RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

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[Letter sent to all New Zealand-incorporated banks 26 March 2020. Material relating to the Outsourcing Policy (BS11) was only included for those banks that are subject to the policy.]

26 March 2020

Dear CEO

Proposed changes to your bank's conditions of registration

This letter is to advise you of changes the Reserve Bank intends to make to your bank's conditions of registration.

The proposed changes will:

- Amend the condition of registration that imposes requirements when the banking group's buffer ratio falls below 2.5%. The restrictions on distributions that currently apply in increasing steps once the buffer ratio is below 2.5% will be replaced by a complete ban on distributions, that will apply regardless of the size of the buffer ratio.
- Reduce the minimum requirement for the core funding ratio from 75% to 50%.
- Refer to a revised version of the Outsourcing Policy (BS11) to be dated March 2020, and make minor amendments to the wording of the transitional outsourcing condition that refer to the January 2006 version of the policy, in order to extend the end of the transitional period by one year from 30 September 2022 to 30 September 2023.

Reasons for the proposed changes are set out below.

Changes to restrictions on distributions

The purpose of the current buffer ratio condition is to provide a buffer above the regulatory minimum requirement for the CET1 capital ratio, within which the bank is not in breach of any condition of registration, but is subject to requirements to ensure that it restores the buffer ratio above 2.5%. The requirements consist of preparing a capital restoration plan and having it approved by the Reserve Bank, and limiting distributions that can be paid, by varying percentages of current year's distributable earnings (an amount which is referred to in the buffer condition simply as "earnings").

In the current very uncertain economic circumstances, banks need as much capital as possible so that they are not limited in their ability to continue lending to their many customers who are likely to face short-term liquidity problems. It is also very hard to predict how long the constraints imposed on the economy in response to COVID-19 will last, and what the potential scale of credit losses might be.

So at the moment we think that there is no realistic size of buffer ratio above which a bank should be comfortable paying out dividends rather than retaining all of its earnings to support its business. The revised condition restricts your bank from paying any dividends, whatever the size of the buffer ratio. Also, it would be pointless imposing this restriction with the aim of preserving capital within the New Zealand banking system if a bank retained all of its current earnings, but was able to pay distributions out of previous years' retained earnings or other reserves. So the proposed wording of the condition adds text to spell out very clearly that the prohibition on distributions will apply for the time being to the whole of the bank's distributable reserves.

Similarly, please do not put requests to us for repayment of current capital instruments, as we would not be in a position to agree.

This condition will remain in place until further notice, but we will aim to relax it to permit at least some portion of earnings to be distributed at specified levels of the buffer ratio, when the economic outlook has sufficiently recovered.

The requirement to prepare a plan to restore capital when the buffer falls below 2.5% will remain unchanged.

Reduction in core funding ratio

The core funding ratio is a key macro-prudential instrument in the Reserve Bank's macro-prudential policy framework, and current economic conditions warrant a significant relaxation of this requirement at this time. The Reserve Bank is therefore proposing to reduce this requirement to 50% (from 75%), until further notice, to help ensure that banks are not otherwise incentivised to reduce lending to the economy in an effort to meet this minimum requirement in the current environment. The Reserve Bank will be monitoring the appropriateness of this setting as conditions develop.

Extension of Outsourcing Policy transitional

On 18 March 2020 the Reserve Bank announced that it would delay or slow down most of its regulatory initiatives for an initial period of six months, in order to reduce the regulatory impost on financial institutions and free up Reserve Bank and industry resources to support our economy and tackle the challenges created by COVID-19.

As part of this announcement, the Reserve Bank also announced that it would extend the transition period for its revised outsourcing policy by 12 months. Banks, including yours, that are subject to the policy will now need to be fully compliant with the new requirements by 1 October 2023 rather than 1 October 2022. Reflecting this change requires a number of minor edits to the text of the September 2017 version of the Outsourcing Policy (BS11). Your conditions of registration also include one reference to the 2022 deadline, which accordingly needs to be revised.

New conditions of registration

Section 74(2) of the Act provides that the Reserve 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 of registration); or

(b) vary, remove, add to or substitute any conditions of registration.

Under section 74(3) the Reserve 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 Reserve Bank's intention to do so; and

(b) the notice contains, or is accompanied by, a statement of the Reserve Bank's reasons; and

(c) the registered bank has a reasonable opportunity to make submissions to the Reserve Bank; and

(d) the Reserve Bank has regard to those submissions.

I enclose a copy of your current conditions of registration and of BS11, marked up to show the proposed changes.

We would welcome any comments you may have by close of business on Monday 30 March.

If you have any questions or require any additional information please contact the analyst for your bank in the first instance.

Yours sincerely

Geoff Bascand
Deputy Governor and Head of Financial Stability
Reserve Bank of New Zealand