Date: 3 November 2011

To: Minister of Finance

Aide Memoire: Reserve Bank consultation on implementing Basel III in New Zealand

[Not relevant to request]

The capital adequacy framework forms a key component of New Zealand's financial stability framework and is typically re-visited infrequently, this time in response to the changes in the Basel Committees recommended standards. A key lesson from the global financial crisis was that distress of major financial institutions can be very costly, both economically and fiscally. These lessons are relevant for New Zealand given the concentration of its banking system and, as such, we are suggesting that the Internationally Focused Growth Strategy contains reference to on-going work on ensuring financial stability settings are best practice. Financial stability policy can be thought of as having two broad strands:

- Regulatory and other policies that seek to minimise the probability of instability – including regulation of capital and liquidity, and macro-prudential policies aimed at managing systemic risk; and

- Resolution tools and policies that seek to minimise the cost and economic damage of institutional distress should it occur (e.g. OBR).

We have not had an opportunity to comment on the Reserve Bank's proposed approach and have not done a full analysis of these proposals. However, we do consider that there are some key issues not covered in the note you have received, and it is worth asking the Reserve Bank to provide you with further advice. In particular:

- Analysis around the fit with other regulatory changes that will form part of the financial stability policy regime, such as the resolution regime (e.g. OBR) and covered bonds. For example, with an effective failure resolution regime in place, that imposes losses on creditors safely, the level of bank capital effectively determines how losses are shared between owners and creditors. Together these enhance the resilience of the banking sector to shocks and reduce the likelihood that government support is needed.

- *[Not relevant to request]*

One international example that brings together bank capital and resolution is the proposals by the UK's Independent Banking Commission. The Commission recommended a higher level of Tier 1 Capital of 10% for larger banks and that they hold further "bail-in" bonds that allow authorities, at the point of non-viability, to either write down those "bail-in" bonds or to convert to equity to recapitalise the distressed bank. This brings total ability to absorb losses to at least 17%.[1] Beyond this, authorities would have power to bail-in all other uninsured creditors in much the same way as proposed under OBR. Depositor preference is also proposed for insured depositors, which would mean the deposit insurance scheme would take losses only after all other creditors have been wiped out.

[Not relevant to request]

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[1] The Banking Commission settled on 17% since this would have been sufficient to absorb losses suffered by major banks in recent history (save Anglo Irish bank that by Commission estimates suffered losses of 39% of Risk Weighted Assets). A higher limit of 20% would apply where banks do not have effective resolution and recovery plans (living wills) in place.