RESERVE BANK
OF NEW ZEALAND

Capital Adequacy Framework

(Basel I Approach)

Prudential Supervision Department
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I INTRODUCTION

1. This document sets out the Basel I methodology for calculating capital adequacy. During the transition to full adoption of the Basel II framework, some locally incorporated banks are required by their conditions of registration to use the Basel I framework for some aspects of their capital calculations, and for some disclosures required by Orders in Council issued under section 81 of the Reserve Bank of New Zealand Act 1989. For example, banks that have been fully accredited to use the Basel II internal models approach are initially subject to a transitional capital floor calculated using the Basel I methodology.

II GENERAL

2. Note that where questions arise as to whether or not particular arrangements come within the ambit of the definitions set out in this document, attention should be directed to the substance of the arrangement, not merely the legal form.

III APPLICATION

3. Registered banks may be subject to disclosure requirements or conditions of registration requiring use of this framework for either or both of the registered bank on a solo basis and the banking group. These are defined as follows:

Banking Group

4. For the purposes of this framework, the **banking group** is as defined for the purposes of the registered bank's conditions of registration (subject to any adjustments required as a result of the bank's involvement in securitisation or funds management activities).

Registered Bank

5. For the purposes of this framework the **registered bank** on a solo basis is defined to include subsidiaries which are both wholly owned and wholly funded by the registered bank. In this context wholly funded by the registered bank means: there are no liabilities (including off balance sheet obligations) to anyone other than:

   (a) The registered bank;
   (b) The Department of Inland Revenue;
   (c) Trade creditors, where aggregate exposure to trade creditors does not exceed 5 per cent of the subsidiary's shareholders funds.

   Wholly owned by the registered bank means: all equity issued by the subsidiary is held by the registered bank.

Where there is a full, unconditional, irrevocable cross guarantee between a subsidiary and the bank, the subsidiary may be consolidated with the registered bank for the purposes of calculating the bank's solo capital position.

IV CAPITAL

6. The following paragraphs provide a definition of capital to be used in calculating capital adequacy ratios.

Capital

7. **Capital** is defined as **tier one capital** plus **tier two capital** less **deductions from total capital**, subject to the following restriction:

   Tier two capital may not exceed 100 percent of **tier one capital**.

Tier One Capital

8. **Tier one capital** is the only form of capital which is permanently and freely available to absorb unanticipated losses without the bank being obliged to cease trading. It is the proprietors' contribution to the bank and as such it represents an ongoing commitment to the business. Consequently, primary focus is placed on tier one capital (or equity which is a close equivalent) for the purposes of disclosing various measures of risk relative to capital, and as a basis for setting a limit on banks' exposures to connected persons.

9. **Tier One Capital** is defined as:

   9.1 **Issued and fully paid up ordinary share capital**

   9.2 **Perpetual fully paid up non-cumulative preference shares** subject to the following requirements:

   (a) They are not redeemable as defined in Section 68 of the Companies Act 1993 and not repayable or redeemable at the option of the holder.

   (b) Dividends must be able to be waived where the financial condition of the bank would not support payment (for example when dividends are not being paid on ordinary shares). Dividends so waived must not cumulate.

   (c) Preference shares which are subject to arrangements for resetting of the dividend margin will not qualify for inclusion in tier one capital, even if subject to an overall cap.

   (d) Perpetual non-cumulative preference shares without full voting rights may not constitute more than 25 percent of tier one capital.

9.3 **Revenue and similar reserves**. This includes capital redemption reserves, general reserves of retained earnings and other reserves which are created or increased by appropriations of retained earnings. It also includes share premium reserves arising from tier one shares.

Reserves which are earmarked to particular assets or particular categories of banking activities, or on account of any assessed likelihood of loss do not qualify as tier one capital.

The following items shall not be included in Tier One capital:

(a) Cumulative gains and losses on cash flow hedges which have been recognised directly in equity, unless the cash flow hedge is against an available-for-sale item on which fair value gains and losses are recognised directly in equity.

(b) Unrealised gains and losses on liabilities designated at fair value through profit and loss arising from changes in an institution's own credit risk.

(c) Any fair value gains and losses relating to financial instruments for which a fair value cannot reliably be calculated, except that a fair value loss which has arisen from credit impairment on a loan and which has been recognised in audited retained earnings must in all cases be reflected in Tier One capital.

(d) Revaluation reserves that are included in Upper Tier Two capital (see paragraph 20.2).

(e) Any surplus, net of any associated deferred tax liabilities, in any defined benefit superannuation fund sponsored by the registered bank as employer.

9.4 **Current period's audited retained earnings**

Audited retained earnings are those which have been subject to audit or review by the bank's auditor. Retained earnings should be reported net of any appropriations such as tax payable, dividends to be paid or transfers to other reserves.

9.5 **Tier one minority interests** (not applicable for calculating the registered bank's solo capital ratio).

These are claims by outside interests in the ordinary share capital of any partly owned subsidiary company which is consolidated for the purposes of calculating the banking group's capital ratios.

9.6 Less: **Deductions from tier one capital:**

(a) Goodwill and other intangible assets

(b) Current year's losses (including unaudited losses)

(c) Future tax benefits arising from income tax losses (ie income tax loss carry forwards)

(d) Net future tax benefits arising from timing differences, to the extent that an income tax loss carry forward would have occurred if tax deductions were available in the current year. In practice this means that net future tax benefits arising from timing differences are allowable, ie need not be deducted from capital, up to the amount of the tax obligation on the current year's (or previous 12 month period's) income, as assessed for income tax purposes.

In cases where the current year's assessable income is negative the full amount of the net future tax benefit arising from timing differences should be deducted from capital.

(e) Credit enhancements provided to associated funds management and securitisation schemes (see paragraphs 43 to 80 for further details).

(f) Credit enhancements provided to affiliated insurance groups which have not been expensed (see paragraphs 55 to 57 for further details).

(g) The full amount of funding provided to an affiliated insurance group, in cases where that funding exceeds the 5% funding limit allowable in terms of paragraphs 55 to 63, or where the minimum separation requirements of paragraph 58 are not otherwise met.

(h) Aggregate funding provided to all affiliated insurance groups and associated funds management and securitisation vehicles, in cases where that funding exceeds the 10% of tier 1 capital limit allowable under paragraphs 52 and 58(g).

(i) Advances of a capital nature provided by the banking group to connected persons, as determined in accordance with BS8: Connected Exposures Policy.

Note: Assets deducted from tier one capital should not be included in risk weighted exposures.

Tier Two Capital

10. **Tier two capital** is capital which has some of the attributes of **tier one capital**, but which is restricted in its ability to absorb losses other than in a winding up.

11. **Tier two capital** is divided into **upper tier two capital** and **lower tier two capital**. **Upper tier two capital** has no fixed maturity while **lower tier two capital** has a limited lifespan, which makes it less effective in providing a buffer against losses for depositors and other ordinary creditors.

12. **Tier two capital** provides a useful supplement to tier one capital or equity. However, because there are significant deficiencies in its ability to provide protection for depositors and other ordinary creditors, its inclusion in capital is restricted.

13. For the purpose of calculating capital adequacy ratios, the following restrictions apply:

    (a) **Tier two capital** may not exceed 100 percent of **tier one capital**.

    (b) **Lower tier two capital** may not exceed 50 percent of **tier one capital**.

    (c) **Lower tier two capital** must be amortised on a straight line basis over the last 5 years of its life such that no more than 20 percent qualifies for capital adequacy purposes in the final four reporting quarters preceding the quarter in which the capital matures, or is to be redeemed.

Upper Tier Two Capital

14. **Upper Tier Two Capital** is defined as:

14.1 **Unaudited retained profits**

Unaudited current period's retained profit, net of appropriations such as tax, dividends and transfers to other reserves.

A registered bank must not include in Upper Tier Two Capital any fair value gains and losses relating to financial instruments for which a fair value cannot reliably be calculated, except that a fair value loss which has arisen from credit impairment on a loan and which is reflected in unaudited current period’s retained profit must in all cases be reflected in Upper Tier Two capital.

14.2 **Revaluation reserves**

(i) Reserves arising from a revaluation of tangible fixed assets including owner-occupied property, and cumulative fair value gains on investment property, which have been subject to audit or review by the bank’s auditor. Cumulative losses below depreciated cost value on any individual property must not be netted against revaluation gains on other property. Such losses impact on Tier 1 capital via the accounting treatment, and no regulatory adjustment should be made to that impact.

(ii) Foreign currency translation reserves.

(iii) Reserves arising from a revaluation of security holdings. Where such reserves have not been incorporated into the accounts, they should be included at a discount of 55 percent (i.e. at 45 percent of the value of the reserves).

14.3 **Upper Tier Two Capital Instruments**

(i) Issued and fully paid up perpetual cumulative preference shares (including share premium)

(ii) Mandatory convertible notes

These are notes which must be converted into ordinary shares of the registered bank at some future date.

(iii) Perpetual subordinated debt

15. Capital instruments (ie items 14.3 (i), (ii) and (iii)) must meet the following requirements in order to qualify as **upper tier two capital instruments**:

(a) They must have no maturity date.

(b) They must not be redeemable or repayable at the option of the holder.

(c) Service obligations must be capable of being deferred (rather than waived altogether) until such time as the financial condition of the bank will support payment.

(d) In a winding up they must constitute a residual interest, such that no distributions may be made to holders unless and until all actual and contingent obligations to all creditors of the bank have been discharged.

(e) The interest or dividend rate must be fixed for the entire term of the debt and the documentation must not allow for the rate to be altered or reviewed except for the following:

(i) Where there is a variable rate and where the formula for setting the rate is fixed (for the term of the debt) at the outset. For example, it would be acceptable to specify the interest rate as a fixed margin above a recognised market benchmark such as the bank bill rate.

(ii) Where there is a variable rate and where the formula for setting the rate is fixed at the outset and provides for an increase, or increases, in the margin over a benchmark rate (the same benchmark must apply for the term of the instrument) which cumulatively do not exceed 50 basis points if they occur within ten years, and cumulatively do not exceed

100 basis points over the life of the instrument, if the life is more than ten years.

(iii) Where the rate is initially fixed and where the documentation provides for an increase, or increases, in that rate which cumulatively do not exceed 50 basis points if they occur within ten years, and cumulatively do not exceed 100 basis points over the life of the instrument, if the life is more than ten years.

(iv) Where the rate is initially fixed, and where the documentation provides for the ability to switch to a variable rate, and the formula for setting the variable rate is fixed at the outset and provides for an increase or increases in a deemed margin over a reference floating rate and where the increase or increases in the deemed margin cumulatively do not exceed 50 basis points if they occur within 10 years, and cumulatively do not exceed 100 basis points over the life of the instrument if the life is more than 10 years. The deemed margin shall be the same as the margin between the interest rate on the fixed leg of the instrument and the rate the bank could fix its interest costs in the same currency for the same term as the fixed leg of the instrument at the time the fixed rate is set.

(f) In the case of subordinated debt a provision whereby repayment is conditional on a solvency test (as defined in s4 of the Companies Act 1993) applied to both the issuer and the issuer's group will be required. Directors are responsible for deciding whether or not the bank is solvent. However, the solvency test should be subject to scrutiny by an independent party such as an external auditor. This scrutiny may take the form of a "negative assurance" based on the latest audited accounts together with a review by the auditors of post balance date events.

(g) Where subordinated debt is repayable at the option of the bank, the option must be exercisable only where the directors have resolved that the repayment is in the best interests of the bank.

(h) In the case of subordinated debt, the agreement should be subject to New Zealand law or a satisfactory equivalent. Where a bank wishes to use other than New Zealand law it will need to satisfy the Reserve Bank that the subordination provisions of the agreement will be effective under that jurisdiction.

Lower Tier Two Capital

16. **Lower tier two capital** may not exceed 50 percent of **tier one capital**.

17. **Lower tier two capital** instruments are subject to straight line amortisation (for capital adequacy purposes) in the final five years of their life, such than no more than 20 percent will qualify for inclusion during the final four reporting quarters preceding the reporting quarter in which the debt matures or is to be redeemed.

18. **Lower level tier two capital** is defined as:

    18.1 **Term subordinated debt** with an original maturity of five years or more.

    18.2 **Other capital elements with original maturity of five years or more.** For example, redeemable preference shares.

19. In order to qualify as **lower tier two capital** these instruments must meet the following requirements:

    (a) They must not be repayable or redeemable at the option of the holder. Except that instruments which are repayable at the option of the holder after a fixed period exceeding 5 years will qualify. In the event that an option of this type is exercised, the maturity date for capital adequacy purposes will be the redemption date.

    (b) They must rank behind all other creditors in the event of a liquidation, ie they must be subordinated and junior in right of payment to the issuer's obligation to all other creditors (excluding other subordinated obligations with which they rank pari passu).

    (c) The interest or dividend rate must be fixed for the entire term of the debt and the documentation must not allow for the rate to be altered or reviewed except for the following:

        (i) Where there is a variable rate and where the formula for setting the rate is fixed (for the term of the debt) at the outset. For example, it would be acceptable to specify the interest rate as a fixed margin above a recognised market benchmark such as the bank bill rate.

        (ii) Where there is a variable rate and where the formula for setting the rate is fixed at the outset and provides for an increase, or increases, in the margin over a benchmark rate (the same benchmark must apply for the term of the instrument) which cumulatively do not exceed 50 basis points if they occur within ten years, and cumulatively do not exceed 100 basis points over the life of the instrument, if the life is more than ten years.

        (iii) Where the rate is initially fixed and where the documentation provides for an increase, or increases, in that rate which cumulatively do not exceed 50 basis points if they occur within ten years, and cumulatively do not exceed 100 basis points over the life of the instrument, if the life is more than ten years.

        (iv) Where the rate is initially fixed, and where the documentation provides for the ability to switch to a variable rate, and the formula for setting the variable rate is fixed at the outset and provides for an increase or increases in a deemed margin over a reference floating rate and where

the increase or increases in the deemed margin cumulatively do not exceed 50 basis points if they occur within 10 years, and cumulatively do not exceed 100 basis points over the life of the instrument if the life is more than 10 years. The deemed margin shall be the same as the margin between the interest rate on the fixed leg of the instrument and the rate the bank could fix its interest costs in the same currency for the same term as the fixed leg of the instrument at the time the fixed rate is set.

(d) In the case of subordinated debt early repayment must be conditional on a solvency test (as defined in s4 of the Companies Act 1993) applied to both the issuer and the issuer's group. Directors are responsible for deciding whether or not the bank is solvent. However, the solvency test should be subject to scrutiny by an independent party such as an external auditor. This scrutiny may take the form of a "negative assurance" based on the latest audited accounts together with a review by the auditors of post balance date events.

(e) In the case of subordinated debt the agreement must be subject to New Zealand law or a satisfactory equivalent. Where a bank wishes to use other than New Zealand law it will need to satisfy the Reserve Bank that the subordination provisions of the agreement will be effective under that jurisdiction.

Deductions from Total Capital

20. The following items are to be deducted from total capital:

(a) In the case of the **banking group**:

Equity investments in unconsolidated subsidiaries of the registered bank.

In the case of the **registered bank**:

Equity investments in subsidiaries of the registered bank other than those which are both wholly owned and wholly funded by the registered bank. (See paragraph 11 for a definition of wholly owned and funded.)

(b) All holdings, whether direct or indirect, of capital instruments issued by other banks where the holdings equal or exceed 10 per cent of the capital of the bank in which the investment is made.

(c) Equity investments, whether direct or indirect, of 10 per cent or more in other financial institutions, ie companies whose business is substantially the borrowing and lending of money or providing financial services, or both.

(d) Unrealised revaluation losses on securities holdings

Revaluation losses which arise where the book value of the securities exceeds the market value but the resulting unrealised loss has not been incorporated into the accounts. In such cases the full value of the difference should be deducted from capital.

(e) Cumulative gains and losses on cash flow hedges, which have been recognised directly in tier two equity.

Note: Assets deducted from total capital should not be included in risk weighted exposures.

V RISK-WEIGHTED EXPOSURES

21. For the purposes of these requirements, capital adequacy ratios are calculated by expressing capital (tier one capital and capital) as a percentage of risk-weighted exposures.

22. Risk-weighted exposures are defined as the sum of risk-weighted on and off balance sheet credit exposures. On balance sheet credit exposures are risk-weighted using the risk weights set out in paragraph 26. Off balance sheet credit exposures are converted into on balance equivalents by the application of credit conversion factors (as specified in paragraph 36) and are then risk-weighted using the risk weights specified in paragraph 35.

23. Where a bank is subject to implicit or explicit credit risk as a result of involvement in funds management and securitisation activities or where the bank is subject to funding risk as a result of its involvement in securitisation, the bank may be required to consolidate these for capital adequacy purposes. (See paragraphs 43 to 54.)

24. Exposures (both on balance sheet exposures and credit equivalent amounts of off balance sheet exposures) are assigned to one of five risk weighting categories according to transaction type.

25. The risk weighting framework is intended to reflect the average credit characteristics of transactions which fall within the various categories, rather than the characteristics of individual exposures. Thus the weightings should not be regarded as an indication of the degree of credit risk attaching to any individual exposure or as a substitute for commercial judgements as to the appropriate market pricing of various instruments.

26. There are five risk weighting categories: 0, 10, 20, 50 and 100 per cent. The following is a list of the risk weighting categories.

RISK WEIGHTING CATEGORIES

Note: (i) Assets deducted from capital should not be included in risk weighted exposures.

(ii) Assets should be reported net of specific provisions/ individual and collective allowances for impairment loss (as appropriate).

(iii) Where a net (unrealised) gain on foreign exchange contracts or interest rate contracts has been taken to retained earnings via the profit and loss account, the corresponding balance sheet asset should be excluded from risk weighted assets in order to avoid double counting.

0% (i) **Cash**

This includes notes and coins held on site and gold bullion held in own vaults or on an allocated basis to the extent that it is backed by bullion liabilities.

(ii) **Short term claims on Government**

Claims on OECD[1] central banks and claims on central banks in non OECD countries which are denominated and funded in the national currency.

Claims on OECD central governments with a residual maturity of up to one year and claims on non OECD central Governments with a residual maturity of up to one year which are denominated and funded in the national currency.

Claims on the New Zealand central government are those which constitute claims on the Crown (Her Majesty in Right of New Zealand). The definition of "central government" to apply in the case of OECD countries will be that adopted by the supervisory authorities in those countries for the purposes of the BIS capital framework.

10% **Long term claims on government**

Claims on OECD central governments which have a residual maturity of one year or more and claims on non-OECD central governments which have a residual maturity of one year or more which are denominated and funded in the national currency.

[1] See Appendix I for a definition of OECD for the purposes of the capital framework.

20% (i) **Claims on banks**

Claims on multilateral development banks

This includes claims on the International Bank for Reconstruction and Development (IBRD), the International Finance Corporation (IFC), the Inter-American Development Bank (IADB), the Asian Development Bank (AsDB), the African Development Bank (AfDB) and the Export-Import Bank (EIB).

Claims on banks incorporated in OECD countries and claims on banks incorporated in non-OECD countries which have a residual maturity of up to one year. Holdings of other banks' capital instruments should not be included here. Banks are defined as financial institutions which have been registered or licensed as banks in their country of domicile by the appropriate banking supervisory authority.

Cash items that are due and in the process of collection.

(ii) **Claims on public sector entities**

Claims on public sector entities in OECD countries.

In New Zealand these are local authorities with a power to make or levy rates under the Local Government (Rating) Act 2002 (only those exposures which are, or can be, serviced from the rates are covered).

The definition of public sector entities in OECD countries other than New Zealand will be that adopted by the supervisory authorities in those countries for the purposes of this framework.

50% **Residential mortgages**

Loans fully secured by mortgage on residential property.

This includes loans fully secured by mortgage on property which is used primarily for residential purposes, either by the borrower or by a tenant of the borrower. Loans secured by mortgage over rural property which is used primarily for other than residential purposes should not be included here.

100% **Other**

(i) Holdings of other banks' capital instruments (other than those which are required to be deducted from capital).

(ii) Claims on New Zealand SOE's, Government corporations and trading entities and majority Government owned companies.

(iii) Holdings of a subordinated class of asset backed securities or holdings of principal and interest "stripped" securities.

(iv) Fixed Assets

(v) All other assets.

Recognition of collateral and guarantees

27. In certain limited circumstances collateral and guarantees are taken into account in determining the appropriate risk weighting of exposures.

Collateral

28. Where a claim (including equity investments other than those which are required to be deducted from capital) is collateralised by cash or securities issued by OECD central governments, OECD central banks, OECD public sector entities or specified multilateral development banks, the risk weight applicable to the collateral may be applied to the claim. If the value of the collateral covers less than the book value of the asset, only that part of the asset which is fully covered may receive the appropriate lower weight. Cash for this purpose means only cash deposited with, or a CD or comparable instrument deposited with, the lending bank. Cash deposits will only qualify as collateral where an express contractual right of set-off exists.

Guarantees

29. Where a claim (including equity investments other than those which are required to be deducted from capital) has been explicitly, irrevocably, and unconditionally guaranteed by OECD central governments, OECD central banks, OECD public sector entities, or OECD incorporated banks, that claim will attract the weight applicable to a direct claim on the guarantor. Claims guaranteed by non-OECD incorporated banks will also be recognised where the underlying transaction has a residual maturity of up to one year. In the case of claims covered by partial guarantees, only that part of the claim which is fully covered by the guarantee will attract the risk weight applicable to the guarantor. The guarantor in all these cases must not be a connected person to the bank, as defined in the connected exposures policy BS8.

Asset backed securities

30. An asset backed security will qualify for the risk weight applicable to the underlying assets, provided that the notes are fully secured at all times against the underlying assets and provided that the risks, claims, interests, rights and rewards of holding the

underlying assets have been transferred to the holders of the securities. This will require that:

(a) The securitisation and administration of the pooled assets takes place through a special purpose vehicle (SPV), which may have either a trust or a company structure. The SPV should be a single purpose entity, i.e. its activities should be limited to the requirements of the securitisation transaction. The SPV should not enter into any unrelated investment activities or incur any unrelated liabilities.

(b) The underlying assets should be held by an independent trustee on behalf of securities holders. The trustee should have a first priority registered charge over all of the assets.

(c) The securities must be structured in such a way that the cash flow from the underlying assets in all cases fully meets the cash flow requirements of the securities, without reliance on reinvestment income.

(d) The SPV should only invest cash flow pending distribution in short term assets with a risk weight which is equivalent to or lower than that of the underlying assets.

(e) The pool should only consist of assets which are fully performing at the time when the asset backed securities are created.

(f) The arrangements should provide, as a minimum, for the following obligations to be observed:

- The special purpose vehicle and the trustee should provide detailed and regular information on the structure and performance of the pooled loans

- The special purpose vehicle and trustee should be legally separate from the originator of the pooled loans. The originator should not be able to exercise any influence over the vehicle or the trustee to the detriment of the investor.

- The special purpose vehicle and the trustee should be responsible for any damage or loss to investors created by their own or their servicer's mismanagement of the pooled assets

- The documentation should contain provisions which would ultimately enable note holders to acquire legal title to the assets and to realise the security in the event of a default.

31. If securities are backed by more than one type of asset, then the entire issue should be assigned to the risk weight category applicable to the highest risk weighted asset underlying the issue.

32. Holdings of asset backed securities of a subordinated class are to be weighted at 100 percent regardless of the risk weighting applicable to the underlying asset.

33. Stripped" securities are to be weighted at 100 percent regardless of the risk weighting attaching to the underlying asset.

Risk weights applicable to transferred loans

34. Where an asset qualified for a concessionary risk weight prior to its transfer, the concessionary weight will also apply in the hands of the buyer, provided that all of the risks, claims, interests, rights and rewards associated with the underlying asset have been transferred to the buyer. This will require that the transfer is affected by one of the following methods:

    (a) A transfer by novation.

    (b) A transfer through an assignment duly notified to the borrower, provided that the buyer's rights under transfer are not impeded by an intervening right, such as a right of set off between seller and borrower.

    (c) A transfer through silent assignment provided that there is a covenant between the seller and the buyer whereby the seller agrees to exercise its rights on the buyer's behalf. For example, if the borrower defaulted the covenant would require the seller to realise the underlying security on the buyer's behalf.

    (d) A transfer through sub-participation provided that the arrangements between the originator (or seller) contain a clause whereby the originator agrees to enforce its rights against the borrower in favour of the sub participant.

    Loans transferred by any other method will receive a risk weighting of 100 percent.

Off-balance sheet exposures

35. All categories of off-balance sheet exposures where there is an associated credit risk are to be included in the calculation of total risk weighted exposures on a credit equivalent basis. This is achieved by applying a credit conversion factor (0, 20, 50 or 100 per cent) to the amount of the exposure, depending on the type of engagement (except in the case of foreign exchange, interest rate and other market related transactions). Exposures are then risk weighted according to counterparty type using the same risk weights as apply to on balance sheet exposures (except in the case of foreign exchange, interest rate and market related transactions, in which case counterparties which would normally be assigned a risk weight of 100 percent are to be assigned a risk weight of 50 percent).

36. For the purposes of determining the appropriate credit conversion factor, off-balance sheet exposures (other than foreign exchange, interest rate and market related transactions) are assigned to one of the following categories.

Credit Conversion Factor

100% A **Direct Credit Substitutes**

These are off balance sheet exposures where the risk of loss to the reporting institution is equivalent to a direct claim on the counterparty, i.e. the risk of loss depends on the creditworthiness of the counterparty. Examples of direct credit substitutes include:

Bills of Exchange
Guarantees of financial obligations
Standby letters of credit
Risk participations

B **Asset Sales with Recourse**

These are arrangements whereby loans or other assets are sold to a third party, but the seller retains an obligation to assume the credit risk on the asset should the borrower default or the value of the asset otherwise deteriorate.

Note: The appropriate risk weight for asset sales with recourse is the weight applicable to the issuer of the security or the underlying asset rather than that of the counterparty to the transaction.

C **Commitments with Certain Draw Down**

Included in this category are legal agreements to purchase assets or acquire claims which are certain to be drawn down at some future date. The credit risk is regarded as being the same as if the asset were already on the balance sheet. Examples include:

Forward purchases
Forward forward deposits
Partly paid shares and securities
All other commitments with certain drawdown.

Note: The appropriate risk weight for commitments with certain drawdown is the weight applicable to the issuer of the security or the underlying asset rather than that of the counterparty to the transaction.

50% D **Transaction Related Contingent Items**

These relate to the ongoing trading activities of a counterparty where the risk of loss to the reporting institution depends on the likelihood of a future event which is independent of the creditworthiness of the counterparty. They are essentially guarantees which support particular obligations rather than supporting customers' general financial obligations. Examples of transaction related contingent items include:

Performance bonds
Bid bonds
Warranties and indemnities
Standby letters of credit (performance related)

E **Underwriting and Sub-Underwriting Facilities**

These include commitments to underwrite equity investments and issues of debt (including note issuance facilities (NIF's) and revolving underwriting facilities (RUF's) which are arrangements whereby a borrower may draw down funds up to a specified limit over a specified period by making repeated note issues to the market. Should the issues not be able to be placed in the market at a minimum price, the unplaced amount will be taken up by the offeror of the facility at a specified price. The relevant credit risk is determined by the nature of the counterparty using the facility.

Where parts of an underwriting have been sub-underwritten, the appropriate risk weight to be applied to the sub-underwritten portions will be the weight applicable to the sub-underwriter.

Where the reporting bank is a sub-underwriter of an underwriting the appropriate risk weight will be that of the counterparty using the underwriting facility.

F **Other Commitments to Provide Financial Services Which Have an Original Maturity of One Year or More**

20% G **Short Term Self Liquidating Trade Related Contingencies**

These include documentary letters of credit, confirmed letters of credit and other trade financing transactions which are secured against an underlying shipment of goods, are self-liquidating and have a fairly short term.

0% H **Other Commitments with an Original Maturity of less than One Year or Which can be Unconditionally Cancelled at Any Time**

Market Related Contracts

37. Market related contracts are defined as foreign exchange contracts, interest rate and other market related contracts. Examples include the following:

Foreign Exchange Contracts
Forward foreign exchange contracts
Currency swaps
Cross currency interest rate swaps
Currency futures
Currency options purchased
and other similar exchange rate contracts

Note: Exchange rate contracts with an original maturity of 14 days or less may be excluded from the calculation of exposure. Where currency futures and options are traded on exchanges which require daily marking to market for gains and losses and are subject to daily margin requirements, they may also be excluded from the calculation of exposure.

Interest Rate Contracts
Forward interest rate agreements (FRA's and similar products)
Interest rate swaps
Interest rate futures
Interest rate options purchased
Other similar interest rate contracts

Note: Where interest rate options and futures are traded on exchanges which require daily marking to market for gains and losses and are subject to daily margin requirements, they may be excluded from the calculation of exposure.

Other Market Related Contracts
Contracts to purchase and sell gold bullion
Gold futures contracts
Gold options purchased
Stock price futures contracts
Stock price options purchased
Forward spread agreements
Commodity based transactions
Other market related contracts where loss would occur in the event of counterparty non-performance.

38. These items differ from other categories of off balance sheet exposure in that a bank is exposed to the potential cost of replacing the cash flows arising from the contract, rather than the principal value of the contract itself. The credit equivalent amount of these transactions may be determined by either the **current exposure method** or the **original exposure method.**

The Current Exposure Method

39. Using this method the credit equivalent amount is calculated by adding the following two components:

- **Current exposure**, which is the total replacement[2] cost (obtained by marking to market) of all contracts with positive value.

- **Potential exposure**, which is calculated on the basis of the total principal amount of the book, split by residual maturity as follows:

Residual Maturity	**Interest Rate Contracts**	**Exchange Rate Contracts**
Less than one year	Nil	1.0%
One year and over	0.5%	5.0%

For basis swaps (ie single currency floating/floating interest rate swaps) potential exposure equals zero.

The Original Exposure Method

40. Using this method, the credit equivalent amount is calculated by applying the credit conversion factor listed below to the notional principal amounts of each instrument according to its nature and original maturity.

Original Maturity	**Interest Rate Contracts**	**Exchange Rate Contracts**
Less than 1 year	0.5%	2.0%
1 year and less than 2 years	1.0%	5.0%
2 years and over	1.0% for year one plus 1% for each	2.0% for year one plus 3.0%

[2] Replacement cost is the market value of a contract if the market value is positive or zero if the market value is negative. It is the cost of replacing the contract on the assumption that theoretical profits on default are not realizable.

	additional year or part thereof.	for each additional year or part thereof.

Netting of Amounts

41. Registered banks may net foreign exchange contracts when calculating the credit equivalent amount where a bilateral agreement based on netting by novation exists. Bilateral netting by novation refers to a master contract between two counterparties under which any obligation between the parties to deliver a given currency on a given date is automatically amalgamated with all other obligations under the agreement for the same currency and value date. The result is legally to substitute a single net amount for the previous gross obligations

Risk Weighting of Foreign Exchange, Interest Rate and other Market Related Contracts

42. Foreign exchange, interest rate and other market related contracts are to be risk weighted according to counterparty type, using the same weights as apply to on balance sheet exposures **except that** foreign exchange and interest rate contracts which would normally be weighted at 100 percent are to be weighted at 50 percent.

Funds management and securitisation

43. Banks may be involved in funds management and securitisation through activities such as:

- originating or supplying assets to special purpose vehicles
- marketing funds management and securitisation products through their branch network
- acting as a servicing agent
- acting as a fund manager
- sponsoring or establishing such arrangements

44. Banks may be exposed to risks as a result of their association with funds management and securitisation activities. For the purposes of this policy, "association" means any relationship other than the provision of normal banking or commercial services on a fully arm's length basis. Some of these risks arise from implicit or "moral" obligations, rather than formal legal obligations. For example, a bank may feel an obligation to provide support to special purpose vehicles set up to conduct securitisation or funds management activities, because it considers that its own reputation and/or customer base will suffer if support is not provided. To the extent that a bank creates a degree of

separation between itself and its funds management and securitisation activities, these implicit risks can be reduced.

45. Banks may face more explicit forms of risk where they provide credit enhancements to special purpose vehicles. Examples of credit enhancements include (but are not limited to) the following:

- holding a subordinated class of securities issued by the special purpose vehicle
- provision of financial services (eg interest rate swaps) on other than arm's length terms and conditions
- provision of risk insurance
- provision of guarantees
- over collateralisation
- repurchase or replacement of non-performing loans
- a (one off) gift or a long term loan, maturing after other securities issued by the special purpose vehicle
- payment of expenses incurred by the fund
- management fee structures which vary with the level of non performing assets held by a special purpose vehicle or with the capital value of a managed fund such that there is potential for fees to fall to a level which would be below that which the bank would expect to receive if fees were set at market levels on arm's length terms and conditions.

46. Banks may also face funding risk as a result of involvement in securitisation schemes. This can occur if associated special purpose vehicles issue securities with maturities which are shorter than those of the underlying assets. In such cases there is a risk that the bank will be required to fund some, or all of, the underlying assets when the securities mature.

47. Where a bank is required by GAAP to consolidate a funds management or securitisation special purpose vehicle for the purposes of its group financial statements, the special purpose vehicle must be treated as part of the banking group for the purposes of the capital adequacy framework.

48. Where consolidation of a funds management or securitisation special purpose vehicle is not required for accounting purposes the following treatment will apply for capital purposes. If there is insufficient separation between the bank and associated funds management and securitisation activities, the bank has provided some form of credit enhancement to an associated scheme, or the bank retains funding risk as a result of its involvement in a securitisation, the bank is required to hold capital against the assets of the scheme, in accordance with paragraphs 49, 51 and 54.

Explicit Risk

49. Where a bank provides any form of credit enhancement to an associated special purpose vehicle and if the obligation can be quantified and does not take the form of a guarantee the bank may choose one of the following three options:

- deduct the maximum level of its obligation to provide support from capital;
- expense the full amount of its obligation at the time its relationship with the special purpose vehicle commences; or
- consolidate the assets of the special purpose vehicle for the purposes of calculating its capital adequacy ratios.

Where the maximum extent of the bank's obligation cannot be readily quantified or where the credit support takes the form of a full or partial guarantee, the assets of the fund should be fully consolidated for capital adequacy purposes.

50. Where banks are providing credit enhancements to securitisation special purpose vehicles and

- the bank and parties related to the bank are not associated with the special purpose vehicle and;

- the credit enhancement is provided on arm's length terms and conditions and at market prices;

the credit enhancement will be treated as a 100 percent risk weighted exposure of the bank.

Implicit Risk

51. Where any of the following minimum separation requirements are not met, a bank will be required to fully consolidate the assets of an associated special purpose vehicle for capital adequacy purposes.

(a) Prospectuses and brochures for funds management and securitisation products must include clear, prominent disclosures of the following:

i that the securities do not represent deposits or other liabilities of the bank.

ii that the securities are subject to investment risk including possible loss of income and principal invested.

iii that the bank does not guarantee (either partially or fully) the capital value or performance of the securities.

Note however, that these requirements do not override or replace any of the issuer's obligations under the Securities Act and Regulations.

(b) Unless the bank is treating financial services provided to a special purpose vehicle as a credit enhancement, the bank's disclosure statements must include a statement that financial services (including funding and liquidity support) provided by the bank (and any of its subsidiaries) are on arm's length terms and

conditions and at fair value. Where the bank or its subsidiaries have purchased securities issued by a special purpose vehicle during the reporting period, or have purchased assets from a special purpose vehicle, the bank's disclosure statements must include a statement that these were purchased at fair value and on arm's length terms and conditions.

(c) When securities are initially issued, investors must be required to sign an explicit acknowledgement that the securities do not constitute bank deposits or liabilities and that the bank does not stand behind the capital value and performance of the securities.

(d) There must either be an independent trustee or there must be clear, prominent disclosure in all prospectuses, brochures and application forms relating to the scheme of whether or not there is a trustee, and, where applicable, that the trustee is not independent of the bank.

(e) Where the bank or its subsidiaries purchase assets from a special purpose vehicle the purchases must take place at fair value and on arm's length terms and conditions.

(f) Where the bank or its subsidiaries provide funding or liquidity support to an associated special purpose vehicle, or purchase securities issued by an associated special purpose vehicle, the following conditions must apply:

(i) Such transactions take place on arm's length terms and conditions at fair value.

(ii) Funding (including funding provided by purchase of securities issued by the SPV) does not exceed 5 percent of the value of securities issued by the special purpose vehicle.

52. In addition, aggregate funding provided to:

(a) all associated special purpose vehicles not consolidated in terms of paragraph 51 above (including funding provided by the purchase of securities issued by an SPV); and

(b) all affiliated insurance groups (see paragraphs 55 to 63 for further details);

must not exceed 10 percent of the bank's tier one capital. Where the 10% limit is breached, the full amount of this aggregate funding is required to be deducted from tier one capital (see paragraph 9.6 on deductions from tier one capital).

53. While there is no requirement to hold capital against funds management and securitisation activities where the above minimum separation has been achieved, banks will need to take into account the fact that it is very difficult to totally eliminate implicit credit risk. Thus banks will need to ensure that their capital adequacy policies take

account of any residual implicit risk, particularly where funds management and securitisation activities are significant in size relative to the bank's other activities.

Funding Risk

54. A bank may face funding risk as a result of its involvement in a securitisation scheme if the securities issued by the special purpose vehicle have a shorter maturity profile than the assets against which the securities have been issued. Where a bank is subject to funding risk as a result of its involvement in a securitisation scheme it will be required to fully consolidate the securitised assets for capital adequacy purposes.

Insurance business

55. The role of distributing or marketing insurance products underwritten by affiliated insurance entities may involve an exposure to implicit risk, ie, to reputational risks and to moral recourse as a result of a close association with those affiliated entities. Implicit risk can be reinforced if explicit support is provided to the insurance entity. To the extent that the banking group and any affiliated insurance entities create a degree of separation between each other, then these risks can be reduced.

56. In this document:

(a) "Insurance entity" means any entity whose business predominantly consists of the conduct of insurance business as defined in registered banks' conditions of registration;

(b) "Affiliated insurance entity" means any insurance entity which is not a member of the New Zealand banking group, but:

- which is either the ultimate parent of the New Zealand banking group;
- or which is a subsidiary of the ultimate parent of the New Zealand banking group;
- or which is an insurance entity in which the ultimate parent of the New Zealand banking group has an interest as an associate, or a direct or indirect interest as a party to a joint venture;

and whose financial products are distributed or marketed by the New Zealand banking group;

(c) An "affiliated insurance group" means any affiliated insurance entity and all that entity's subsidiaries.

For the purposes of these definitions, the terms "parent", "subsidiary", "associate" and "joint venture" are determined in accordance with generally accepted accounting practice, as defined in the Financial Reporting Act 1993.

Credit Enhancements

57. The full amount of any credit enhancements provided by the banking group to any member of an affiliated insurance group is required to be either fully expensed, or deducted from the banking group's tier one capital. Examples of credit enhancements include, but are not limited to, the following:

    (a) Holdings of, or investments in, equity instruments or subordinated classes of financial instruments;

    (b) Provision of exchange rate, interest rate, or other market related contracts for hedging purposes on other than arm's length terms and conditions. For this purpose, market related contracts which are not traded in an active and liquid market, or whose data inputs are not taken from an active and liquid market, are regarded as credit enhancements;

    (c) Provision of funding and liquidity support on other than arm's length terms and conditions;

    (d) Guarantees and other risk assumption techniques which provide support for the asset risks of any member of the insurance group (for example, asset credit risks, equity risks, or property price risks), other than market related contracts on arms length terms and conditions;

    (e) Asset transfers from the banking group to any member of the affiliated insurance group at less than fair value;

    (f) Repurchase or replacement of non-performing assets;

    (g) Payment of expenses or liabilities.

Implicit Risk - Minimum Separation Requirements

58. Where any of the following minimum requirements are not met, the whole amount of any funding exposures which the banking group has to the affiliated insurance group is required to be deducted from tier one capital:

    (a) Investment statements, prospectuses and brochures for insurance products must include clear, prominent disclosures that the bank and its subsidiaries do not guarantee the affiliated entity which is the issuer of the products, nor any of that entity's subsidiaries, nor any of the products issued by that affiliated insurance group.

    (b) Where the insurance products are subject to the Securities Act 1978, investment statements, prospectuses and brochures must additionally include clear and prominent disclosures that:

- the policies do not represent deposits or other liabilities of the bank or its subsidiaries;

- the policies are subject to investment risk, including possible loss of income and principal;

- the bank and its subsidiaries do not guarantee the capital value or performance of the policies.

(c) At initial issue to an insurance product purchaser, the purchaser must be required to sign an explicit acknowledgement that the bank and its subsidiaries do not guarantee the affiliated entity which is the issuer of the products, nor any of that entity's subsidiaries, nor any of the products issued by that affiliated insurance group. Where an insurance product is subject to the Securities Act 1978, the investor must also sign an explicit acknowledgement that the policies do not represent deposits or other liabilities of the bank or its subsidiaries, and that the banking group does not stand behind the capital value or performance of the policies.

(d) Asset purchases by the banking group from an affiliated insurance group must take place on arms-length terms and conditions, and at fair value.

(e) Unless a bank is treating financial services provided to an affiliated insurance group as a credit enhancement, the bank's disclosure statements must include a statement that financial services (including funding and liquidity support) provided by the bank or any of its subsidiaries are made on arms-length terms and conditions and at fair value. Similarly, where the bank or its subsidiaries have purchased securities issued by an affiliated insurance group, or have purchased assets from it during the reporting period, the bank's disclosure statement must include a statement that these were purchased at fair value and on arm's length terms and conditions.

(f) Funding and liquidity support provided by the banking group to each affiliated insurance group must not exceed 5% of the total consolidated assets of that insurance group, and must be provided on arm's length terms and conditions, and at fair value.

(g) Aggregate funding provided to all affiliated insurance groups (see paragraph 56) and to all associated funds management and securitisation vehicles (see paragraphs 43 to 54 for further details) must not exceed 10 percent of the bank's tier 1 capital.

59. For the purposes of paragraph 58, funding and liquidity support provided by the banking group to any member of the affiliated insurance group comprises the following items:

(a) its share of policyholder liabilities;

(b) other than for credit exposures arising from market related contracts, any claims which represent senior credit exposures;

(c) the undrawn portion of any commitments to provide funding or purchase assets;

(d) the full amount of direct credit substitutes.

60. This definition of funding does not include credit exposures arising from the provision of market related contracts used for hedging price movements, such as interest rate swaps, or foreign exchange risk hedging instruments (historical rate rollovers excepted). Nor will it include investments in equity instruments or other classes of subordinated financial instruments, as these are required to be deducted from tier one capital (see paragraphs 9.6 and 57 above). However, it will include loans, overdrafts, revolving credit lines, money market placements, investments in senior ranking securities, forward asset purchases, guarantees of borrowings, and similar items.

61. In line with the definition of an affiliated insurance group, where there are a number of insurance entities within a group of insurance companies, the funding limits relate to each operating life insurance or general insurance entity (and their subsidiaries) within the group. Therefore, if one operating insurance entity is controlled by another, and the banking group has a marketing role in relation to each of those operating entity’s products, the funding requirements apply on a tiered sub-group/group basis.

62. The funding limit does not apply to the holding companies, parents, or other related parties of these affiliated insurance groups, although any credit exposures to those entities are subject to the applicable connected person exposure limits contained in registered banks’ conditions of registration. Likewise, all credit exposures to affiliated insurance groups, including funding exposures, are still subject to those connected person exposure limits.

63. Even where the above requirements are met, banks will need to take into account the fact that it is very difficult to totally eliminate the implicit risks that might arise from the marketing of an affiliated insurance group’s products. Accordingly, banks should ensure that their capital adequacy policies take account of any residual implicit risk, particularly where the volume of insurance products distributed is significant in relation to the banking group’s other activities.

Loan transfers

64. Loans which have been transferred from the originator to another party may be regarded as falling outside of the bank's business where a "clean transfer" of risk has been achieved ie where the bank (or another member of the banking group) is under no obligation to repurchase the transferred loans, would incur no loss (of interest or

principal) in the event of non performance by the borrower and would not feel impelled to support the loan in any circumstances.

Transfers by any of the following methods will qualify:

(a) transfers through novation.

(b) transfers by notified assignment.

(c) transfers through silent assignment.

(d) loan sub participations.

subject to the following requirements being met:

- The transfer does not contravene the terms and conditions of the underlying loan agreement and all necessary consents have been obtained.

- The seller has no residual beneficial interest in the principal amount of the loan (or that part which has been transferred) and the buyer has no formal recourse to the seller for losses.

- The seller has no obligation to repurchase the loan, or any part of it at any time.

- The seller has given notice to the buyer that it is under no obligation to repurchase the loan or support any losses suffered by the buyer and that the buyer has provided written acknowledgement of the absence of obligation.

- The documented terms of the transfer are such that if the loan is rescheduled or renegotiated the buyer and not the seller would be subject to the rescheduled or renegotiated terms.

- Where payments are routed through the seller, it is under no obligation to remit funds to the buyer unless and until they are received from the borrower.

- Where the buyer is a trust, the trustees of that trust should be independent of the seller or companies related to the seller either during or subsequent to the sale negotiations.

65. Where banks transfer undrawn commitments to lend, the commitment should be excluded from the selling bank's risk weighted exposures only if the transfer is by novation or by an assignment accompanied by a formal acknowledgement from the borrower.

APPENDIX I

List of OECD Countries

For the purposes of the capital adequacy framework OECD countries are defined as full members of the Organisation for Economic Co-operation and Development which have not rescheduled their external sovereign debt within the previous five years plus the following:

Saudi Arabia
Singapore
Hong Kong

The following countries were full members of the OECD as at December 2000:

Australia
Austria
Belgium
Canada
Czech Republic
Denmark
Finland
France
Germany
Greece
Hungary
Iceland
Ireland
Italy
Japan
Korea
Luxembourg
Mexico
Netherlands
New Zealand
Norway
Poland (rescheduled debt in October 1994)
Portugal
Slovak Republic
Spain
Sweden
Switzerland
Turkey
United Kingdom
United States

APPENDIX II

Glossary of terms

EXCHANGE RATE CONTRACTS

Forward Foreign Exchange Contract - a foreign exchange contract which calls for delivery of a specified amount of one currency for a specified amount of another currency, at a fixed future date. The exchange rate is established at the time the contract is agreed on, but payment and delivery are not required until maturity.

Currency Swaps - A fixed rate currency swap consists of the exchange between two counterparties of fixed rate interest in one currency in return for fixed rate interest in another currency. The following steps are common to most currency swaps:

(a) initial exchange of principal at an agreed exchange rate;

(b) ongoing exchanges of interest based on the outstanding principal amounts at the respective fixed interest rates agreed at the outset of the transaction;

(c) re-exchange of the principal amounts on the maturity date, usually at the same exchange rate used on the value date.

Cross-Currency Interest Rate Swaps - a combination of an interest rate swap and a currency swap which involves the exchange of payments in different currencies and also on different interest rate bases.

Currency Futures - These are exchange traded futures contracts for the delivery of a standardised amount of foreign currency at some future date. The price for the foreign currency is agreed on the date the contract is bought or sold. As with forward contracts, gains and losses are incurred as a result of subsequent currency fluctuation. Unlike forward contracts, however, futures contracts are trade able reflecting the standardisation of each contract size, specification and delivery date.

Currency Options - an option contract allows the holder to exchange (or choose not to exchange) a specific amount of one currency for another at a predetermined rate during some period in the future. For the institution writing the option, the risk lies in its exposure to movements in the exchange rate between the two currencies (a pricing risk). For an institution buying an option the risk lies in the ability of the counterparty to perform (a credit risk).

Options may be contracted "over the counter", that is, directly between counterparties, or via recognised exchanges. The latter have standardised terms and delivery dates and are trade able. Currency options sold are excluded from the risk based capital analysis because there is no credit risk involved, but currency options purchased are included unless they are traded on a recognised exchange and subject to daily margin requirements.

Other Similar Exchange Rate Contracts - Other contracts which expose the issuing institution to credit risk in the context of exchange rate movements.

INTEREST RATE CONTRACTS

Forward Interest Rate Agreements (FRAs and similar products) - A contract in which two parties agree on the interest rate to be paid on a notional deposit of specified maturity at a specified future time (the settlement date).

Interest Rate Swaps - A transaction in which two counterparties exchange interest payments streams of differing character based on an underlying notional principal amount. The two main types of interest rate contracts are: coupon swaps (fixed rate to floating in the same currency) and basis swaps (one floating rate index to another floating rate index in the same currency.

Interest Rate Futures - An exchange traded contract for the future delivery of a standardised amount of a specified security, such as bank bills or government stock. Gains or losses are incurred as a result of subsequent movements in interest rates.

Interest Rate Options - The buyer of an option has the right (but not the obligation) to lock into a predetermined interest rate during some period in the future. As with currency options, the instruments may be traded over the counter or exchange traded (in the latter case, such instruments may be excluded where they are subject to daily margin requirements).

Interest rate options include various types of interest rate guarantees, known as "caps', "collars" and "floors". In addition, some interest rate options are sold as a package with capital market instruments, for example, as capped FRN's.

Only interest rate options purchased are to be included. Interest rate options sold, or written, are excluded because writing an option does not entail any credit risk. The buyer of an option, on the other hand, assumes the credit risk of the writer's ability to perform throughout the life of the contract.

Other Similar Interest Rate Contracts - Other contracts which expose the issuing institution to credit risk in the context of interest rate movements should be recorded here.

OTHER MARKET RELATED CONTRACTS

Other market related contracts include contracts to purchase and sell gold bullion, gold futures contracts, gold options purchased, stock price futures contracts, stock price options purchased, forward spread agreements, commodity based transactions and other market related contracts where loss would result in the event of counterparty non-performance.

OTHER

Asset Sales with Recourse - Arrangements whereby loans or other assets are sold to a third party, but the seller retains an obligation to assume the credit risk on the asset should the borrower default or the value of the asset otherwise deteriorate.

Bid Bonds - These are a type of bond required in public construction projects which must be filed at the time of the bid and which protects the public agency in the event that the bidder refuses to enter into a contract after it has been awarded or withdraws its bid before the award.

Bills of Exchange - the Bills of Exchange Act defines a bill of exchange as:

> "an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person, or to a bearer".

An acceptor of a bill undertakes to pay the face value of the bill when it is due and is thus primarily liable for the face amount of the bill.

An endorser incurs a liability similar to that of a guarantor, but generally has recourse to prior endorsers, the acceptor and the drawer.

Confirmed Letters of Credit - This relates to letters of credit which have been confirmed by the reporting bank to provide an additional guarantee of payment. Confirmed letters of credit represent an exposure to a bank and should be assigned a 20 percent risk weight.

Documentary Letters of Credit - Also known as commercial letters of credit in some countries these are letters of credit guaranteeing payment by the issuing bank in favour of an exporter, against presentation of shipping and other documents.

Forward Purchases - These are commitments to purchase a loan, asset or security at a specified future date, usually on pre-arranged terms. Firm commitments for capital expenditure should be included here.

Forward Forward Deposits - An agreement between two parties whereby one will pay and the other will receive an agreed rate of interest on a deposit to be placed by one party with the other at a pre-determined future date. Such deposits differ from forward rate agreements in that the principal amount involved is actually exchanged, not just the interest rate differential. Thus the bank that is contracted to place the deposit is exposed to the credit risk of the counterparty on the full amount of the deposit.

Guarantees - This includes general guarantees of indebtedness where the registered bank undertakes to stand behind the current financial obligations of a client and to carry out these obligations should the client fail to do so (e.g. loan guarantees).

Partly Paid Shares and Securities - Where a bank has paid only part of the nominal price or face value of securities held and the remainder may be called at a predetermined or unspecified date in the future, the unpaid portion is callable at any time at the discretion of the issuer, these notes should be treated in the same way as a NIF or a RUF.

Performance Bonds - These are a form of surety or guarantee which contains the promise of the issuer to complete or pay for the cost of completion of, for example, a construction contract if the contractor is unable or unwilling to do so.

Risk Participations - This refers to the share of risk exposure resulting from acquisitions of risk participations in bankers' acceptances and participations in financial guarantee type standby letters of credit or other direct credit substitutes. Such risk participations entail a level of credit risk analogous to that of a direct loan.

Standby Letters of Credit - These are contractual agreements issued on behalf of a client under which the issuing bank is obliged to provide compensation to a third party should the client fail to meet the terms or conditions of an agreement with that third party.

Standby Letters of Credit (Performance Related) - included here are all letters of credit which include non-financial undertakings, whereby the issuer on behalf of the client provides an assurance to a third party that the customer will perform under the terms of the contract. These letters of credit fulfil the same functions as a performance bond.

Warranties and Indemnities - This category includes counter-guarantees provided by a bank that a client will pay compensation if goods or services provided by the client to a third party do not meet the terms specified in the contract.