

MEMORANDUM FOR FSO Committee

FROM Financial Policy (Author: Richard Downing)

MEETING DATE 7 November 2018

SUBJECT **Role of buffers in capital framework**

FOR YOUR Decision

It is recommended that the Committee:

1. **Note** that the Capital Review aims to ensure that the benefits of capital are realised in practice, that capital requirements are commensurate with the risk of individual exposures and New Zealand's circumstances, and relatively simple.
2. **Note** that buffers provide a degree of flexibility by encouraging banks to hold capital without requiring the strong regulatory responses that are associated with breaches of minimum capital requirements.
3. **Note** that decisions about the design of the counter-cyclical capital buffer (CCyB) will be sought in a separate paper to FSO. Decisions on the CCyB will be reflected in the full calibration (ratio) paper to come.
4. **Note** that further work will be done to support the effectiveness buffers in the event it is decided buffer should have an increased role: e.g. supporting lending in mild downturns and supervisory escalation as institutions 'use up' their buffer.
5. **Agree** that all current aspects of the New Zealand framework (minimum ratio, conservation buffer, countercyclical buffer, and scope to impose pillar 2 requirements where needed) will continue to be part of the New Zealand system.
6. **Agree** we should give preference to increasing the size of buffers over material increases in 'hard' regulatory minima, for the reasons explained in the paper.

Purpose and background

1. The aim of the Capital Review is to identify the most appropriate capital framework for New Zealand. Minimum capital requirements help to promote the maintenance of a sound financial system and, by reducing the probability or extent of bank failures, also help to protect the financial system from the wider costs that can arise from the failure of financial institutions.
2. This paper sets out considerations and recommended for the use of buffers within the capital framework in New Zealand.

What are ‘capital buffers’?

3. “Buffers’ refers to a set of regulatory responses and/or rules that complement the minimum capital requirements. In this sense we see buffers as being ‘soft’ limits, albeit regulatory requirements, whereas minimum requirements are ‘hard’ requirements in the sense that if they are breached the consequences for a bank can be severe, such as loss of registration, being placed into insolvency and so on if the breach is deemed sufficient grounds for questioning the institution’s solvency.
4. Placing more emphasis on the quantum of buffers compared to simply increasing the ‘hard’ minima is seen to have a number of practical advantages, whilst still enabling a) the regulator to target a desired level of capital, b) more time to assess the situation of an institution operating within the buffer, and c) solvent and liquid banks to continue to lend in times of pressure.
5. Just to be clear, banks may opt to voluntarily incur the regulatory responses embedded in the capital buffers, these are not hard minimums which threaten a bank’s right to operate in New Zealand.

Capital buffers were introduced under Basel III

6. The concept of ‘buffers’ was introduced with Basel III. The BCBS was concerned about the pro-cyclical impacts of minimum capital requirements. When large losses place a bank under stress, in order to comply with the minimum requirements, the bank needs to restore its capital ratio. One way to do this is to restrict lending but, if the bank is large, this may impact on output and asset prices, triggering a further round of losses.
7. In 2009 the BCBS was proposing to increase minimum capital requirements and was aware this could introduce more pro-cyclicality into the capital framework. They needed a policy that could counter this effect. Hence the committee proposed a policy that they believed would support lending after banks incurred losses, and thus lessen the ‘second round’ effects of bank losses (this subsequently became the ‘conservation buffer’). The benefits of the conservation buffer were expected to arise not just when losses were unexpected, but when economies were in severe recession (and losses were expected but very large).

“The Basel Committee is introducing a number of measures to make banks more resilient to such pro-cyclical dynamics. These measures will help ensure the banking sector serves as a shock absorber instead of a transmitter of risk to the financial system and broader economy...These measures have the following key objectives:

.....conserve capital to build buffers at individual banks and the banking sector that can be used in stress; and achieve the broader macro-prudential goal of protecting the banking sector from periods of excess credit growth.”¹

8. The purpose of the ‘conservation’ buffer was to ensure banks had additional capital (above the regulatory minimum) that could be ‘drawn down’ in times of stress. The BCBS envisaged banks going in and out of the buffer capital zone but wanted to make sure that, once there, banks restored their capital to the level necessary to support continued lending.

“The Committee is introducing a framework to promote the conservation of capital and build-up of adequate buffers above the minimum that can be drawn down in periods of stress. At the onset of the financial crisis, a number of banks continued to make large distributions in the form of dividends, share buy backs and generous compensation payments even though their individual financial condition and the outlook for the sector were deteriorating. Much of this activity was driven by a collective action problem, where reductions in distributions were perceived as sending a signal of weakness. However, these actions made individual banks and the sector as a whole less resilient. Many banks soon returned to profitability but did not do enough to rebuild their capital buffers to *support new lending* activity. Taken together, this dynamic increased the pro-cyclicality of the system.”² [Emphasis added]

9. Buffers also improve the quality of bank capital by increasing loss absorption, as they must be 100% met with CET1.
10. Banks would face constraints on their dividends if their capital ratio entered the conservation buffer zone. Once profits resumed, the dividend constraints would ensure the profits were retained, thus increasing common equity capital. This retained-earnings effect, rather than any stigma attached to breaching the buffer, seems to have the primary rationale for conservation buffer (in fact, the BCBS does not appear to have viewed breaching the conservation buffer as reputation-damaging).

¹ BCBS (2009) Strengthening the resilience of the banking sector Dec 2009. Wording maintained in subsequent revision in June 2011.

² *ibid*

B. The framework

129. A capital conservation buffer of 2.5%, comprised of Common Equity Tier 1, is established above the regulatory minimum capital requirement.⁴⁷ Capital distribution constraints will be imposed on a bank when capital levels fall within this range. Banks will be able to conduct business as normal when their capital levels fall into the conservation range as they experience losses. The constraints imposed only relate to distributions, not the operation of the bank.

130. The distribution constraints imposed on banks when their capital levels fall into the range increase as the banks' capital levels approach the minimum requirements. By design, the constraints imposed on banks with capital levels at the top of the range would be minimal. This reflects an expectation that banks' capital levels will from time to time fall into this range. The Basel Committee does not wish to impose constraints for entering the range that would be so restrictive as to result in the range being viewed as establishing a new minimum capital requirement.

11. The Basel III standards were silent on the issue of whether the conservation buffer would be lowered once a crisis eventuated, or whether it would apply to non-systemic banks as well as systemic.
12. As well, and serving a quite different purpose, the BCBS proposed a time-varying capital add-on that would build banks' capital buffers in periods of excessive credit growth and lean against excessive credit growth. This is known as the 'counter-cyclical capital buffer'. In practice, many regulators are primarily using the counter-cyclical capital buffer to build capital buffers when they assess systemic risks to be elevated, with influencing credit growth as a side benefit. Our focus in this paper is the conservation buffer (an accompanying paper, prepared by MFD, will address the counter-cyclical buffer).

Excess credit growth

29. As witnessed during the financial crisis, losses incurred in the banking sector during a downturn preceded by a period of excess credit growth can be extremely large. Such losses can destabilise the banking sector, which can bring about or exacerbate a downturn in the real economy. This in turn can further destabilise the banking sector. These inter-linkages highlight the particular importance of the banking sector building up its capital defences in periods when credit has grown to excessive levels. The building up of these defences should have the additional benefit of helping to moderate excess credit growth.

30. The Basel Committee is introducing a regime which will adjust the capital buffer range, established through the capital conservation mechanism outlined in the previous section, when there are signs that credit has grown to excessive levels. The purpose of the countercyclical buffer is to achieve the broader macroprudential goal of protecting the banking sector in periods of excess aggregate credit growth.

31. The measures to address procyclicality are designed to complement each other. The initiatives on provisioning focus on strengthening the banking system against expected losses, while the capital measures focus on unexpected losses. Among the capital measures, there is a distinction between addressing the cyclicity of the minimum and building additional buffers above that minimum. Indeed, strong capital buffers above the minimum requirement have proven to be critical, even in the absence of a cyclical minimum. Finally, the requirement to address excess credit growth is set at zero in normal times and only increases during periods of excessive credit availability. However, even in the absence of a credit bubble, supervisors expect the banking sector to build a buffer above the minimum to protect it against plausibly severe shocks, which could emanate from many sources.

13. Thus far the RBNZ has adopted both policies – i.e. the conservation buffer and the counter-cyclical capital buffer. The conservation buffer imposes dividend restrictions on banks that have total capital below 10.5% of RWA, or Tier 1 capital below 8.5% of RWA. This policy mirrors the requirements set in Basel III. The counter-cyclical buffer has been adopted but not used (the additional capital requirement is currently set at 0% of RWA). All banks are subject to both buffers, despite the fact that only the

lending of systemic banks can be expected to have the macroeconomic ‘second round’ effects that the policies target.

‘D-SIB’ buffer

14. As a separate issue, the BCBS proposed requiring more capital from globally systemic banks, compared to non-systemic banks. This was to reflect the far greater losses imposed on the financial system and the broader economy by globally systemic banks. Many jurisdictions have extended this policy to domestically systemic banks. These policies are known as G-SIB or D-SIB ‘buffers’.
15. There are many tools available to increase the capital required of domestically systemic banks (for example, the IRB ‘scaler’ and Pillar 2 capital add-ons). The pros and cons of applying greater capital requirements on D-SIBs lies outside the scope of this paper, but we will address it in a subsequent paper to FSO.

Current capital framework

16. The New Zealand system currently includes a ‘hard’ minimum for capital as a percentage of risk-weighted assets. This is supported by a number of buffers and additional capital requirements. Figure 1 below provides a graphical representation of the New Zealand system. The minimum CET1 ratio (‘D’ in Figure 1) and both components (‘B’ and ‘C’) of the conservation ratio constitute ‘through-the-cycle’ capital and their combined value is the target CET1 capital ratio that will be decided in the forthcoming capital ratio paper. The calibration of the counter-cyclical buffer is the subject of a separate stream of work (MFD). Annex One provides a summary of the components on the New Zealand system.

Figure 1

Components of capital		Objective of policy and implied supervisory actions
Through-the-cycle capital	A	Counter-cyclical capital (CCyB) Objectives: (i) enhance banks ongoing viability when risks are high and (ii) to support lending after a crisis.
	B	Conservation buffer (CCB) Objective: ensure the bank's ongoing viability Supervisory action: intensive monitoring, capital planning, implementing recovery plans (pre-resolution phase)
	C	Conservation buffer (CCB) Objective: effective resolution Supervisory action: intensive work to prepare entity for resolution
	D	Minimum CET1 Objective: license banks Supervisory action: bank in resolution

17. This paper presumes that all of the elements that are currently part of the New Zealand framework would remain part of the system in the future (minimum ratio, conservation buffer, countercyclical buffer, and scope to impose pillar 2 requirements where needed.) On top of this, the paper proposes that the capital framework in the

future make more use of buffers, by increasing the relative size of buffers compared to the current state.

Australian framework

18. The Australian approach incorporates the full range of buffers and minima that make up Basel III. APRA requires locally incorporated ADIs to hold a buffer of Common Equity Tier 1 (CET1) capital, over and above each ADI's minimum requirement, comprised of three components:

- a capital conservation buffer (2.5 per cent of risk-weighted assets)
- an additional capital buffer applicable to any ADI designated by APRA as a domestic systemically important bank (D-SIB), currently set to 1.0 per cent of risk-weighted assets; and
- a countercyclical capital buffer applicable to all affected ADIs (may range between zero and 2.5 per cent of risk-weighted assets).

19. OIA s9(2)(ba)

20. In 2013 APRA published their D-SIB framework.³ APRA determined that the following four banks are D-SIBs in Australia, and applied a 1% capital buffer to each: Australia and New Zealand Banking Group Limited, Commonwealth Bank of Australia, National Australia Bank Limited, Westpac Banking Corporation.

Connection between minimum ratio and buffers

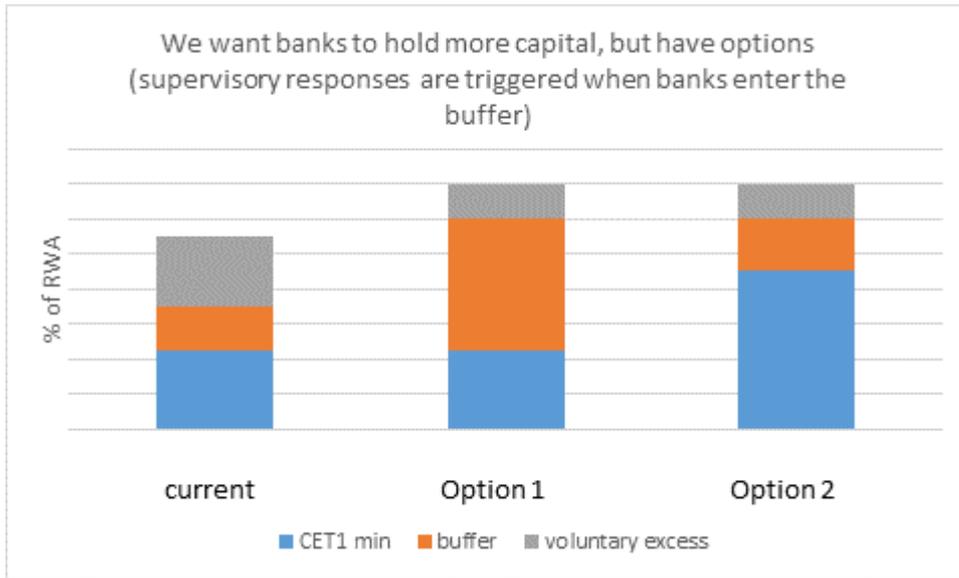
21. The 'hard' minimum capital ratio provides a strict lower limit for capital. Breaches of this limit trigger strong regulatory consequences. A breach of the buffers also triggers consequences, with limits on dividends and requirements to produce a capital plan. While the buffer breach consequences are not as strong, banks focus on not breaching either the minimum or the buffers, due to the regulatory and reputation consequences. To avoid a breach, banks hold their own voluntary buffers on top of the regulatory ones.

22. From a regulatory perspective the buffers are a valuable tool. In particular, the use of buffers provides a way to ensure higher levels of capital, without having to rely on the stronger regulatory responses that are available in the event of a breach of the 'hard' minimum capital ratios.

23. As part of the review we are proposing that the future capital framework includes an expanded use of buffers. This is represented by Option 1 in Figure 2 below. This will serve the purpose of lifting capital to a level that promotes the maintenance of a sound financial system, without having to significantly lift the 'hard' minimum ratio.

³ 2013, APRA Information Paper: Domestic systemically important banks in Australia.

Figure 2



Recommendation

24. This paper recommends that all current aspects of the New Zealand framework (minimum ratio, conservation buffer, countercyclical buffer, and scope to impose pillar 2 requirements where needed) continue to be part of the New Zealand system.
25. A second recommendation is to increase the size of buffers, rather than material increases in 'hard' regulatory minima, in the context of an increasing target for through-the-cycle CET1 capital.

ANNEX 1 Aspects of New Zealand capital framework

Table 1: Overview of New Zealand capital framework

Item	Rationale	Consequences of breach
Part of current New Zealand framework		
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.
Capital Conservation buffer (CCoB) (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.
Countercyclical Capital Buffer (CCyB) (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.
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.
Not part of current New Zealand framework		
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.