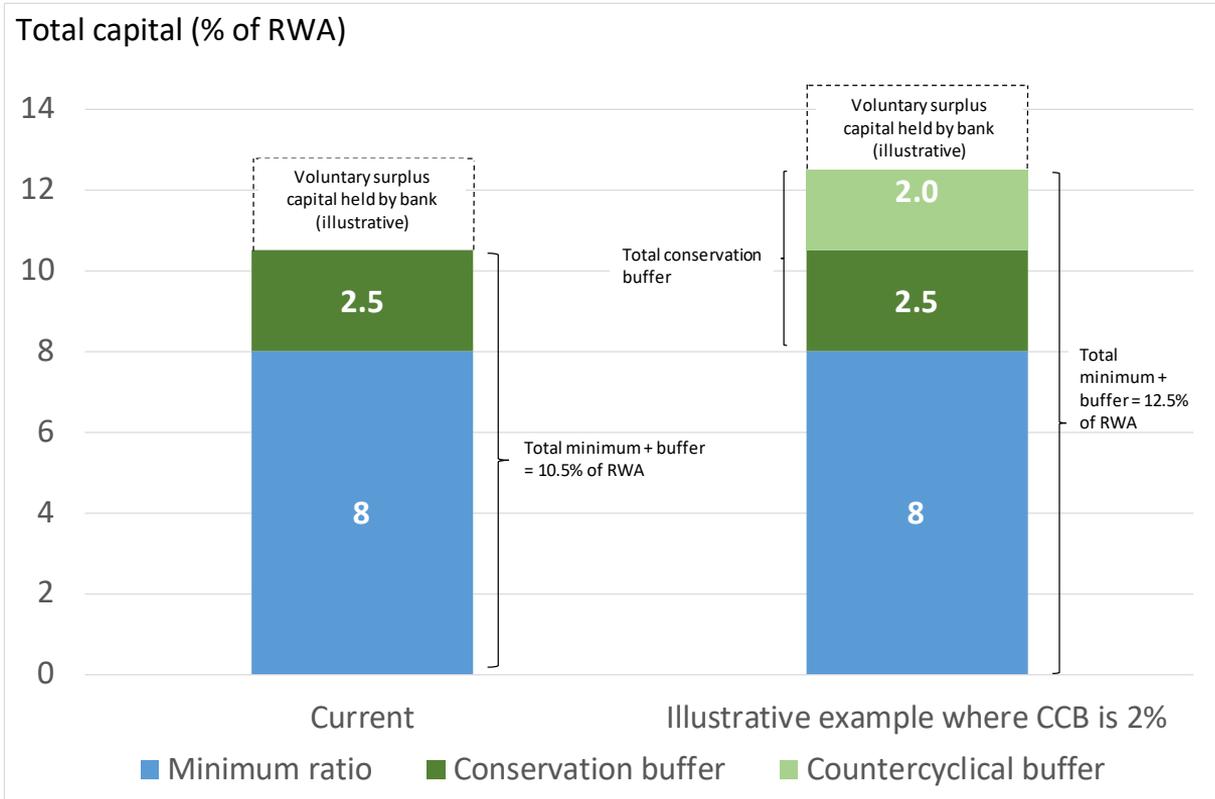
- Conservation buffer
- Time-varying buffers: countercyclical buffer (CCB)
- Buffers for domestic systemically important banks (DSIBs).

Decisions are not being sought now.

Decision paper will be provided to next FSO meeting, alongside a supporting paper from MFD covering the countercyclical buffer.



Current New Zealand approach includes two buffers



NZ framework consists of:

- Minimum total capital (8% of Risk Weighted Assets (RWA))
- Conservation buffer (2.5% of RWA)
- CCB (currently 0% of RWA)

Rationale for minima and buffers



Item	Rationale	Consequences of breach
Minimum capital ratio (currently 8% in NZ)	Designed to ensure banks can absorb losses when they fail/enter resolution.	Dipping below the minimum ratios is a serious breach of a bank's Conditions of Registration and would be expected to provoke a severe supervisory response.
Conservation buffer (currently 2.5% in NZ)	Designed to ensure that banks can survive a downturn without breaching the minimum capital requirements. It is a softer limit than the minimum ratio.	Breaches trigger automatic limitations on dividends and other distributions that are designed to restore capital over time. Must prepare a capital plan for RBNZ approval.
CCB (currently set at 0% in NZ)	Time-varying capital requirement designed to increase the conservation buffer when systemic risks are judged to be high.	Breaches trigger automatic limitations on dividends and other distributions that are designed to restore capital over time.
Global/Domestic Systemic Important Banks (GSIB/DSIB)	Designed to reflect the impact negative externalities resulting from the failure or impairment of large, interconnected financial institutions can cause to the financial system and real economy.	Not part of NZ system.
Pillar 2 requirements	Regulators can impose additional Pillar 2 capital requirements to cover risks that specific banks face. Often managed through side-letters or other arrangements.	Pillar 2 requirements generally treated as part of the minimum capital ratio, so consequences of breach would be the same as a breach of the minimum.
Voluntary buffer/surplus	Banks generally choose to hold more capital than rules require, in order to satisfy rating agencies and meet self-imposed internal buffers.	No regulatory requirement to do this.



Australian regulations incorporate a range of additional requirements

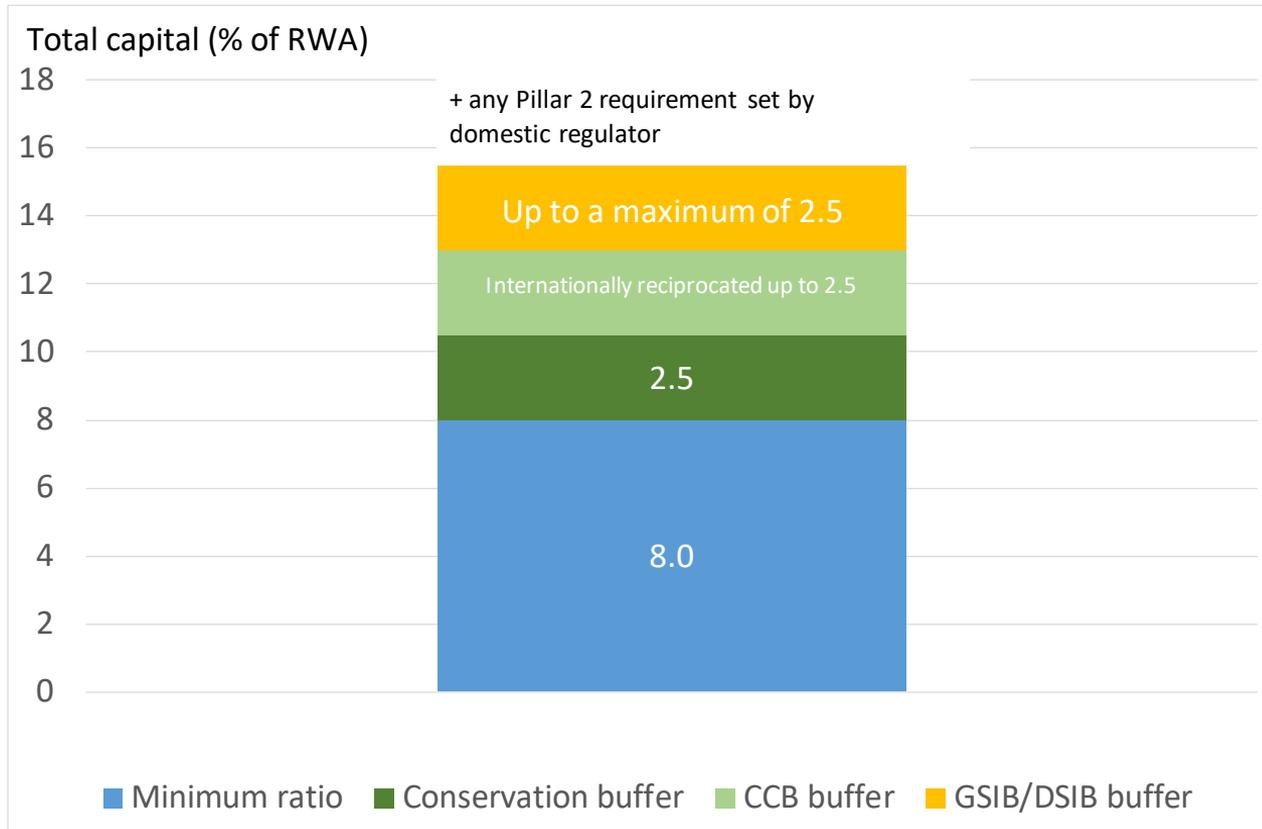
- Capital conservation buffer, applicable at all times, generally equal to 2.5% of risk-weighted assets.
- Countercyclical capital buffer applicable to all affected Authorised Deposit-taking Institutions (ADIs). In Australia the CCB may range between zero and 2.5% of risk-weighted assets (there is no upper limit in NZ).
- An additional capital buffer applicable to any ADI designated by APRA as a DSIB, currently set to 1% of risk-weighted assets – this applies to ANZ, CBA, NAB and Westpac.

OIA s6(a)





Basel III requires buffers in addition to minimum capital ratio





There can be a trade-off between the use of minima and buffers

- Putting more emphasis on the minimum capital ratio (ie. setting a higher minimum ratio) provides more assurance that the capital will be available in the event of a bank failure/resolution.
- A higher minimum ratio may also increase the likelihood that a future economic downturn is worsened due to banks cutting back on lending (to avoid hitting the hard minimum).
- Conversely, the use of time-varying buffers (eg. CCB) may help increase the likelihood that banks keep lending through downturns and stress events as the risk of hitting the hard minimum is lower.
- Breaching a “hard” minimum triggers serious regulatory consequences. While buffers contribute to the capital requirements and impose constraints in the event of a breach, they do so without triggering the regulatory response associated with a breach of the minimum ratio.

Starting point for analysis is that buffers will continue to be part of NZ system



- Retaining buffers in the NZ system helps support the sustainability of capital.
- Continuing to use buffers also maintains a degree of consistency with APRA and Basel III.
- Some of the key issues to consider are:
 - Which buffers should be part of the NZ system?
 - Should we expand the role of buffers?
 - How large should the buffers be?
 - How should the buffers be implemented?
 - How should the buffers interact with the minimum capital requirements?



Role of the conservation buffer

- The conservation buffer is designed to ensure that banks can survive a downturn without breaching the minimum capital requirements set out above. The conservation buffer applies at all times.
- A breach of the conservation buffer would result in limits on a bank's distributions of earnings, without triggering the consequences of breaching minimum capital requirements.
- The conservation buffer strengthens the quantity and quality of capital and increases the probability that losses will be absorbed by capital.



Role of the countercyclical buffer (CCB)

- The CCB is intended to provide protection from risks to financial stability when risks are elevated.
- The CCB operates through two channels:
 - Increasing capital available to absorb losses.
 - Supporting lending in a period of stress.
- The expectation is that banks would have 12 months to build up the capital needed to meet an announced CCB rate
- A key decision will be whether to implement “early or “late” strategy CCB:
 - “Early cycle” strategy: CCB would be X% (eg. 1%, 2% etc) unless the financial system is in, or recovering from, a crisis. CCB would be lifted when risks elevated.
 - “Late cycle” strategy: CCB zero for the majority of the financial cycle. CCB raised when there are signs of significant emerging risks to the financial system, and reduced when those risks crystallise or dissipate



Role of the GSIB/DSIB requirements

- Basel III rationale for adopting additional capital requirements for GSIBs/DSIBs was based on the “negative externalities” created by systemically important banks.
- These negative externalities include the impact of the failure or impairment of systemically important banks that can send shocks through the financial system which, in turn, can harm the real economy.
- In addition, the moral hazard costs associated with direct support and implicit government guarantees may amplify risk-taking.
- Added requirements calibrated to manage the larger impacts associated with failure of big banks.
- Based on the strongly held view of the Group of Twenty (G20) leaders that no financial firm should be ‘too-big-to-fail’ and that taxpayers should not bear the cost of resolution.



Previous FSO consideration of DSIBs

- In 2013 FSO considered a policy of having additional capital requirements for systemic banks.
- The 2013 decision not to include DSIB-specific requirements reflected concerns that a DSIB regime could give the impression that there is a group of banks that are too-big-to-fail, which is not consistent with New Zealand's non-zero failure regime.
- 2017 FSAP conclusions recommended that New Zealand reconsider DSIB requirements
- In March 2017 the issue was included in the scope of the Capital Review.



Some key questions

- Should we expand the use of buffers in NZ system?
- How to get the right balance between higher absolute minimum requirements and the use of buffers?
- Should the buffers be additive to hard minimum ratio requirements?
- What type of capital should buffers be made up of?



Next steps

- Incorporate input from today into decision paper for next FSO meeting.
- FSO decision paper will be accompanied by a separate paper about the design and implementation of the CCB (paper to be led by MFD).