

DRAFT NBDT POLICIES:

Related Party Requirements and Minimum Capital Ratio Requirements

The Reserve Bank invites submissions on this Consultation Paper by 9th of February 2009. Submissions and enquiries about the consultation should be addressed, in the first instance, to:

Ian Woolford
Manager, Financial System Policy
Prudential Supervision Department
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

Email: woolfordi@rbnz.govt.nz

Please note that submissions may be published. If you think any part of your submission should properly be withheld on the grounds of commercial sensitivity or for any other reason, you should indicate this clearly.

December 2008

NBDT Consultation Document: Related Party Requirements and Capital Adequacy Requirements

1. INTRODUCTION

1. The passing of the Reserve Bank of New Zealand Amendment Act 2008 in September 2008 established a new Part 5D of the Reserve Bank of New Zealand Act (the Act). Part 5D provides the Bank powers to regulate the non-bank deposit taking (NBDT) sector to promote the maintenance of a sound and efficient financial system by:
 - i. ensuring that all NBDTs meet a transparent set of prudential requirements designed to promote sound governance and risk management in NBDTs, and to promote depositor confidence; and
 - ii. providing depositors with a clearer basis for distinguishing between lower-risk and higher-risk NBDT.
2. The legislative changes made the Reserve Bank the regulator of NBDTs and require NBDTs to comply with a new set of prudential requirements. The new prudential requirements will set rules to govern the behaviour of deposit takers and improve the disclosure of financial risk to investors by providing for a mandatory credit ratings regime.
3. The Reserve Bank has regulation making powers under Part 5D of the Act to require NBDTs to:
 - Specify the type of credit rating an NBDT must hold;
 - Maintain a minimum dollar amount of capital;
 - Meet a minimum capital ratio requirement;
 - Meet related party restrictions; and,
 - Meet liquidity requirements.
4. This consultation paper proposes a framework for regulations for capital and related party requirements.
5. It is worth noting that some aspects of the Reserve Bank's thinking have evolved over the last year.¹ At that time, the intention was that NBDTs would have to hold minimum capital of \$2 million (unless exempted by the Reserve Bank), but the capital ratio would be set by trustees, with the Reserve Bank's role being to put in place a capital measurement framework for trustees to follow. It was also the intention to exempt NBDTs with total assets of under \$10 million from the mandatory credit rating requirement.
6. In the light of greater experience with stakeholders, we believe some refinements to earlier thinking make sense. In particular, we propose to establish a minimum capital ratio requirement in regulation (rather than have trustees set the minimum

¹ The September 2007 Cabinet paper is a useful summary of earlier thinking, and can be found at <http://www.rbnz.govt.nz/finstab/nbd/3116779.pdf>

against a measurement framework), that no minimum dollar capital requirement be put in place at this time, and that the threshold for an exemption from the requirement to hold a credit rating be raised.

7. In the light of concerns about the compliance cost of credit ratings on small-to-medium sized NBDTs the Reserve Bank has done further work. The original intention for a \$10 million exemption threshold recognised the compliance cost impact on very small NBDTs. We still see ratings, and the transparency they can bring, as a core component of the regime in the long term, but think moving the threshold up to 20 million dollars would provide significant relief for a material number of small NBDTs. The Reserve Bank expects to issue a consultation paper on draft policies for credit rating regulations early next year.
8. In coming to these recommended refinements, we have tried to balance a relatively simple rules-based approach (by removing complexity from the Basel capital framework by simplifying where possible) with the desire to enable diversity of risk and return in the NBDT sector. But of course, no matter where a NBDT wishes to position itself on the risk spectrum, it should have adequate capital to support that position. Moreover, both of these proposed policy changes are consistent with principles laid out in the Act, particularly that the intention is not to eliminate risk; that depositors are provided with enough information to distinguish between low-risk and high-risk deposit takers; and the need to avoid unnecessary compliance costs.

Key matters and principles to take into account in recommending regulations

9. Under section 157F, the Reserve Bank must take into account a number of principles in recommending regulations to the Minister under Part 5D of the Act:
 - the desirability of consistency in the treatment of similar institutions, regardless of matters such as their corporate form;
 - the importance of recognising ----
 - (i) that it is not the purpose of Part 5D to eliminate all risk in relation to the performance of deposit takers or to limit diversity among deposit takers;
 - (ii) that depositors are responsible for assessing risk in relation to potential investments and for their own investment choices;
 - the desirability of providing to depositors adequate information to enable them to assess risk in relation to potential investments and to distinguish between high-risk and low-risk deposit takers;
 - the desirability of sound governance of deposit takers;
 - the desirability of effective risk management by deposit takers;
 - the need to avoid unnecessary compliance costs; and
 - the need to maintain competition within the deposit taking sector.
10. We have had regard to all of these principles in developing these policies on minimum capital ratio requirements and restrictions on related party exposures, with the following principles being particularly relevant:

- the desirability of consistency in the treatment of similar institutions, regardless of matters such as their corporate form;
 - the need to avoid unnecessary compliance costs;
 - the desirability of sound governance of deposit takers; and
 - the desirability of effective risk management by deposit takers.
11. Following consultation, the Reserve Bank intends putting recommendations to Cabinet, and developing draft regulations. The recommendations will include a Regulatory Impact Statement. Therefore, while this consultation paper asks a number of specific questions, we are also interested in receiving compliance cost estimates.
12. The intention is to have regulations in place in the second quarter of 2009, although some form of transition path before full compliance is required will be in place.

2. PROPOSED RELATED PARTY REQUIREMENTS

2.1 Overview of Related Party Requirements

13. Related counterparties are entities linked via collective or common ownership, financial linkages or interdependency, or generally whereby one party significantly influences the other such that the deposit taker is less able to pursue its own independent interest.
14. Relationships with related parties can be abused especially if the related party is accorded preferential treatment. This could take the form of exposures where related parties extract benefits from the relationship that would not otherwise be available, or offered, if there was no connection in the first place. Moreover, there may be a tendency on the part of the deposit taker to be less rigorous or robust in terms of credit decisions and monitoring in such situations. One of the main policy concerns is that such behaviour could lead to an erosion of the deposit taker's capital base and undermine public confidence.
15. The proposed scope of related party regulation includes:
 - defining who is a related party;
 - defining what constitutes a related party exposure; and,
 - setting a maximum limit on aggregate exposure to related parties relative to the capital position of the deposit taker or the capital of the borrowing group of which the deposit taker is part.
16. Our starting point for regulations for restrictions on related party exposures for NBDTs, was the banking framework. However, we have sought to simplify that framework, and calibrate it to the NBDT sector.

Definition of related party

17. Section 157B of the Reserve Bank of New Zealand Act defines a related party, in relation to a deposit taker to mean the following:
 - directors and senior office holders of the deposit taker and their relatives; and
 - subsidiaries; and
 - in case of a deposit taker that is a company, any person who—
 - (i) owns or has power to control (directly or indirectly) or right to acquire 10% or more of the ordinary shares of the company; or
 - (ii) owns, or has power to control (directly or indirectly), or right to acquire, 10% or more of the voting rights of the company; or
 - (iii) has by any other means 10% or more of the control of the company; and
 - in case of a deposit taker that is an entity other than a company, any person who—
 - (i) is in a position to control (directly or indirectly) 10% or more of the voting rights in relation to that entity; or
 - (ii) has, by any other means, 10% or more of the control of that entity; and

- any person who has control (directly or indirectly) or significant influence over 25% or more of the composition of the governing body of the deposit taker.
18. In addition, section 157B(2) states that regulations may declare any person or class of persons to be a related party. We propose extending the definition of a related party for NBDTs to include the following:
- entities where owners have control/substantial interest (sister subsidiaries);
 - persons with substantial interest in owners (ultimate shareholders); and
 - entities with interlocking directorates.
19. We propose that entities with interlocking directorates be defined to include entities where 20% or more of the directors are also directors of the NBDT or the NBDT's sister subsidiaries or an entity with a substantial direct or indirect interest in the NBDT.
20. Where the NBDT has guaranteeing subsidiaries, the definition of related party will be adapted accordingly. Section 157B states that a borrowing group comprises the deposit taker and its guaranteeing subsidiaries. A guaranteeing subsidiary is a subsidiary that is:
- unconditionally liable (whether or not jointly or severally with the deposit taker or any other person) to repay some or all debt securities issued by the deposit taker; or,
 - liable to repay some or all debt securities issued by the deposit taker subject only to the condition that the deposit taker or any other person has failed to do so.
21. We believe that the above definition of related party broadly covers the relevant relationships a deposit taker may have that in substance could influence its capacity for independent decision making.

Questions for Submission

1. Do you agree with the proposed additions to the definition of related parties contained in the Act?
2. Do you agree that the definition of related party for a deposit taker should apply with respect to the borrowing group, modified as necessary?
3. Are there other relevant matters the Reserve Bank should consider when adapting the definition of related party to the borrowing group?

Exposures

22. Section 157V under Part 5D of the Act refers to regulations that may impose a requirement that trust deeds include a maximum limit on *exposures* to related parties. In this regard, only exposures of a credit nature will be considered. Although the range of connected party relationships is not limited to credit

exposures alone, the related party regime for NBDTs, just like that for banks, will be focused on credit exposures.

23. Credit exposure means the amount of 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. We propose that credit exposure be defined to include the credit-equivalent value of guarantees, standby lines and other legal obligations to commit funds and that it be measured net of any allowances for impairment. Advances of a capital nature will not be counted as a related party exposure as they will be deducted directly from capital. The inclusion of the credit equivalent value of off-balance sheet exposures in the calculation of credit exposures, and the deduction of advances of a capital nature from tier 1 capital, are consistent with the capital measurement framework.

Question for submission

4. Do you agree with the definition of exposure?

Limit

24. Registered banks are subject to a rating-contingent framework where the limit on aggregate connected exposure to related parties ranges from 75 percent to 15 percent of tier 1 capital, according to the bank's credit rating. A simplified approach consisting of a single maximum limit on aggregate exposure is proposed for NBDTs.
25. In practice, if an NBDT holds a high proportion of tier 1 capital in gross exposure to a related counterparty that fails or gets into difficulty, the NBDT itself would be at grave risk of failure. The limit should therefore be set at a low enough level to take into account the likely impact on tier 1 capital of the exposed entity, of a related party failure. In terms of calibrating the limit compared to the ratings-based framework for banks, a cap set at 15 percent of tier 1 capital for related party exposures appears prudent in view of the fact that a large majority of NBDTs are unrated and in the banking regime, aggregate exposure to *non-bank related parties* is likewise capped at 15 percent.
26. It is proposed that a limit on aggregate credit exposures of the deposit taker or the borrowing group to all related parties must be specified in the trust deed and fixed by agreement between the deposit taker and the trustee, provided it does not exceed a maximum limit of 15 percent of tier 1 capital.
27. Where a deposit taker is part of a borrowing group, the maximum limit on aggregate exposure to related parties would be calculated across the borrowing group instead of for the solo entity. This means that the borrowing group must calculate its related party exposures ratio on a 'consolidated basis', which is essentially aggregating the balance sheet of the deposit taker and the rest of the members of the borrowing or charging group. This will enable depositors to make

a better assessment of the overall position of the borrowing group in respect of related party exposures.

Questions for submission

5. Do you agree that the maximum limit on aggregate related party exposures should apply in respect of exposures of the deposit taker or exposures calculated across the borrowing group, as the case may be?
6. Do you agree that the limit for exposures to related party be capped at 15 percent of tier 1 capital?

2.2 Other matters: Path to compliance and exemptions

Some NBDTs have related party exposures above the proposed limit, and will therefore need time to comply with regulations. The Reserve Bank proposes a one year transition period to enable NBDTs to be fully compliant.

Question for submission

7. Do you agree that the proposed transition period (to start from when the regulation comes into force) of one year for full compliance is appropriate?

28. In some circumstances it may be necessary to provide an exemption or alternative related party requirement to cater to situations that cannot be dealt with appropriately by the generic requirements as set above. Of course, as required by section 157G(2), the Reserve Bank will need to be satisfied that any exemption granted is consistent with the maintenance of a sound and efficient financial system and that compliance to the regime by the NBDT is unduly onerous or burdensome.
29. Without prejudging any individual case, examples where some form of exemption may be appropriate are where particular business structures or models may be constrained by restricting related party exposures. One example could be NBDTs which are part of a banking group, where the parent is already regulated at the banking group level. In this case the banking group would then be covered by the Connected Exposures Policy for registered banks. Another case could be the so-called funding conduits where the principal activity of the NBDT is to raise funds from the public which are then exclusively on-lent to, or invested in, the parent company and/or its subsidiaries.

3. PROPOSED MINIMUM CAPITAL RATIO FRAMEWORK FOR NBDTS

30. The starting point for the construction of the NBDT minimum capital ratio framework was the Reserve Bank's standardised framework for banks, which is set out in the Reserve Bank's Prudential Supervision Department's document BS2A.² This section of this consultation paper discusses the components of the proposed capital adequacy framework, including how they have been amended from the registered bank framework to better fit the NBDT sector.
31. The proposed framework has three main components. They are:
- The definition and measurement of capital.
 - The definition and measurement of credit exposures and other risks.
 - A minimum capital adequacy ratio requirement.
32. Note that at this stage the Reserve Bank is not proposing a minimum capital level, as allowed for in the legislation. This position will be reviewed from time to time.

3.1 The definition and measurement of capital

Qualifying capital instruments under the registered bank standardised framework

33. Under the registered bank capital adequacy framework, capital is defined as tier one capital plus tier two capital less deductions from total capital. Tier two capital in turn consists of two types: upper tier two capital and lower tier two capital. There are rules that set limits on the amount of tier two capital and the amount of lower tier two capital that can be held within a total capital requirement.
34. The instruments that qualify for the different tiers of capital are as follows:

Tier one capital includes:

- issued and fully paid up ordinary share capital;
- perpetual fully paid up non-cumulative preference shares subject to a set of restrictive conditions (these may not represent more than 25 percent of tier one capital), and
- retained earnings.

Upper tier two capital instruments are:

- perpetual cumulative preference shares;
- mandatory convertible notes; and
- perpetual subordinated debt.

Upper tier two capital instruments must also meet a complex set of tests to qualify as tier two capital.

² This can be found at <http://www.rbnz.govt.nz/finstab/banking/regulation/3174397.pdf>

Lower tier capital is term subordinated debt with an original maturity of five years or more.

Qualifying instruments under the NBDT framework

35. It is proposed that only tier one capital be defined as capital in the NBDT framework, and that the limit of 25 percent for the share of preference shares in total capital in the registered bank framework would also apply to NBDTs. The 25% limit will be measured against total capital net of deductions from capital. The reasons for the focus on tier one capital are as follows:

- Tier one capital is the only form of capital which is permanently and freely available to absorb unanticipated losses without the financial institution being obliged to cease trading. A higher level of tier one capital reduces the probability of an NBDT failing whereas tier two instruments primarily have value in reducing the extent of losses borne by depositors and ordinary creditors in the event of failure. A tier one capital requirement is, therefore, more directly targeted to the second of the two purposes of the part 5D of the Reserve Bank Act set out in section 157A (b), , which is to avoid significant damage to the financial system that could result from the failure of a deposit taker.
- The international regulatory community is moving towards a greater emphasis on tier one capital within their banking capital requirements. Most banks now place relatively little reliance on tier two instruments.
- A single tier regime is much simpler than the current multi-tier bank regime which is difficult to understand and which is more likely to raise compliance issues.
- Relatively few NBDTs that are currently operating have tier two capital.

The full definition of NBDT capital is set out in appendix one.

Deductions from capital in the standardised banking framework

36. The standardised banking framework provides for a set of deductions from either tier one or total capital. They are listed below. The main reasons for making deductions from capital is that certain assets are likely to have little value if the NBDT gets into distress or the assets represent an equity, or equity-like investment, in another entity. In the latter case if the asset were to count toward the NBDT's capital then this would mean that the same capital would be counted twice. It would be supporting the business behind the equity investment and the NBDT's business.

37. Deductions under the registered bank framework are as follows:

- (a) Goodwill and other intangible assets.

- (b) Current year's losses.
- (c) Future tax benefits.
- (d) Credit enhancements provided to associated funds management and securitisation schemes.
- (e) Funding to affiliated insurance groups where certain requirements are not met.
- (f) Advances of a capital nature provided to connected persons.
- (g) Equity investments and advances of a capital nature in unconsolidated subsidiaries.
- (h) Capital instruments issued by financial institutions where the holding exceeds 10% of the capital of the financial institution in which the investment is made.
- (i) Unrealised revaluation losses in certain circumstances.
- (j) Cumulative gains and losses on cash flow hedges, which have been recognised in tier two capital.

Proposed deductions from capital under the NBDT framework.

38. It is proposed that most of the deductions applying in the banking framework also apply to the NBDT regime, but amended to be appropriate to the sector. Generally speaking, the economic and supervisory logic behind the capital deductions for banks also applies to NBDTs, although we also propose to simplify where possible.
39. The proposals for the NBDT regime, therefore, broadly follow that for banks, but with the following changes:
- No deduction for funding to affiliated insurance groups (i.e. drop (e) from the above list). This requirement was imposed to support the bank conglomerates policy, which does not apply to NBDTs.
 - Instead, we propose to add a requirement to deduct assets held with respect to insurance business. Unlike banks, NBDTs may currently conduct material insurance business on the guaranteeing group's balance sheet. The intermixture of deposit taking and insurance makes it difficult to assess the capital adequacy of the deposit taking activity because this requires an understanding of the adequacy of the insurance business's capital position. An assessment of insurance capital adequacy cannot be done within a simple NBDT regime. Requiring a deduction of insurance assets will provide a strong incentive to shift the insurance business to a separate entity outside the borrowing group.
 - Strengthen (f) with the inclusion of the words 'and subordinated advances.' This amendment is intended to make the intent of the registered bank framework clearer: that is to capture hybrid and subordinated instruments as well as more straight-forward equity instruments.
 - Remove the 10 percent threshold for the deduction of investments in financial institutions (i.e. remove the conditions in (h) in the above list). It is

appropriate to remove the threshold to apply the straightforward principle that double gearing will not be recognised for capital adequacy purposes.

- Drop requirements (i) and (j). These are complicated provisions which are unlikely to be relevant to NBDTs.

Questions for Submission

1. Do you agree with the proposal to recognise one tier of capital?
2. Do you agree with the proposed set of deductions from capital set out in paragraph 10?

3.2 Risk exposures: definition and measurement

40. This part of the standardised registered bank framework has the following components:

- The measurement of on-balance sheet credit exposures.
- The measurement of off-balance sheet credit exposures.
- Credit risk mitigation recognition.
- Funds management and securitisation.
- Recognition of loan transfers.
- Measurement of operational risk exposures.
- Measurement of market risk exposures.

Measurement of on-balance sheet credit exposures

41. The proposed framework for measuring on-balance sheet credit exposures also takes the standardised registered bank framework as a starting point. The bank framework differs from the methodology typically used in the calculation of the kind of capital adequacy ratio requirements that NBDTs currently have in their trust deeds, in that credit exposures are risk weighted. A risk weighting methodology captures the idea that not all credit exposures have equal risk by assigning different risk weights to different classes of assets based on an assessment of their relative risk. In the registered bank regime, a portfolio of well diversified commercial loans of reasonably good quality is taken as the benchmark and is given a risk weight of 100 percent. Less risky exposures are given lower risk weights and more risky ones higher risk weights. For example, a highly-rated bank exposure has a risk weight of 20 percent.
42. To measure a registered bank's total on-balance sheet credit exposures, classes of exposures are multiplied by their risk weights and then added together. Banks with relatively safer assets will have to hold less capital than a bank with riskier

assets. By contrast, trust deed conditions have generally given the same weighting to all exposures regardless of their relative risk.

43. The proposed set of NBDT risk weights is somewhat simpler than that applying to registered banks, although some additional risk sensitivity has been added to reflect the different nature of NBDT business. The risk weights have also been recalibrated, as necessary, to reflect differences between the bank and NBDT situation and, in part, to reflect some of the recent lessons from developments in New Zealand and international financial markets. The following discussion sets out the registered bank framework risk weights, together with the corresponding proposed NBDT risk weights and where they are different, explains why. A summary is presented in table 1.

44. *Cash*

A risk weight of 0% applies to notes and coins held on site under both the bank and NBDT frameworks.

45. *Claims on sovereigns and central banks*

Under the standardised registered bank framework, both government and central bank exposures attract a range of risk weights according to the sovereign credit rating of the particular country. Under the NBDT regime only New Zealand government exposures would receive this treatment. That is, a risk weight of 0 percent, reflecting New Zealand's AAA sovereign rating for local currency debts, would apply. The reason for this treatment, and for the treatment of exposures to multinational lending agencies below, is that these foreign investments are generally not relevant to NBDTs. The regime is therefore simplified by not making special provision for them.

46. *Multinational development banks and other international organisations.*

A 0 percent risk applies under the standardised registered bank framework. No special provision for these organisations is proposed for the NBDT framework, on the same basis as above – that it is not anticipated to be likely that this would be relevant for NBDTs, and therefore a simplification of the framework would be desirable.

47. *Banks*

An array of risk weights from 20 percent to 150 percent apply to claims on banks under the standardised registered bank regime, depending on the credit rating of the bank and the duration of the claim. It is proposed that a single risk weight of 20 percent apply to all claims on New Zealand registered banks. This structure is simpler and more relevant to NBDTs than the standardised framework.

48. *Claims on corporates*

The standardised framework applies risk weights of from 20 percent to 150 percent depending on the rating of a particular corporate and whether the claim is a short- or long-term one. Consideration was given to applying a single risk weight to NBDT corporate exposures in keeping with the approach adopted above for public sector and bank exposures. However, some NBDTs invest in rated New Zealand corporate paper and it is proposed to recognise the lower risk of the higher rated corporate exposures even though this will increase the complexity of the framework.

The risk weights that would apply would be the same as under the standardised registered bank regime, except that unrated exposures would receive a 150 percent risk weight in line with the standard risk weight under the NBDT framework which is discussed below. The full set of risk weights is set out in appendix one.

49. *Residential mortgage loans*

The standardised framework risk weights for first ranking residential mortgages (that are not past due) are: 35 percent where the loan to valuation ratio (LVR) does not exceed 80 percent; 50 percent where the LVR exceeds 80 percent and not 90 percent; and 75 percent where the LVR exceeds 90 percent and not 100 percent. Risk weights in the over 80 percent LVR categories are reduced when they are covered by qualifying lender's mortgage insurance.

50. For the NBDT regime it is proposed that a risk weight of 35 percent apply to loans with an LVR not exceeding 70 percent and a risk weight of 100 percent to loans with an LVR above that figure. The reasons why a higher risk weight is proposed for high LVR loans are that:

- Under the registered bank regime banks must include loan commitments in their measure of residential mortgage lending exposures. In the proposed NBDT framework specific provision is not required for these exposures in order to simplify compliance. Instead, commitments have been subsumed within a higher average risk weight for all residential lending.
- The average risk of NBDT mortgage loan portfolios is higher, on average, than that of registered bank residential mortgage loan portfolios. This reflects the lower degree of diversification in smaller NBDT portfolios, and in many cases, a lower average credit worthiness of individual NBDT borrowers.
- The international financial crisis has drawn attention to the risks imposed by high LVR loans, and conditions in the New Zealand housing market have become more risky since the standardised mortgage risk weights were set in 2006. A higher proportion of owners' equity is, therefore, required before the concessional risk weight of 35 percent can be applied.

51. It is proposed that the registered bank framework methodology for the calculation of an LVR be applied to the NBDT framework. The value of the security is the

value at the time the loan was originated. The amount of the loan is the current balance outstanding. This balance should include all advances secured against the property.

52. *Recognition of lenders' mortgage insurance*

It is not proposed to apply a lower risk weight to residential mortgages covered by lenders' mortgage insurance. To do so would increase the complexity of the regime and raise compliance monitoring (and therefore cost) issues. More importantly, recent experiences have heightened concerns about the value of mortgage insurance in a capital adequacy framework. While mortgage insurance may assist with income smoothing in moderate recessions, there is a risk that in the periods of acute stress, for which capital is held, the mortgage insurer may either drop out of the required rating range for mortgage insurance (in which case the concessional treatment would cease to apply placing sudden pressure on the lender's capital adequacy) or fail to perform to the terms of the insurance arrangement.

Other lending risk weights

53. It is proposed that the standard risk weight for other lending be 150 percent, compared to 100 percent in the standardised registered bank framework because:

- It is the risk weight for the lowest rated corporate exposures under the standardised regime.
- It reflects the lower average quality of NBDT exposures compared to bank exposures, and the lesser capacity for diversification within smaller NBDT balance sheets.
- It includes an allowance for loan commitments which are separately measured under the bank framework. For commercial loans these commitments add an average of around 35 percent to banks on-balance sheet exposures

It is also proposed that the NBDT framework take some note of the diversity of risk amongst non-residential lending exposures by identifying another further risk weight class. That is, aA risk weight of 300 percent for property development loans where the LVR of a first ranking security is over 60 percent, or where there is a second or subsequent security, or no security.

54. The higher risk weight for property reflects the much higher risk of loans for property development that are relatively weakly secured. This view is supported by Reserve Bank modelling of the risk of these exposures within the Basel II advanced risk modelling framework. This work confirms that risk is strongly related to the lender's security and that risk weights of between 500-800 percent can be justified for weaker security positions (particularly some second or subsequent ranking). The proposed risk weight of 300 percent, or twice the other lending risk weight, is designed to capture the average of a range of risk positions. It would still be open to trustees to increase an NBDT's minimum capital ratio requirement if there was a large concentration of poorly secured

property development loans, where risk was not fully captured by the 300 percent risk weight.

Equity

55. The risk weights for listed and unlisted equities in the standardised bank model are 300 percent and 400 percent respectively. A risk weight of 600 percent is proposed for the NBDT framework. This higher risk weight reflects our judgement that the standardised model risk weight for publically listed shares does not reflect the risks of NBDT equity investments. The bank risk weight is relevant to a well diversified portfolio of shares, and even then is arguably not conservative enough. However, NBDTs tend to hold equity positions in just one or two companies, which is much more risky than holding a diversified portfolio of shares. The higher risk weight captures some of this additional risk. A higher risk weight for what are typically illiquid and opaque investments in non-traded shares could be justified, but a single risk weight is proposed for simplicity. The higher risk weight should discourage complex business structures with equity positions in non-financial companies.

Other assets

56. It is proposed that a risk weight of 500 percent apply to ‘other’ assets. In the standardised registered bank framework the ‘other’ risk weight category primarily applies to other loans that are not captured in the corporate and residential mortgage lending categories. It covers small and medium businesses and personal loan exposures. In the NBDT framework these loans are already captured by a 150 percent risk weight, and the other risk weight applies mostly to assets such as furniture and office equipment (which support the business), and also to nonfinancial assets such as buildings. As these assets are closer in character to equity investments than loan exposures, it is appropriate that they have a much higher risk weight than loan exposures.
57. The proposed 500 percent risk weight is lower than the equity rate because the ‘other’ category will also sometimes include assets that are closer in nature to loans. The higher risk weight will not have a material impact on most entities because the amount of other assets they hold is small, but it will – and is designed to – discourage NBDTs from placing material risky non-financial assets on the balance sheet in an attempt to boost capital.

58. Past due loans

Higher risk weights are applied to loans that are more than 90 days past due in the registered bank framework. It is proposed that in the NBDT framework the risk weight for each loan category be increased by 50 percentage points for 90 day past due loans. For example, the risk weight for residential mortgage loans with a normal risk weight of 100 percent would be increased to 150 percent, and that of a commercial loan would go from 150 percent to 200 percent. These higher risk weights take into account the higher risk of loss associated with loans in arrears for more than 90 days.

Table one
Comparison of registered bank and proposed NBDT risk weights

	<i>Standardised bank framework</i>	<i>Simplified NBDT framework</i>
<i>Cash</i>	0%	0%
<i>NZ government and RBNZ</i>	0%	0%
<i>Non NZ govt</i>	As per rating grade: 0-150%	Other lending risk weight
<i>Public sector entities</i>	As per rating grade: 20-150%	New Zealand only 20% Otherwise other lending risk weight
<i>Multinational development banks</i>	0%	Other lending risk weight
<i>Banks</i>	As per rating grade 20-150 %	20%
<i>Rated Corporate</i>	As per rating grade 20-150%	As per rating grade: 20-150 %
<i>Other Lending</i>	100%	150%
<i>Property Development lending: unsecured or second ranking security or LVR greater than 60%</i>	100%	300%
<i>Residential Mortgages</i>	80% and under LVR 35% Over 80% LVR: 50-75% Reduction for mortgage insurance	LVR 70 % and under: 35% Over 70% LVR: 100% No reduction for mortgage insurance
<i>Past due loans</i>	100-150%	50 percentage points above normal risk weight
<i>Equity</i>	300 % publically traded 400% for all others	600% for all equity
<i>Other assets</i>	100%	500%

Measurement of off-balance sheet credit exposures

59. There are two components to the measurement of the credit risk of off-balance sheet exposures in the standardised registered bank framework. They relate to market-related contracts and other off-balance sheet exposures.

Market related contracts

60. It is proposed that no provision be made to measure off balance-sheet exposures arising from market-related contracts. This part of the standardised registered

bank framework is very complicated. And, typically, it only generates a small amount of risk exposures, and is not likely to be relevant for most NBDTs.

Other off-balance sheet exposures

61. The standardised registered bank framework covers the following other off-balance sheet exposure types:
- (a) direct credit substitutes;
 - (b) asset sales with recourse;
 - (c) forward asset purchases;
 - (d) commitment with certain drawdown
 - (e) note insurance facilities
 - (f) revolving underwriting facilities
 - (g) performance-related contingency
 - (h) trade-related contingency
 - (i) placement of forward deposits\other types of commitment
 - (j) commitments without a certain draw down; credit equivalent of 0-100%.
62. It is proposed that categories (e) to (i) be dropped from the NBDT framework because they are not relevant to the business models of nearly all NBDTs.
63. It is also proposed that categories (d) and (j) which provide for different credit equivalent treatments depending on the degree to which the lender is obliged to make an advance, be dropped. As explained in paragraph 53 loan commitments have largely been subsumed within higher risk weights for on-balance sheet exposures, and therefore we do not, at this stage, propose to make an off-balance sheet provision for these exposures.

Credit risk mitigation

64. It is proposed that the credit risk mitigation component of the standardised registered bank regime not carry over to the NBDT regime. The risk mitigation provisions are often complex and the conditions are restrictive and unlikely to be of interest to most NBDTs. Finally, they raise potential compliance issues if they are not policed intensively.

Funds management and securitisation

65. The standardised registered bank regime covers both explicit and implicit risks relating to securitisation. Implicit risks arise because a financial institution may feel obliged to support an associated special purpose vehicle (SPV) set up to conduct securitisation or funds management activities, even though there is no formal legal obligation to do so, because its reputation may suffer if support is not provided. Explicit risks arise when a financial institution provides any form of credit enhancement to an associated SPV.

66. It is proposed that the NBDT framework only covers explicit risks. Implicit risk is not as important for NBDTs as it is for registered banks because they incur less reputational risk if they do not provide support for an SPV when they have no legal obligation to do so.
67. The proposed provision for explicit risk is the same as for registered banks. Where the credit enhancement can be quantified, and does not take the form of a guarantee, the NBDT may choose one of the following options:
- (a) deduct the maximum level of its obligation to provide support from capital;
 - (b) expense the full amount of its obligation at the time its relationship with the special purpose vehicle commences; or,
 - (c) consolidate the assets of the SPV for the purpose of calculating its capital adequacy ratio.

Where the maximum extent of support cannot be readily quantified or takes the form of a guarantee the assets of the SPV should be consolidated for capital adequacy purposes.

Loan transfers

71. The loan transfer section of the standardised registered bank framework sets out the conditions that must be met before a loan transfer to another party can be regarded as falling outside the bank's current business. It is proposed that section should apply in full in the NBDT framework. These conditions are set out in appendix one.

Other risks:

72. As with the registered bank regime, we propose that operational and market risk are taken into account in capital requirements. Operational risk covers the risks arising from the execution of an entity's business functions and covers amongst other things physical or environmental risk, fraud, and legal risk. Market risk covers risks to the economic value of the entity from the movement of interest rates, exchange rates and equity prices. In the standardised registered bank framework these risks are quantified and added to credit exposures..
73. In the bank regime, operational risk is calculated as a scalar of a moving average of both balance sheet and income statement items. Market risk is calculated using the market risk exposure methodology developed some time ago as part of the registered bank disclosure regime. It captures interest rate risk in the banking book as well as trading book market risks. However, the regime is dated, complex, and due to be replaced.
74. Consequently, it is proposed that for NBDTs the separate risk exposures calculated for market risk and operational risk be replaced by a single risk exposure figure, which would be generated from a scalar of balance sheet aggregates. Either credit risk weighted assets or total assets could be used and

there are arguments for both. On the one hand many operational risks are likely to be correlated with risk weighted exposures. On the other hand, the biggest market risk, interest rate risk in the banking book, would be more closely correlated with the total size of the balance sheet. Therefore, it is proposed that a simple average of the two be used. This asset-based regime will require no more information than that already required for the calculation of credit risk weights, is simple, and would therefore minimise compliance costs.

75. It is proposed that the scalar be calibrated with reference to reported registered bank operational and market risk figures. Operational and market risk, as a percentage of credit risk exposures, ranges from 12 to 23 percent and, as a percentage of total assets, from 5 to 8 percent.
76. Operational and market risks, as a proportion of the relevant balance sheet scalars, should be an inverse function of size. In general, the smaller the institution the less the scope for diversification and the less sophisticated the risk mitigation techniques employed. It is proposed, therefore, that the scalars be above the range of outcomes reported for banks - 25 percent of credit risk weighted exposures and 10 percent of total assets. The calculation will be:

$$\text{Operational and market risk exposures} = \frac{(\text{total credit risk weighted exposures} + \text{total assets})}{2} \times 0.175$$

77. The proposed treatment will mean that, on average, capital held by NBDTs for operational and market risk exposures will be proportionately similar to that held by banks for these risks. It will not mean, however, that NBDTs will, on average, be as well capitalised with respect to operational and market risks as banks. In general a much higher provision would have to be made to offset the factors discussed above.

Questions for Submission

1. Do you agree with the structure of risk weights set out in table 1? In particular do you think that the higher risk of some property development lending should be recognised in the risk weighting regime?
2. How should the LVR on a property development loan be measured?
3. Is the simplified treatment of off-balance sheet credit exposures appropriate?
4. Are the assumptions made about relevance – for multinational development banks, for example – accurate, or too constraining?
5. Do you agree that the registered bank credit risk mitigation regime should not apply to NBDTs?
6. Do you agree with the proposed simplified treatment of operational and market risk?

3.3 Minimum Capital Ratio Requirement

78. An NBDT's capital ratio is calculated by dividing its capital by its risk weighted exposures . Specifically:

$$\text{Capital ratio} = \frac{\text{Capital}}{(\text{risk weighted on- and off-balance sheet credit exposures} + \text{operational and market risk exposures})}$$

79. It is proposed that a minimum capital ratio requirement be set in regulation. Trustees would still be expected to assess the particular situation of a given NBDT and seek a higher ratio if they thought that the circumstances of a particular NBDT justified it. The reasons why it is appropriate to set a minimum ratio requirement and not leave it to be entirely a matter of negotiation between the NBDT and its trustee are as follows.

- Relatively weak capitalisation has contributed to an unacceptably high failure rate amongst NBDTs over the last two years. This suggests that minimum standards should be raised.
- A regulatory minimum requirement may have more credibility than individually negotiated ratios and help restore confidence in the NBDT sector.
- The government deposit guarantee scheme means that it is now more important to have a more robust minimum capital ratio requirement to offset some of the distortions generated by the scheme, such as weaker incentives upon depositors to monitor an NBDT's performance.
- Given the proposals set out above to apply a more finely differentiated set of risk weights to credit exposures it is appropriate to impose an across the board minimum capital ratio requirement. Many of the relative risk differences between NBDTs are now captured by the risk weighting regime and there is less need to allow for flexibility in the setting of capital ratio requirements to capture differences in those risks. (That said, as noted above, we would still expect to see capital ratio requirements agreed with trustees above the regulation-imposed minimum ratio.)

A minimum ratio requirement of eight percent

80. It is proposed that the minimum capital ratio requirement be set at eight percent of tier one capital.
81. It is important to note that while the proposed minimum ratio requirement is around the average of actual bank tier one capital ratios this does not mean that NBDTs will have bank-like risk. First, as noted above the various risk weights have not necessarily been calibrated to ensure that capital will be sufficient to ensure that NBDTs have a similar probability to default as banks. Second, capital is only one of the factors that impacts on a financial institution's risk. Other factors, including the value and robustness of its franchise value or the quality of

management and governance may be just as important. The effect of the eight percent minimum NBDT capital ratio requirement will be to help raise the floor in terms of risk but it will still allow a substantial range of possible risk models.

Ratio requirement for NBDTs without a credit rating

82. It is proposed that NBDTs without a credit rating would have a minimum tier one capital ratio requirement of 10 percent. The higher ratio requirement is intended to compensate for the lesser degree of outside scrutiny applied to unrated NBDTs. The higher ratio requirement for unrated NBDTs means that it may be appropriate to increase the cut-off figure below which NBDTs are not required to have a rating.

Compliance requirements

83. NBDTs will have to be compliant with the minimum capital ratio requirement at all times not just at the annual balance date. Consequently, we would expect that the NBDT would have a risk management programme that includes a targeted capital ratio which is above the minimum ratio and which is designed to ensure compliance with the minimum in most circumstances.

Note that section 157M(1) of Part 5D of the Act states that:

Every deposit taker must have a risk management programme and take all practicable steps to comply with that programme.

Transitional Arrangements

84. It is likely that some NBDTs will have a capital ratio that is below the 8 percent minimum, or 10 percent minimum if applicable to them, when the regulations come into force. It is proposed that NBDTs in this position be given one year from June 2009 to become fully compliant. Over this transition period, the minimum ratio requirement would be based on their actual ratio calculated from their latest set of audited accounts.
85. Where NBDTs still have an issue with compliance they could apply to the Reserve Bank for an exemption from the regulations. The Bank must be satisfied that compliance would be unduly onerous or burdensome in the circumstances. Any such exemption would be likely to come with alternative conditions that set out a path to compliance.

Questions for Submission

1. Should a minimum capital ratio requirement be set by regulation?
2. Should the regulatory minimum capital ratio requirement be 8 percent?
3. Should a higher minimum capital ratio requirement apply to NBDTs without a credit rating and if so what should that higher ratio be?

Appendix One

Detail of the NBDT capital adequacy framework proposals

1. Note that the following is only a mock-up of the proposed NBDT framework. It is primarily based on the relevant sections of the standardised registered bank capital adequacy framework (Reserve Bank of New Zealand Capital Adequacy Framework (Standardised Approach) Prudential Supervision Department Document BS2A November 2007). Elements of the NBDT framework may have to be expressed differently in regulation.

1 Definition of capital

2. Capital is defined as:
 - (a) Issued and fully paid up share capital. For the purposes of this requirement ordinary share capital is defined as share capital with the following characteristics.
 - (i) Holders of the shares have full voting rights.
 - (ii) Holders of the shares have no preferential or predetermined rights to distribution of capital or income.
 - (iii) The shares are not redeemable as defined in section 68 of the Companies Act 1993.
 - (b) Perpetual fully paid up non-cumulative preference shares subject to the following requirements:
 - (i) They are not redeemable as defined in section 68 of the Companies Act 1993 and are not repayable or redeemable at the option of the holder.
 - (ii) Dividends must be able to be waived where the financial condition of the bank would not support payment (for example where dividends are not being paid on ordinary shares). Dividends so waived must not cumulate.
 - (iii) 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.
 - (iv) Perpetual non-cumulative preference shares without full voting rights may not constitute more than 25% of capital (measured net of deductions from capital).
 - (c) Revenue and similar reserves including capital redemption reserves, general reserves of retained earnings and other reserves which are created or increased by appropriations from retained earnings. It also includes share premium reserves arising from the issue of ordinary share capital.

Reserves that are earmarked to particular assets or particular activities, or on account of any assessed likelihood of loss, do not qualify as capital.

The following items must not be included in capital

- (i) 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.
- (ii) Unrealised gains and losses on liabilities designated at fair value through profit and loss that arise from changes in an institutions own credit risk.
- (iii) Any fair value gains and losses relating to financial instruments for which a fair value cannot be reliably calculated, except that a fair value loss which has arisen from credit impairment on a loan and which has been recognised in audited earnings must in all cases be reflected in tier one capital.
- (iv) Any surplus net of any associated deferred tax liabilities, in any defined benefit superannuation fund sponsored by the NBDT (or, as necessary, another entity in the group) as employer

Note that the bank framework excludes certain asset revaluation reserves from tier one capital but allows it a tier two treatment. It is appropriate that these items are treated as capital within the NBDT framework because the additional risk is captured by the higher risk weights that are generally applied to the revaluations.

- (d) Current period's audited earnings. Retained earnings should be net of any appropriations such as tax payable, dividends to be paid or transfers to other reserves.
- (e) Minority interests.
- (f) Less: Deductions from capital
 - (i) Goodwill and other intangible assets;
 - (ii) Current year's losses (including unaudited losses)
 - (iii) Future tax benefits.
 - (iv) Assets held with respect to insurance business,
 - (v) Advances of a capital nature, including subordinated debt, provided to related parties
 - (vi) Equity investments in unconsolidated subsidiaries of the NBDT.
 - (vii) All holdings, whether direct or indirect, of capital instruments issued by other financial institutions.

Assets deducted from capital should not be included in risk weighted exposures

II Credit risk

3. Introduction

This part sets out the methodology for measuring credit risk exposure.

Subpart A— Standardised rating grades

4. Introduction to Subpart A

- (1) This subpart sets out the standardised rating grades to be used for risk weighting exposures to credit risk.
- (2) Credit risk exposure is calculated by risk weighting on and off-balance sheet exposures to credit risk according to broad categories of relative credit risk, as set out in this part.
- (3) Note:
 - (a) Assets deducted from capital should not be included in risk weighted exposures.
 - (b) Assets should be reported net of allowances for impairment loss.
 - (c) 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.

Credit ratings

5. Rating agency credit assessments

Only credit assessments produced by the rating agencies that have been approved by the Reserve Bank under section 157J of the Reserve Bank of New Zealand Act 1989 may be used for determining ratings grades used for risk weighting exposures to credit risk.

6. Credit assessments must be solicited

Credit assessments may be used for determining rating grades only if they have been solicited from a rating agency, and paid for, by:

- (a) the issuer or rated counterparty; or
- (b) a commercial associate of the issuer or rated counterparty.

7. Issue-specific credit assessments

The rating grade for a claim is the issue-specific credit assessment of that claim.

8. Multiple assessments

- (1) If there are two credit assessments that apply to a particular claim that relate to different rating grades and different risk weights, the credit assessment that must be used is the credit assessment that relates to the higher (less favourable) of those rating grades and risk weights.
- (2) If there are three or more credit assessments that apply to a particular claim that relate to different rating grades and more than one risk weight, the credit

assessment that must be used is the credit assessment that relates to the higher of the two lowest rating grades.

Rating grades

9. “Unrated” grade when no rating agency credit assessment applies

The rating grade for a claim is “unrated” if no credit assessment produced by a rating agency applies to the claim.

10. Ratings for short-term credit assessments

The rating grade for a short-term assessment is the rating grade that corresponds to a rating agency’s credit assessment according to Table 4.1. Note that the rating agency credit assessments are illustrative. At this point no rating agencies have been approved.

Table 1

Rating grades for short-term credit assessments

<i>Rating grade</i>	<i>Rating agency credit assessments</i>		
	<i>Std & Poors</i>	<i>Moody’s Investor Services</i>	<i>Fitch Ratings</i>
1	A-1	P-1	F-1
2	A-2	P-2	F-2
3	A-3	P-3	F-3
4	Other	Other	Other

11. Rating grades for long-term assessments

The rating grade for a long-term or issuer credit assessment is the rating grade that corresponds to the rating agency’s credit assessment according to table 2

Table 2
Rating grades for long-term and issuer credit assessments

Rating grade	Rating agency credit assessments		
	Standard & Poor's	Moody's Investor Services	Fitch Ratings
1	AAA AA+ AA AA-	Aaa Aa1 Aa2 Aa3	AAA AA+ AA AA-
2	A+ A A-	A1 A2 A3	A+ A A-
3	BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-
4	BB+ BB BB-	Ba1 Ba2 Ba3	BB+ BB BB-
5	B+ B B-	B1 B2 B3	B+ B B-
6	CCC+ CCC CCC- CC C D	Caa1 Caa2 Caa3 Ca C	CCC+ CCC CCC- CC C D

Subpart B— Risk weights for on-balance sheet exposures

12. Cash

A 0% risk weight applies to notes and coins held on site.

13. Claims on the Crown and Reserve Bank

A 0% risk weight applies to a claim on the Crown (as defined in the Public Finance Act 1989) or the Reserve Bank of New Zealand that is denominated in New Zealand dollars.

14. Claims on New Zealand public sector entities

A risk weight of 20% applies to a claim on a New Zealand public sector entity.

15. Claims on New Zealand Banks

A risk weight of 20% applies to a claim on a New Zealand registered bank.

16. Claims on corporates

- (1) The risk weight for a short-term claim on a corporate is the risk weight that corresponds to the issue-specific rating grade for the claim in Table 2

Table 3

Risk weights for short-term claims on corporate

Risk weights for short-term claims on corporate <i>Short-term issue-specific rating grade</i>	<i>Risk weight (%)</i>
1	20
2	50
3	100
4	150
unrated	150

The risk weight for a long-term claim on a corporate is the risk weight that corresponds to the rating grade for the claim in Table 4

Table 4

Risk weights for long-term claims on corporate

Risk weights for long-term claims on corporates <i>Rating grade</i>	<i>Risk weight (%)</i>
1	20
2	50
3	100
4	100
5	150
6	150
unrated,	150

17. Residential mortgage loans not past due

- (1) The risk weight for a first ranking residential mortgage loan that is not a 90 day past due asset is 35% when the loan to valuation ratio (LVR) does not exceed 70 percent and 100% when the LVR is greater than 70 percent.

18. Loan-to-valuation ratio

- (1) The loan-to-valuation ratio for a residential property is calculated by the formula:

$$\text{Loan-to-valuation ratio} = \text{loan value/property value} \times 100$$

(2) In the formula—

- (a) “loan value” is the total amount, as at balance date, of:
 - (i) all claims secured by way of first ranking mortgage over the residential property; and
 - (ii) subsequent claims of the lender that are secured over the residential property
- (b) “property value” is the value of the residential property determined under a NBDT’s residential property valuation policy when a residential mortgage loan is originated.

19. Past due loans

The risk weight for loans that are 90 day past due assets is 50 percentage points higher than the risk weight that would apply if the loan was not past due.

20. Other lending

The risk weight for other lending is 150%

21. Property development lending

Lending on property developments where:

- (a) There is no security or a second or subsequent ranking security; or
- (b) A first ranking security where the loan to valuation ratio is over 60 percent shall have a risk weight of 300%

22. Equity

The risk weight for equity holdings is 600%.

23. Other assets

The risk weight for other assets is 500%.

24. Definitions for subpart 4B

In this subpart—

- (a) “Crown entity” has the same meaning as in the Crown Entities Act 2004:
- (b) “corporate” includes:
 - (i) a securities firm;
 - (ii) an insurance company;
 - (iii) a state enterprise;
 - (iv) a Crown entity;
- (c) “independent valuer” means a person who is not associated with a person who has an interest in the residential property for which a valuation is made and who is:
 - (i) a registered valuer as defined in the Valuers Act 1948; or
 - (ii) another person approved to provide valuation services by rules made under the Rating Valuations Act 1998:

- (d) “public sector entity” means a local authority as defined for the purposes of the Local Government (Rating) Act 2002:
- (e) “residential mortgage loan” means a loan fully secured by a first ranking mortgage over a residential property used primarily for residential purposes either by the mortgagor or a tenant of the mortgagor:
- (f) “residential property valuation policy” means a policy governing how a property value is determined for a residential mortgage loan that—
 - (i) is approved by a bank’s board of directors; and
 - (ii) includes guidance on the use of—
 - (A) a valuation produced by an independent valuer; and
 - (B) the purchase price of a residential property:
- (g) “state enterprise” has the same meaning as in the State-Owned Enterprises Act 1986:
- (h) “90 day past due asset” has the same meaning as in Appendix E of the New Zealand Equivalent to International Financial Reporting Standard 7 – Financial Instruments: Disclosure (NZ IFRS 7).

Subpart C – Risk weights for off-balance sheet exposures

25. Introduction to subpart 4C

This subpart sets out the methodology to be used for converting off-balance sheet exposures other than market related contracts into credit equivalent amounts, and for applying risk weights to the credit equivalent amounts.

26. Calculating credit equivalent amounts for off-balance sheet items

- (1) The credit equivalent amount for an off-balance sheet exposure is calculated under the formula:

Credit equivalent amount = credit conversion factor x (principal amount – provision amount)

- (2) In the formula—
 - (a) “credit conversion factor” is the credit conversion factor specified in this subpart for the off-balance sheet exposure;
 - (b) “principal amount” is the principal amount of the off-balance sheet exposure; and
 - (c) “provision amount” is the total amount of any allowance for impairment for the exposure.

27. Credit conversion factors for off-balance sheet exposures

- (1) The credit conversion factors for off-balance sheet exposures are set out in Table 5

(2) The risk weight for a non-market related off-balance sheet exposure is that which applies to a claim on the counterparty to the transaction or to the underlying asset type, as specified in Table 1.5

Table 5
Credit conversion factors

<i>Type of transaction</i>	<i>Credit conversion factor (%)</i>	<i>Risk weight by:</i>
direct credit substitute	100	counterparty type
asset sale with recourse	100	type of asset, or issuer of securities as appropriate
Forward asset purchase	100	Type of asset

Part III Funds management and securitisation

28. Where a NBDT 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 NBDT 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 NBDT'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.

The credit enhancement will be treated as an equity exposure of the NBDT where the bank is providing credit enhancements to securitisation special purpose vehicles and:

- the NBDT and parties related to the NBDT 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.

Part IV- Loan Transfers

29. "Clean transfer" required

(1) Loans transferred from the originator to another party may be regarded as falling outside of the NBDT's business if a "clean transfer" of risk has been achieved.

- (2) A clean transfer is achieved if, as a result of the transfer, the NBDT
- is under no obligation to repurchase the transferred loans;

- (b) would incur no loss (of interest or principal) in the event of non-performance by the borrower; and
- (c) would not feel impelled to support the loan in any circumstances.

30. Qualifying transfers

(1) For the purposes of this Part and subject to the requirements in subsection (2), 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.

(2) A transfer must meet the following requirements:

- (a) The transfer must not contravene the terms and conditions of the underlying loan agreement and all necessary consents have been obtained.
- (b) The seller must have no residual beneficial interest in the principal amount of the loan (or that part which has been transferred) and the buyer must have no formal recourse to the seller for losses.
- (c) The seller must have no obligation to repurchase the loan, or any part of it at any time.
- (d) The seller must have 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.
- (e) The documented terms of the transfer must be such that if the loan is rescheduled or renegotiated the buyer and not the seller would be subject to the rescheduled or renegotiated terms.
- (f) If payments are routed through the seller, the seller must be under no obligation to remit funds to the buyer unless and until they are received from the borrower.
- (g) If the buyer is subject to a trust arrangement, the trustees of that trust must be independent of the seller or companies related to the seller either during or subsequent to the sale negotiations.

V Operational risks and market risk exposures

31. The operational and market risk exposure is calculated as follows:

$$(\text{Total assets} + \text{total risk weighted credit exposures})/2 \times 0.175$$

Appendix 2

Application of the NBDT capital adequacy to illustrative NBDTs

The following shows how the capital ratio would be calculated by three stylised NBDTs. They are a small credit union with assets of \$5 million that is a member of NZACU; a small building society that is engaged in the traditional building society business of lending on the security of first ranking residential mortgages; and a finance company that has a substantial amount of second ranking security over property developments and that has a relatively complex balance sheet.

A Small credit union

Balance sheet

	\$'000	Ref
Assets		
Bank deposits	300	(1)
NZACU deposit	1,500	(2)
Loans to members	3,000	(3)
Property plant & equipment	100	(4)
NZACU capital notes	100	(5)
Total assets	5,000	
Liabilities		
Trade and other payables	100	
Members deposits	3,900	
Total liabilities	4,000	
Members' Funds		
Retained earnings	1,000	(6)

Capital ratio calculation – Small Credit Union

Capital	\$,000		
Retained earnings (6)	1,000		
Deductions (5)	100		
Total (6) – (5) (7)	900		
Exposures			
<i>On balance sheet credit exposures</i>			
	<i>Exposure \$,000</i>	<i>Risk weight %</i>	<i>Risk weighted exposures \$'000</i>
Bank deposits (1)	300	20	60
NZACU deposit (2)	1,500	150	2,250
Other lending (3)	3,000	150	4,500
Other assets (4)	100	500	500
Total	4,900 (8)		7,310 (9)
<i>Off balance sheet credit exposures</i>	nil		nil
<i>Operational and market</i>			
((4900(8)+7310(9))/2) X 0.175			1068.38 (10)
Total exposures (9)+(10)			8378.38 (11)
Capital ratio % (7)/(11) x 100	10.7%		

B 'Traditional' Building Society

Balance sheet

	\$'000	
Assets		
Cash	500	(1)
Bank deposits	10,000	(2)
Residential mortgages	82,000	(3)
Other lending	5,000	(4)
Property	1,500	(5)
Intangible assets	300	(6)
Plant and equipment	700	(7)
Total assets	100,000	
Liabilities		
Borrowings	91,000	
Other	1,000	
Total liabilities	92,000	
Equity		
Share capital	4,000	
Retained earnings	4,000	
Total	8,000	(8)
Memorandum items:		
Residential mortgages LVR 70% or less	41,000	(9)
LVR greater than 70%	41,000	(10)

Capital ratio calculation – Building Society

Capital	\$,000		
Shares & retained earnings (8)	8,000		
Deductions (6)	300		
Total (8)-(6) (11)	7,700 (11)		
Exposures			
<i>On balance sheet credit exposures</i>			
	<i>Exposure \$,000</i>	<i>Risk weight %</i>	<i>Risk weighted exposures \$'000</i>
Cash (1)	500	0	0
Bank deposits (2)	10,000	20	2,000
Res. mort. LVR 70% or less (9)	41,000	35	14,350
Res. Mort. Over 70% LVR (10)	41,000	100	41,000
Other lending (4)	5,000	150	7,500
Other assets (5)+(7)	2,200	500	11,000
Total	99,700(12)		75,850 (13)
<i>Off balance sheet credit exposures</i>	nil		nil
<i>Operational and market</i>			
((99,700(12)+75,850(13))/2) X 0.175			15,360.62 (14)
Total exposures (13)+(14)			91,210.62 (15)
Capital ratio % (11)/(15) x 100	8.4%		

C Complex finance company

Balance sheet

	\$'000	
Assets		
Bank deposits	75,000	(1)
Loans	380,000	(2)
Investments	40,000	(3)
Deferred tax asset	3,000	(4)
Plant and equipment	2,000	(5)
Total assets	500,000	
Liabilities		
Deposits	440,000	
Other	2,000	
Total liabilities	442,000	
Equity		
Ordinary shares	30,000	(6)
Cumulative Preference shares	10,000	
Retained earnings	18,000	(7)
Total	58,000	
Memorandum items:		
Property dev. loans >70% LVR, 2 nd ranking	190,000	(8)
Investments unconsol. subs	20,000	(9)
Other investments	20,000	(10)

Capital ratio calculation – Complex Finance Company

Capital	\$,000		
Ordinary shares and Retained earnings (6)+(7)	48,000		
Deductions (4)+(9)	23,000		
Total (11)	25,000		
Exposures			
	<i>Exposure \$,000</i>	<i>Risk weight %</i>	<i>Risk weighted exposures \$'000</i>
Bank deposits (1)	75,000	20	15,000
Prop lending high risk (8)	190,000	300	570,000
Other lending (2)-(8)	190,000	150	275,000
Investments (10)	20,000	600	120,000
Other assets (5)	2,000	500	10,000
Total	477,000 (12)		990,000 (13)
<i>Off balance sheet credit exposures</i>	nil		nil
<i>Operational and market</i>			
			128,362.50 (14)
((477,000(12)+990,000(13))/2) X 0.175			
Total exposures (13)+(14)			1,118,362.50 (15)
Capital ratio % (11)/(15) x 100	2.2%		