



Connected Exposures Policy

Prudential Supervision Department
Document BS8

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1. Locally incorporated banks are generally subject to standard conditions of registration relating to exposure to connected persons. This document sets out these standard requirements.
2. The Reserve Bank reserves the right to impose a non-standard condition of registration or to vary the standard condition of registration where special circumstances apply. For example, the Bank may consider it appropriate to impose a lower than normal connected lending limit on a bank that is undercapitalised relative to the levels of risk it is facing, but which is not in a position to raise additional capital.
3. Advances of a capital nature by a banking group to connected persons must be deducted from the banking group's tier 1 capital. An advance will be considered to be of a capital nature if, in a connected person's financial statements, it is described as a capital or subordinated debt instrument and/or it is counted as capital under the capital adequacy requirements imposed by a parent supervisor.
4. Aggregate credit exposures (of a non-capital nature and net of any allowances for impairment) of the banking group to all connected persons shall not exceed the rating-contingent limit outlined in the following matrix.

Credit rating¹	Connected exposure limit (% of the Banking Group's Tier 1 capital)
AA/Aa2 and above	75
AA-/Aa3	70
A+/A1	60
A/A2	40
A-/A3	30
BBB+/Baa1 and below	15

Within the rating-contingent limit, credit exposures (of a non-capital nature and net of any allowances for impairment) to non-bank connected persons shall not exceed 15 percent of the banking group's tier 1 capital.

For the purpose of compliance with the rating-contingent limit:

- (a) The credit rating will be the rating applicable to the bank's long-term senior unsecured New Zealand dollar obligations payable in New Zealand, in New Zealand dollars. Where a bank has more than one credit rating, the lowest rating will be used in determining the connected exposure limit.
- (b) Only credit ratings produced by rating agencies approved by the Reserve Bank may be used. Those agencies are: Standard & Poor's, Moody's Investor Services and Fitch Ratings. (The Reserve Bank's "Statement of

¹ The rating scales in this column are presented as "Standard & Poor's scale/Moody's Investor Services scale," noting that Fitch Ratings' scale is identical to Standard & Poor's.

Principles” (BS1), in particular Appendix Three of BS1, provides details on the approval of credit rating agencies.)

- (c) A three-month grace period starting from the date of a credit rating downgrade will be allowed for the limit which applies before the downgrade to reduce to the new limit based on the above matrix. The Reserve Bank will consider allowing an extension of the limit adjustment period if a bank has structural reasons for not being able to comply within the three-month period. The limit extension would be for a specific time period (but no longer than an additional three months).
- (d) “Tier 1 capital” is determined for a bank as specified in the bank’s conditions of registration under the Reserve Bank documents:
 - (i) “Capital Adequacy Framework (Standardised Approach)” (BS2A) dated November 2007;
 - (ii) “Capital Adequacy Framework (Internal Models Based Approach)” (BS2B) dated March 2008; or
 - (iii) “Capital Adequacy Framework (Basel I Approach)” (BS2) dated March 2008.
- (e) “Connected person” means any person, other than a government of a country which is a member of the Organisation for Economic Co-operation and Development, which is:
 - (i) an owner (which means any person who has a substantial interest in the registered bank), or
 - (ii) an entity in which an owner has a substantial interest (other than the registered bank and entities in which the registered bank itself has a substantial interest), or
 - (iii) a person which has a substantial interest in an owner, or
 - (iv) a director of the registered bank.
- (f) A person has a “substantial interest” in an entity if that person:
 - (i) holds (whether directly or indirectly) more than 20 percent of the issued securities of an entity, other than securities that carry no right to participate beyond a specified amount in a distribution of either profits or capital; or
 - (ii) is entitled to receive (whether directly or indirectly) more than 20 percent of every dividend (or, in the case of an entity which is not a company, distributions of a similar nature) paid on securities issued by the entity, other than securities that carry no right to

participate beyond a specified amount in a distribution of either profits or capital; or

- (iii) is in a position to exercise, or control the exercise of, more than 20 percent of the maximum number of votes that can be exercised at a meeting of an entity or the owners of the entity; or
 - (iv) controls or significantly influences the composition of the board of the entity, or, if the entity does not have a board of directors, the body which has the power to manage or direct or supervise the management of the business and affairs of the company.
- (g) In determining whether a person has a substantial interest in an entity, sections 7 and 8 of the Companies Act 1993 shall apply with all necessary modifications.
- (h) “Non-bank connected person” means any connected person other than a bank or an entity in which a bank has a substantial interest.
- (i) “Credit exposure” means the amount of the maximum loss that a party to a contract could incur as a result of the counterparty to that contract failing to discharge its obligations, without taking into account the value of collateral, guarantees, indemnities, other support arrangements, and any potential recoveries, and excluding contingent exposures arising as a result of risk lay-offs to a bank owner, where the maximum loss in relation to:
- (i) a market related contract means the credit equivalent amount of the contract determined in accordance with the Reserve Bank document entitled “Capital Adequacy Framework (Standardised Approach)” (BS2A) dated November 2007.
 - (ii) any other contract means the full value of the contract; provided that a financial liability may not be offset against any such loss even if to do so would accord with generally accepted accounting practice as defined in the Financial Reporting Act 1993.

In certain circumstances, however, aggregate connected exposures can be calculated on a net basis. Where a robust industry standard netting agreement is used, on- and off-balance sheet exposures of a non-capital nature to a connected person can be bilaterally offset against borrowings of a non-capital nature from the same legal entity. As an interim arrangement, pending the establishment of a robust industry standard netting agreement, bilateral netting agreements whose robustness has been validated by an independent third party expert to the satisfaction of the Reserve Bank will be permitted. The amount of gross exposures netted off shall not be greater than 125 percent of a banking group’s tier 1 capital.

- (j) “Securities” shall have the same meaning as in the Reserve Bank of New Zealand Act 1989.
 - (k) The term person includes a corporation sole, a company or other body corporate (whether incorporated in New Zealand or elsewhere), an unincorporated body of persons and a public body.
5. Where a bank’s obligations are fully, irrevocably and unconditionally guaranteed by a parent entity with a AAA credit rating from a Reserve Bank approved rating agency, the rating-contingent limit framework will not apply.
 6. Exposures to connected persons shall not be on more favourable terms (e.g. as relates to such matters as credit assessment, tenor, interest rates, amortisation schedules, requirement for collateral) than corresponding exposures to non-connected persons.