



Reserve Bank
of New Zealand
Te Pūtea Matua

Risk Weights

Omnibus Consultation Paper

29 September 2022

CONSULTATION
PAPER

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Submission Contact Details

This paper covers a wide range of topics. In order to provide stakeholders time to provide their views, the Reserve Bank – Te Pūtea Matua invites submissions on this consultation paper in line with the two dates below:

- The consultation paper seeks stakeholder’s views on the proposals for the risk weighting of exposures to the Business Growth Fund by 5pm on 30 November 2022.
- The consultation paper seeks stakeholder views on all other topics in the paper by 5pm 28 February 2023.

Please note the disclosure on the publications of submissions below.

Address for Submissions and Enquiries

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Publication of Submission

All information will be made public unless you indicate you would like all or part of your submission to remain confidential. Respondents who would like part of their submission to remain confidential should provide both a confidential and a public version of their submission. Apart from redactions of the information to be withheld (i.e. blacking out of text) the two versions should be identical. Respondents should ensure that redacted information is not able to be recovered electronically from the document (the redacted version will be published as received).

Respondents who request that all or part of their submission be treated as confidential should provide reasons for why this information should be withheld if a request is made under the Official Information Act 1982 (OIA). These reasons should refer to section 105 of the Banking (Prudential Supervision) Act 1989, section 54 of the Non-Bank Deposit Takers Act, section 135 of the Insurance (Prudential) Supervision Act 2020 (as applicable), or the grounds for withholding information under the OIA. If an OIA request for redacted information is made, we will make our own assessment of what must be released taking into account the respondent’s views.

We may also publish an anonymised summary of the responses received in respect of this Consultation Paper.

1 Background

In 2017, The Reserve Bank of New Zealand – Te Pūtea Matua began a comprehensive review of the capital adequacy framework for locally incorporated registered banks in New Zealand, known as the 'Capital Review' (the Review).¹ The purpose of the Review was to identify the most appropriate capital requirements for New Zealand banks, taking into account how the current framework operates and international developments in bank capital requirements.

Final decisions for the Review were announced by the Reserve Bank on 5 December 2019. The key decisions included banks' total capital ratios increasing from 10.5 percent to 18 percent for the four largest banks (identified as 'Domestic Systemically Important Banks') and 16 percent for the remaining smaller banks. The central factor driving the decisions was to make the banking system safer for all New Zealanders – more capital in the banking system better enables banks to weather economic volatility and maintain good, long-term customer outcomes.

In November 2020, the Reserve Bank opened a consultation on the details for implementing the final Capital Review decisions that were announced in 2019 – *Changes to the Banking Supervision Handbook: Exposure Draft for Capital Review Changes*.² Some of the most significant changes in the consultation included implementing the new rules for instruments that make up a bank's capital and consulting about the responses the Reserve Bank would take if a bank does not meet capital buffer requirements. The exposure draft consultation closed on 31 March 2021.

After considering the feedback we received during the exposure draft consultation, the Reserve Bank published a *Response to Submissions* and the final bank capital adequacy requirements in June 2021. These were outlined in the new *Banking Prudential Requirements* (BPR) documents, which took effect from 1 October 2021.³

In the *Response to Submissions*, we noted that submissions on the exposure draft consultation covered several different topics that related to long-standing features of the framework, rather than the specific changes that were being implemented as part of the Capital Review. We responded to some of those points, but in several cases, deferred additional issues for further consideration. This consultation paper aims to address some of these deferred issues, such as the definition of sovereigns, public sector entities and multilateral development banks, the treatment of reverse residential mortgage loans, and cross-method guarantees.

We have also received queries from industry about other risk weight-related topics that we are taking the opportunity to address in this omnibus consultation paper. These include the treatment of first home loans underwritten by Kāinga Ora, the treatment of exposures to the new Business Growth Fund, and the treatment of Qualifying Central Counterparties. We are also collating and publishing our responses to several questions about the standardised approach for calculating risk-weighted assets on credit risk exposures (see Annex B).

We intend to reconsider risk weighting on a regular basis. In general we expect that this will be no longer than every three years. This would mean the next opportunity to change the system will be in 2025. But we will do so more quickly if there is a pressing need to do so.

¹ All background documents related to the Capital Review, including previous consultation papers and the Reserve Bank's responses to submissions can be found here: <https://www.rbnz.govt.nz/regulation-and-supervision/oversight-of-banks/how-we-regulate-and-supervise-banks/our-policy-work-for-bank-oversight/capital-review#:~:text=The%20Capital%20Review%20was%20a,and%20external%20expert%20review%20papers>

² [Exposure draft for Capital Review implementation changes - Reserve Bank of New Zealand - Te Pūtea Matua \(rbnz.govt.nz\)](#)

³ [Capital and credit risk requirements - Reserve Bank of New Zealand - Te Pūtea Matua \(rbnz.govt.nz\)](#)

2 Purpose, Format and Framework for the Consultation

2.1 Purpose and framework

Scope of Consultation

This Consultation Paper seeks stakeholder feedback about possible changes to a range of parts of the approach to risk weighting of bank exposures that is set out in the following Banking Prudential Requirements (BPRs) documents:⁴

- BPR130: Credit Risk RWAs Overview
- BPR131: Standardised Credit Risk RWAs
- BPR133: IRB Credit Risk RWAs

The purpose is to set out the Reserve Bank's thinking about a range of topics where stakeholders have asked for amendments to the existing approach. The consultation will run until 28 February 2023 for all topics except for the risk weighting of exposures to the Business Growth Fund, for which the consultation period will run to 30 November 2022. This two stage approach is intended to provide stakeholders sufficient time to engage with the wide range of topics in the paper. Once each consultation period closes we will consider the feedback and determine whether to proceed with any changes. The topics covered in this paper are:

- First Home Loans underwritten by Kāinga Ora;
- Sovereigns, Public Sector Entities and Multilateral Development Banks;
- Reverse Residential Mortgage Loans;
- Cross-method guarantees: the treatment of a subset of loans where guarantees cross over between the standardised and IRB approaches;
- The Business Growth Fund; and
- Qualifying Central Counterparties.

We have also included an Annex with responses to questions that we have received from banks about specific parts of the BPR documents. These responses have been generalised to remove references to specific banks, but reflect the responses we have provided to similar questions. We have done this to provide transparency.

Framework Used Throughout This Paper

The topics covered in this Consultation Paper tend to be technical in nature and focused on the detailed implementation of aspects of the capital adequacy framework.

The general approach underpinning this Consultation Paper is that the risk weighting framework should reflect the underlying risk of the exposure. We consider that the framework achieves this purpose – it has been adapted from the Basel source material to include variations for New

⁴ [Capital and credit risk requirements - Reserve Bank of New Zealand - Te Pūtea Matua \(rbnz.govt.nz\)](https://www.rbnz.govt.nz/capital-and-credit-risk-requirements)

Zealand conditions. Nevertheless as circumstances change, or new information about risks is available, we are open to considering whether any adjustments to the approach are warranted.

We have used the framework set out below in Table 1 to guide our assessment of various options covered in this paper. The framework is drawn from the approach published during the Capital Review, with some adjustments to make it more directly applicable to the narrower focus on risk weights. The framework is used throughout this Consultation Paper to assess options for change. We are interested in stakeholder feedback about the framework and our assessments of options.

The framework is separated into those considerations that underpin the purpose of risk weighting and those that underpin the implementation of risk weighting.

Table 1: Key considerations for assessing changes to the risk-weighting framework

Consideration	Rationale
Purpose of framework	
1. Approach to risk weights should help ensure that capital must readily absorb losses before losses are imposed on creditors and depositors.	This is drawn from the Capital Review, but edited to make its application to risk weights clearer.
2. Capital requirements should be set in relation to the risk of bank exposures, where that risk captures all elements of risk that the bank could face, including climate change.	The text used in the Capital Review has been expanded a little, to make it clear that <u>all</u> risks should be considered. For example, this consideration should capture risks associated with climate change.
3. Risk weighting should reflect the risks inherent in the New Zealand financial system and the Reserve Bank’s regulatory approach, while also promoting the efficiency of the financial system, encouraging innovation and boosting competition	Based on previous Capital Review text, but we have added “while also by lifting the efficiency of the financial system, encouraging innovation and boosting competition”. This more directly incorporates the need to consider these perspectives.
4. Risk weighting should help remove barriers to credit without reducing financial stability.	This is a new addition and was not covered in the previous specification. This has been added as it helps ensure that we consider barriers to credit, that can affect a range of groups in society, when assessing the approach to risk weights.
Implementation of framework	
5. Where there are multiple methods for determining risk weights, outcomes should not vary unduly between methods.	This general approach from the Capital Review has been tailored specifically for risk weights, to ensure IRB and standardised methods do not vary unduly.
6. The risk weighting approach should be practical to administer, minimise unnecessary complexity and compliance costs and take into consideration relationships with foreign-owned banks’ home country regulators.	The text replaces “capital framework” from the Capital Review specification with “risk weighting approach”.

Consideration	Rationale
7. The risk weighting should be transparent to enable effective market discipline.	The text replaces “capital framework” from the Capital Review specification with “risk weighting approach”.

The framework above is designed to bring consistency to the way that any potential changes to the approach to risk weights are considered over time and across topics.

The key considerations above are broadly similar to those considered during the Capital Review, with two important differences.

Item 3 has been expanded to directly reference innovation and efficiency. These factors were considered during the Capital Review. For example, a key focus of the Regulatory Impact Analysis was assessing the impacts of higher capital requirements on efficiency, mainly measured through impacts on interest rates and output. However, the new text makes it clearer that this has been considered.

We consider item 3 to be consistent with the approach set out in the Exposure Draft of the Deposit Takers Bill, for which the public consultation period has recently ended.⁵ The Exposure Draft was published in late 2021. If agreed by Parliament, it would replace the powers legislated to the Reserve Bank. The current drafting of the Purposes of that Bill includes the following text: “contribute to a sustainable and productive economy by protecting and promoting the stability of the financial system”. The Principles in the Exposure Draft would require the Reserve Bank to take into account maintaining competition, reducing compliance costs and applying proportionality in the exercise of its powers. While this is yet to be considered by Parliament we consider the framework in this Consultation paper to be consistent with the Purposes and principles in the Exposure Draft.

Item 4 is completely new. This will require us to ensure the approach to risk weight does not unduly affect access to credit to people across New Zealand – an issue raised by some stakeholders during different stages of the Capital Review. For example, our Te Ao Māori strategy should be embedded in the approach to assess risk weights through item 4, by considering possible barriers to credit. Likewise, the effects on barriers to credit to other groups of people should also be considered. Item 4 provides this more general focus on barriers to credit access, where it does not reduce financial stability.

2.2 An Overview of the Approach to Risk Weighting in New Zealand

This section briefly describes risk weighting’s role in the capital adequacy framework.

Locally incorporated registered banks in New Zealand calculate their exposures based on the Basel 2 framework. This framework is set out in 'Basel 2: International Convergence of Capital Measurement and Capital Standards: A Revised Framework' on the website of the Bank for International Settlements.

[Basel 2: International Convergence of Capital Measurement and Capital Standards: A Revised Framework](#)

⁵ [Exposure draft of the Deposit Takers Bill - Reserve Bank of New Zealand - Te Pūtea Matua \(rbnz.govt.nz\)](#)

Pillar 1 of Basel 2 involves calculating the minimum capital requirements to cover credit risk, market risk and operational risk. Credit risk is determined through the calculation of risk-weighted exposures. This means that the actual dollar amount of any given exposure receives a 'risk weight' that converts the dollar amount into a risk-weighted equivalent that reflects the risk associated with the specific exposure.

The Basel 2 framework has applied to locally incorporated New Zealand banks since the first quarter of 2008. Under Basel 2, banks may, if accredited, use the internal models-based approach to calculate their capital requirements; otherwise they must use the standardised approach.

For banks registered as branches in New Zealand, Basel 2 developments have disclosure implications only.

The overarching approach is set out in 'BPR100: Capital Adequacy' and 'BPR130: Credit Risk RWAs Overview'.

Locally incorporated registered banks in New Zealand using the standardised approach under Pillar 1 are subject to conditions of registration that require capital adequacy to be calculated using the frameworks set out in:⁶

- BPR131: Standardised credit risk RWAs
- BPR132: Credit risk mitigation
- BPR140: Market risk exposure
- BPR150: Standardised operational risk
- BPR160: Insurance, securitisation, and loan transfers

Locally incorporated registered banks in New Zealand using the internal ratings-based (IRB) approach under Pillar 1 are subject to conditions of registration that require capital adequacy to be calculated using the frameworks set out in:⁷

- BPR132: Credit risk mitigation
- BPR133: IRB credit risk RWAs
- BPR134: IRB minimum system requirements
- BPR140: Market risk exposure
- BPR151: AMA operational risk
- BPR160: Insurance, securitisation, and loan transfers

As part of our Capital Review decisions made in December 2019, banks accredited to use the IRB approach have been subject to an 'output floor' from 1 January 2022. This means their estimates of risk-weighted assets (RWA) must be either the outcome of their IRB models, or 85% of the standardised outcome, whichever is highest.

⁶ [Capital and credit risk requirements - Reserve Bank of New Zealand - Te Pūtea Matua \(rbnz.govt.nz\)](#)

⁷ [Capital and credit risk requirements - Reserve Bank of New Zealand - Te Pūtea Matua \(rbnz.govt.nz\)](#)

3 First Home Loans Underwritten by Kāinga Ora

Responding to stakeholder requests, this section seeks feedback on a risk weight, applicable under the Reserve Bank's document BPR131 (Standardised Credit Risk RWAs), for residential mortgage loans underwritten by Kāinga Ora under its First Home Loan (FHL) programme.

3.1 Background

What are First Home Loans (FHLs)?

First Home Loans are a type of residential mortgage loans issued by commercial lenders (e.g., banks) and underwritten by Kāinga Ora in its capacity as a provider of Lenders Mortgage Insurance (LMI).

The FHL programme is designed for first home buyers who can afford to make regular repayments on a loan but have only a 5% or more deposit compared to the total value of the property (i.e., the highest loan-to-value ratio (LVR) reaches 95%).

To be eligible for a FHL, a borrower's annual income must be \$95,000 or less.⁸ According to Stats NZ's income data, this means that most people in Aotearoa who earn the national average income will meet this eligibility condition for a FHL. If there are two or more borrowers, they must have a combined before tax-income of less than \$150,000 in the previous 12-months. In addition, an individual borrower can have an income of no more than \$150,000 (before tax) for an individual buyer who has one or more dependents.

From 1 June 2022 the FHL scheme has had no borrowing limits based on house prices, with the Government announcing the removal of borrowing limits based on regional house prices as part of Budget 2022.⁹

FHLs are high-LVR loans and often high-DTI mortgage loans, issued by commercial lenders with support from Kāinga Ora, which covers 100% of all losses incurred by lenders subject to Kāinga Ora's scheme requirements.

⁸ According to Kainga ora, if there are two or more borrowers, they must have a combined before tax-income of less than \$150,000 in the previous 12-months.

⁹ kaingaora.govt.nz/news/budget-2022-changes-announced-for-first-home-products/

What is the Current Risk-Weight Treatment of First Home Loans under BPR131?

For banks using the Standardised Approach (BPR131), the risk weight for a residential mortgage loan (RML) that is neither property investment nor a 90 days past due asset is determined based upon whether it is covered by qualifying lender’s mortgage insurance (LMI) (See Section C3.10 of BPR131).

If the RML is covered by qualifying LMI, then the risk weight applicable to the RML is dependent upon the RML’s loan-to-value ratio (LVR), as shown in Table 2. The current treatment in BPR131 provides for a lower risk weight where a loan is covered by qualifying LMI, where the loan’s LVR is greater than 80% but less than 100%.

Table 2: Risk weights for RMLs that are neither property investment nor 90 days past due and that are covered by qualifying LMI

LVR	Risk weights	Risk weight if for same loan if not covered by qualifying LMI
≤80%	35%	35%
>80% & ≤90%	35%	50%
>90% & ≤100%	50%	75%
≥100%	100%	100%

Qualifying LMI is required to meet one of these conditions under Section C.3.9 of BPR131:

- The insurance is provided by Housing New Zealand Corporation (HNZC); or
- The insurance provider providing the LMI has an insurer financial strength rating of at least A (Standard & Poor’s or Fitch), A2 (Moody’s Investor Services) or A (AM Best) and the LMI covers all losses realised in a default on the mortgage up to an amount of no less than 40% of the loan value.

The qualification that the HNZC held under Section 3.9 was grandparented to Kāinga Ora, when Kāinga Ora was established as a Crown Entity in 2019 and the HNZC transferred all of its operations, assets, liabilities, rights, and obligations to Kāinga Ora.

Therefore, the RMLs that are covered under insurance provided by Kāinga Ora are eligible for a 50% risk weight in accordance with Table 2 above. This is because First Home Loans (FHLs) require borrowers to hold only a 5% minimum deposit of the total value of the property at its origination (i.e., FHLs fall into the 90-100% LVR bucket).

Kāinga Ora as an Insurer

According to Kāinga Ora's 2020/2021 annual report¹⁰, the number of loans underwritten in that year was constrained up to a maximum of approximately 1,650 loans by the appropriation provided by the Government for 2020/21. Kāinga Ora underwrote 1,272 loans in the 2020/21 financial year. As part of changes announced in Budget 2022 the Government has stated that there will be an extra 2,500 First Home Loans available each year.

The total value of amounts that were originally lent and still remain insured has been stable throughout recent years and was \$1,787 million as at 30 June 2021. Kāinga Ora recorded \$31 million as a liability to cover potential claims in the future.

Kāinga Ora collects a single insurance premium for FHLs at the loan origination. The insurance premium is 2.2% of the loan value, of which 1% is paid by the borrower and 1.2% by the Government's appropriation to Kāinga Ora.

Kāinga Ora underwrites 100% of the possible loss associated with the loan subject to Kāinga Ora's scheme requirements. It will also cover the sale costs of a property incurred by commercial lenders in the sale of a property, arising because of default.

There is no explicit Government guarantee for the insurance other than the appropriation from the government. The annual report states that Kāinga Ora does not reinsure its mortgage insurance risk through third parties.

The insurance function of Kāinga Ora is not required to be regulated under the Insurance (Prudential Supervision) Act 2010 (IPSA).

3.2 Problem Definition

Although First Home Loans (FHLs) are high-LVR and high-DTI mortgage loans issued by commercial lenders, Kāinga Ora's lender's mortgage insurance can minimise lenders' loss given default. This means the bank originating the loan would not bear any costs in the event of a default.

Given that, some stakeholders have suggested to us that the current level of risk weight applicable to FHLs (50%) is too high compared to the actual level of underlying risk that banks are exposed to. These stakeholders have suggested that the risk weight for FHLs should be reduced from 50% to 35% or further down to 20%.

The 35% risk weight is the same level that applies to RMLs whose LVR is less than 90%, that are covered by qualifying LMI, and is neither property investment nor 90 days past due (see Table 2 above).

The 20% risk weight is the risk weight applicable to bonds issued by Kāinga Ora under section C2.7 of BPR131 – this is the risk weight applicable to a corporate (including a Crown entity) with a 'rating grade' of 1 in section B2.3 of BPR131.

Applying a 20% risk weight to residential mortgage loans would be unprecedentedly low within the banking prudential requirements. However, some stakeholders have argued that unless Kāinga Ora becomes insolvent, there is no risk to a bank from its FHL business (i.e., the risk is ultimately

¹⁰ Kāinga Ora 2020-21 annual report: <https://kaingaora.govt.nz/assets/Publications/Annual-report/2020-21-Annual-Report.pdf>

only Kāinga Ora's credit risk as an insurer). Stakeholders have also pointed out that Non-Bank Deposit Takers (NBDTs) are currently required to apply a 20% risk weight to FHLs under the Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010.

3.3 Options

The Reserve Bank sees some rationale for a reduction in risk weights, as Kāinga Ora underwrites 100% of the possible loss associated with FHLs. This enables its participating lenders to minimise their loss given default more than they could have possibly done with other qualifying LMLs.

Therefore, we are proposing these two options to risk weight where LVR is greater than 90% but less than 100%.

- Option 1: The risk weight remains at 50%; or
- Option 2: The risk weight lowered to 35% with a condition imposed on either insurer financial strength ratings or credit ratings.

The Reserve Bank's preferred option at this stage is Option 2. The reasoning behind this preferred option and the associated conditions are summarised in the next section. While our preference is for Option 2, this is based on currently available information including the current level of banks' uptake of FHLs and the loss allocation mechanism between Kāinga Ora and banks. We will continue to assess how recent changes to the programme are affecting uptake, including whether this has any implications on the proposals in this Consultation paper. Likewise, we will review any new information about the loss allocation settings. We will take all of this information into account when making final decisions.

3.4 Points to Consider

Financial Stability Risks

The FHL is exempted from the LVR restrictions. Since the Reserve Bank introduced LVR restrictions and the FHL exemption in 2013¹¹, our view has been that financial stability is less likely to be jeopardised by FHLs even in the event of borrowers' mortgage defaults.

This is because any bank losses associated with the FHL programme are underwritten by Kāinga Ora under government housing policy objectives. Additionally, the number of FHLs underwritten by Kāinga Ora is constrained by the appropriation that the Government provides. This limits the exposure of the financial system as a whole to FHLs to within the level of the appropriation.

However, if this constraint is eased at some point in the future and, consequently, banks expand their FHL portfolios, the possible impact on financial stability may increase. However, this would only be the case if Kāinga Ora's financial strength as an insurer (or as an entire organisation) was to deteriorate, because there is no explicit government guarantee backing Kāinga Ora's residential mortgage insurance. Otherwise, in all other circumstances the insurance would be sufficient to cover banks' losses.

Hence, Option 2 proposes to impose a condition on either insurer financial strength ratings or credit ratings along with the lower risk weight (i.e., 35%). While our preference is for Option 2, this is based on currently available information including the current level of banks' uptake of FHLs and our current understanding of the allocation of risk between Kāinga Ora and banks. If the scale of

¹¹ The Kāinga Ora First Home Loans LVR exemption is outlined here: [Loan-to-value restrictions explained - Reserve Bank of New Zealand - Te Pūtea Matua \(rbnz.govt.nz\)](#) and here: [Loan-to-value ratio restrictions - Reserve Bank of New Zealand - Te Pūtea Matua \(rbnz.govt.nz\)](#)

the impacts on financial stability changes (e.g., changes in the current uptake level), we may revisit this option and/or will be taking the impacts into account when making our decision.

We are interested in stakeholder feedback about changes in banks' uptake level of FHLs and the loss allocation of risk between Kāinga Ora and banks.

Potential Gap among Participating Lenders

Lenders participating in the FHL programme are currently made up of banks and non-bank lending institutions.¹²

The banks are further separated into a bank that has been accredited by the Reserve Bank to use the Internal Ratings Based (IRB) approach for credit risk capital requirements ("IRB bank") and banks that use the standardised approach ("standardised bank") for the requirements.

Our proposed options are only applicable to standardised banks. IRB banks use a different way to measure risks associated with loans including FHLs. IRB banks may prudently choose, due to the nature of FHLs (i.e., high-LVR and high-DTI), to allocate a higher probability of default to FHLs. This could result in a higher implied risk weight to FHLs than that which standardised banks are required to use under *BPR131: Standardised Credit Risk RWAs*.

On the other hand, non-bank lending institutions are also further separated into licenced non-bank deposit taking institutions (NBDTs) and non-deposit taking finance companies. Licenced NBDTs are regulated by the Reserve Bank and are required to apply a 20% risk weight to FHLs under the Deposit Takers Regulations 2010.¹³

Option 2 could potentially widen the gap on the eligible risk weight between standardised banks and IRB banks, while narrowing the gap between standardised banks and NBDTs.

Applying the 20% risk weight to residential mortgage loans would be unprecedentedly low within the banking prudential requirements. Hence, we are not proposing to lower the risk weight to 20%.

Connection with LVR Policy and Impacts on Borrowers

The Reserve Bank steadily tightened LVR restrictions during 2021.¹⁴ This reflected our concerns that house prices have remained at unsustainable levels, and that the risks of a housing market correction have continued to rise, increasing risks to economic and financial stability. Restricting high-risk lending will help prevent these problems getting worse.

Reducing the risk weight for FHL loans may encourage banks to offer more high-LVR loans to borrowers who qualify for the programme. However, as the appropriation limits the number of people that can receive a FHL, the financial stability risks associated with this will be small. Nevertheless, it would also expose those borrowers to the risk of house price falls, which could lead to those borrowers being in a position of negative equity.

¹² kaingaora.govt.nz/home-ownership/first-home-loan/lenders/

¹³ Non-deposit taking finance companies are not regulated by the Reserve Bank.

¹⁴ For example: rbnz.govt.nz/news/2021/09/reserve-bank-tightens-lvr-restrictions

Assessment against Framework

Annex A contains an assessment of the proposed change with the framework for assessing changes to the risk weighting framework set out earlier in this paper. The assessment shows that Option 2 would align risk weights more closely with actual risk. It would also have a small impact on reducing barriers to access capital.

3.5 Questions

The Reserve Bank is seeking feedback on our proposed options and also seeking input from stakeholders including:

- The anticipated impacts on banks' risk profiles and the financial system;
- The loss allocation mechanism between Kāinga Ora and participating lenders, including in a scenario where Kāinga Ora's liability kept aside for the future claims becomes deficient;
- Information about how FHL lending fits into responsible lending considerations; and
- Potential impacts on borrowers.

Other Insurances Provided by Kāinga Ora

For the avoidance of doubt, our proposals in this paper would only be applicable to First Home Loans insured by Kāinga Ora. For all other loans (e.g., Kāinga Whenua loans), the currently applicable risk weights will continue to be applied (i.e., the 50% risk weight for $90% < LVR \leq 100%$ and the 35% risk weight for $80% < LVR \leq 90%$). These are the risk weights applicable to loans covered by qualifying LMIs and are lower than those applicable to loans that are not covered by qualifying LMIs.

If there are any other loans covered by insurance products that stakeholders believe have been risk weighted higher than actual the actual risk of those loans, the Reserve Bank is open to hear stakeholder views about these loans and the evidence supporting the risk assessment. Please provide it as part of your feedback on our proposed options.

Q1 Do you have any comments on our proposed options for the risk weight applicable to First Home Loans (FHLs)? Please provide us with inputs about the possible impacts of the proposed options.

Q2 Do you have any views about changes in banks' uptake level of FHLs and the loss allocation process between banks and Kāinga Ora?

4 Sovereigns, Public Sector Entities and Multilateral Development Banks

4.1 Background

One of the reforms decided in the Capital Review was to switch banks using the IRB approach to the standardised approach for sovereign and bank exposures. This meant that, from 1 January 2022, IRB banks have been subject to the standardised approach to estimate risk weights for exposures to sovereigns, public sector entities (PSEs) and multilateral development banks (MDBs).

BPR131: Standardised Credit Risk RWAs sets out the standardised approach for calculating risk-weighted assets for claims on different types of entities (summarised in Table 3). These risk weights are based off rating grades, which are mapped to the credit ratings of four credit rating agencies: Standard & Poor's Corporation, Moody's Investment Services, Fitch Ratings and AM Best. For example, a long-term or issuer credit rating of A+ from Standard & Poor's has an associated rating grade of 2.

Table 3: Summary of standardised risk weights (%)

Rating Grade	Sovereign & Central Bank	PSE	Other MDBs	Bank (original maturity > 3m)	Corporate	Bank (original maturity ≤ 3m)
1 (AAA to AA-)	0	20	20	20	20	20
2 (A+ to A-)	20	50	50	50	50	20
3 (BBB+ to BBB-)	50	100	50	50	100	20
4 (BB+ to BB-)	100	100	100	100	100	50
5 (B+ to B-)	100	100	100	100	150	50
6 (CCC+ to D)	150	150	150	150	150	150
Unrated	100	100	50	50*	100*	20*

For banks and corporates, the cells with an asterisk in Table 3 are subject to floors (relating to the sovereign in which the entity is incorporated, and the case where the entity has debt issues outstanding with poor issue-specific short-term ratings). 'Corporate' includes state-owned enterprises and other government-owned entities that are not part of the Crown. Additionally, a 0% risk weight applies to claims against the Crown or the Reserve Bank that are denominated in New Zealand dollars, irrespective of the rating grade.

A broad summary of the current approach is that:

- For claims that are below investment grade (i.e. a rating grade less than 3), the applicable risk weights are all the same except for short-term claims on banks; and
- Public sector entities are one band up from sovereigns; and
- Claims on banks and other MDBs in rating grade 3 get the same risk weights as sovereigns – one up from public sector entities.

4.2 Problem Definition

During the 2020 exposure draft consultation, several banks approved to use the internal ratings-based approach questioned the definitions and standardised risk weights of sovereigns, public sector entities and multilateral development banks. The concerns raised during the consultation all fall under a general interest from IRB banks for additional guidance and clarity about these definitions.

Currently, 'sovereign' is only defined with reference to New Zealand, while there is no definition of 'multilateral development bank' and 'public sector entity' is only narrowly defined. In our *Response to Submissions* to the 2020 exposure draft consultation, we said that we would review and consult with banks on a coherent set of changes across the definitions. This will help to ensure that all banks take a consistent approach. It will also minimise the need for us to respond to bespoke requests in the future from banks about how to classify entities.

The concerns raised by banks fall under five separate topics, each of which are discussed separately in the following sections. The options selected have been developed to support the framework in Section 2 of this paper, in particular:

- Risk weighting should reflect the risks inherent in the New Zealand financial system and the Reserve Bank's regulatory approach, while also promoting the efficiency of the financial system, encouraging innovation and boosting competition.
- The capital framework should be practical to administer, minimise unnecessary complexity and compliance costs, and take into consideration relationships with foreign-owned banks' home country regulators.
- The capital framework should be transparent to enable effective market discipline.

4.3 Topic One: Definition of Sovereign

One concern that has been raised by banks is that there is no clear definition of a sovereign, particularly relating to a foreign sovereign. Because we do not define what level 'sovereign' goes down to, it has been unclear as to whether it includes states within federal jurisdictions (e.g. Queensland Treasury Corporation).

One option would be to include state and regional governments in the definition of 'sovereign'. This option would be closely aligned to APRA's approach, whereby Authorised Deposit Institutions can assign a zero risk weight for claims against certain entities at the state-level. However, we do not prefer this approach as it would add complexity and reduce transparency. This complexity would arise as we would need to decide what state and regional levels apply. For example, would it cover states in Australia and the United States? Similarly, would it cover regional level governments in Germany? These are all examples of queries we have received in the past.

Our preferred approach is the most simple, which is to limit the definition tightly to minimise the need for guidance or decisions on particular levels of government. While this is more conservative than the APRA approach, it is consistent with the principles of the Capital Review.

To implement our preferred approach, we are proposing to add the following definition to *BPR100: Glossary*:

"Sovereign means the **Crown** in the case of New Zealand and in all other instances means the central, national government of a country other than New Zealand. It does not include subdivisions such as states, provinces and regions."

Assessment against Principles

Annex A contains an assessment of the proposed change with the principles for assessing changes to the risk weighting framework set out earlier in this paper.

We do not expect the implementation of our preferred approach to have any impact, unless some banks are currently classifying state governments as sovereigns. This proposal is also consistent with the framework set out in this paper.

Q2 Do you have any comments on the proposed definition of sovereign?

4.4 Topic Two: Implicit Guarantees from a Sovereign

Section C2.2 of *BPR131* addresses claims on sovereigns and central banks. It outlines that a 0% risk weight applies to a claim on the Crown or the Reserve Bank that is denominated in New Zealand dollars. The Crown is further defined in *BPR001* as having the same meaning given in section 2(1) of the Public Finance Act 1989, which is the Sovereign in right of New Zealand and includes all Ministers of the Crown and all departments. It does not include, for example, a Crown entity.

In the exposure draft consultation, one submitter said that we should provide guidance to section C2.2 to clarify that entities, such as export guarantee offices, with implicit (rather than explicit) guarantees should be eligible to receive treatment as a sovereign. They believe that the intent would seem to be to treat these as a sovereign risk in order to facilitate trade, but that the risk weight treatment is not clear.

In the case of guarantees by the New Zealand Export Credit Office (NZECO), we have provided guidance in the past that exposures to certain NZECO products and services could be risk weighted at 0% due to the explicit government guarantee provided by the Crown in the event of default.

However, allowing implicit guarantees from sovereigns to other entities would substantially expand the coverage of the 0% risk weight. It would not be transparent as banks would need to decide at what point an implicit guarantee was sufficient to qualify for a 0% risk weight. This would be difficult to apply in a consistent way.

Therefore, we propose adding the following guidance box to section C2.2 of *BPR131*:

“An implicit guarantee from a sovereign to another entity does not qualify that other entity for a lower risk weight than would otherwise apply. Any consideration of the use of guarantees should be done in accordance with BPR132: Credit Risk Mitigation.”

Assessment against Principles

Annex A contains an assessment of the proposed change with the principles for assessing changes to the risk weighting framework set out earlier in this paper.

We do not expect there to be any impact from issuing the proposed guidance, unless some banks are currently using implicit guarantees to lower risk weights. This proposal is consistent with the framework set out in this paper.

Q3 Do you have any comments on the proposed guidance on implicit guarantees from a sovereign?

4.5 Topic Three: Definition of Public Sector Entity

The current definition of a public sector entity is purely domestic. *BPR100* defines a PSE as a local authority as defined in section 5 of the Local Government (Rating) Act 2002, which is a territorial authority or a regional council.

According to section C2.3 of *BPR131*, ‘the risk weight for a claim on a public sector entity is determined by the sovereign rating grade for a claim on the country in which the PSE is located’. While the definition of a PSE appears to restrict it to New Zealand-based entities, some banks have stated that section C2.3 gives the impression that entities outside of New Zealand could also qualify.

Widening the definition of a public sector entity would mean that banks would need to make judgements about which regions and states are covered. However, we believe that the risks of widening the definition, to include foreign entities, are lower than widening the definition in Topic One. This is because the lowest possible risk weight for an exposure would be 20%, not the 0% risk weight that would apply in Topic One if a 0% risk weight was applied in the wrong circumstances (see Table 3).

To clarify the definition of a public sector entity, we propose changing (addition underlined) the definition in *BPR001* to:

“public sector entity means a local authority (as defined in section 5 of the Local Government (Rating) Act 2022) in the case of a New Zealand entity. For non-New Zealand entities, public sector entity means a non-national level government in a country, such as a state, province or region.”

This may shift some non-sovereigns from corporate to public sector entity (for example, the Queensland Government). However, it will not affect the risk weights for exposures with a rating grade from 1 to 4 since there is no difference between the treatment of PSEs and corporates with these ratings. Additionally, we would expect banks to reach their own judgements in relation to the assessment of a public sector entity based on our text. We do not intend to publish a list of qualifying entities.

Assessment against Principles

Annex A contains an assessment of the proposed change with the principles for assessing changes to the risk weighting framework set out earlier in this paper.

We have assessed the proposal as being consistent with the framework in this paper.

Q4 Do you have any comments on the proposed change to the definition of public sector entity?

4.6 Topic Four: Status of the Local Government Funding Agency

We have been asked whether classifying the Local Government Funding Agency (LGFA) as a public sector entity is acceptable. There is some ambiguity about this. In the past, given this ambiguity, we have said that this classification is acceptable as the LGFA is a ‘council-controlled trading organisation’ and does not neatly fit into either the PSE or corporate categories. However, we are proposing to remove this ambiguity.

A strict interpretation of the current definition of public sector entities (see Topic Three) in New Zealand is that only the local authority itself qualifies as a PSE. This would mean that the LGFA would be classified as a corporate and, given the strong credit rating of the LGFA, would qualify for a 20% risk weight.

However, the LGFA is a ‘council-controlled trading organisation’ set up by local authorities to undertake activities on their behalf. In this case, the activity is to provide funding for local authorities through issuing bonds. Local authorities do not carry this out in their own name but, instead, rely on the economies of scale associated with a single entity issuing the debt.

Thirty councils own 80% of the LGFA, with the Crown owning the remainder. There are also very close connections between the local authorities and the LGFA. In particular, the LGFA’s indebtedness to its Guaranteed Creditors (including bondholders) is guaranteed by the local authorities and the ‘Security Trustee’. These guarantors cover all of the thirty councils that have an ownership stake in the LGFA as well as any other local authority that has borrowed more than \$20 million from the LGFA.

In practice, this means that if the LGFA fails to repay the principal amount to any Guaranteed Creditor, the Security Trustee can demand a payment from the guarantors. Such a demand must

be made on a pro-rata basis according to each guarantor's prior year's annual rates revenues relative to the aggregate rates revenues of all guarantors. This is designed to ensure large local authorities (which have a higher percentage of the aggregate rates revenue of the guarantors) pay more of the amount demanded by the Security Trustee than smaller local authorities. This means that, ultimately, the rates revenue of the local authorities acts as a guarantee of the LGFA debts.

This ties the LGFA closely to the actual local authorities. As such, we believe that it is appropriate to carry across the public sector entity designation to the LGFA. However, this rationale would not hold for another form of a 'council-controlled trading organisation' that does not have the guarantee structure that supports the LGFA.

To clarify the status of the LGFA, we propose adding the following guidance box to section C2.3 of *BPR131*:

"The close ownership and funding connections between New Zealand local authorities and the Local Government Funding Agency (LGFA) mean that it is acceptable to classify the LGFA as a public sector entity. This treatment does not apply to other council-controlled trading organisations, which will generally qualify as a 'corporate' under BPR131."

Assessment against Principles

Annex A contains an assessment of the proposed change with the principles for assessing changes to the risk weighting framework set out earlier in this paper.

We do not expect there to be any impact from issuing the proposed guidance. The current credit rating of the LGFA means that the same risk weight would apply if the LGFA were considered a corporate.¹⁵ This proposal is consistent with the framework in this paper.

Q5 Do you have any comments on the proposed guidance on the status of the Local Government Funding Agency?

4.7 Topic Five: Definition of Multilateral Development Bank

There is no definition of a multilateral development bank, as the existing approach relies on naming particular entities. Section C2.4 of *BPR131* lists the lowest-risk MDBs and supranationals, which are eligible for a 0% risk weight. There is also a separate specific risk-weighting category for 'other MDBs' (see Table 3), which applies to a claim on any multilateral development bank not listed in section C2.4. However, 'other MDBs' is not defined.

Banks have requested clarification on the definition of a multilateral development bank. The main area causing confusion relates to the 'other MDBs' as there is no definition of MDB, only the list of 0% risk-weighted entities.

We do not want alter the existing treatment of the MDBs listed in *BPR131* that qualify for a 0% risk weight. However, we are proposing several options of a definition to cover the 'other' group. These are:

¹⁵ At the time of publication, LGFA securities are rated at AAA (domestic long term) by S&P Global Ratings and AA+ by Fitch Ratings. For further details see: [lgfa.co.nz/investors/credit-ratings](https://www.lgfa.co.nz/investors/credit-ratings)

- Option 1: Add a narrow MDB definition to *BPR001: Glossary*; and
- Option 2: Rename the 'other MDB' group to allow for a wider range of entities, including 'quasi-sovereign' banks.

These options provide a definition to cover the 'other' group. The risk weights of these entities, under either option, would still be determined by their credit rating and no change is proposed to this framework. Both Option 1 and Option 2 are unlikely to have a significant impact on risk weights. This is because most of the entities would qualify for the same risk weight if classified as an 'other MDB' or as a 'bank' due to their credit rating. Each option is discussed in further detail in the following sections, with Option 1 being our preferred approach due to its simplicity.

Option 1

Under this option, we would add the following narrow MDB definition to *BPR131: Glossary*:

"multilateral development bank means any bank listed as such in BPR131, or any other supranational institution set up by two or more sovereign states, with a remit to reflect the development aid and cooperation policies established by those states."

This is a strict definition, based on the European Investment Bank's definition.¹⁶ It would exclude any banks set up by 'single sovereign' states, which would most likely be classified as 'banks'. We have assessed this option as being consistent with the framework in this paper as it applies to a limited group and the definition is clear.

Option 2

Under this option, we would rename the 'other MDB' group to allow for a wider range of entities. This would be based on the list of supranationals and quasi-sovereigns that we maintain on our website, which do not have to be covered in large exposure reporting and disclosure.¹⁷

We would add the following text (new text underlined) to section C2.4(2) of *BPR131*:

"The risk weight for a claim on any multilateral development bank or quasi-sovereign development bank not listed in subsection (1) is determined by the rating grade for the claim in accordance with Table C2.4."

The following definitions would be added to *BPR001: Glossary*:

"multilateral development bank means any bank listed as such in BPR131, or any other supranational institution set up by two or more sovereign states, with a remit to reflect the development aid and cooperation policies established by those states."

"quasi-sovereign development bank means any institution set up by a sovereign state, with a remit to reflect the sovereign's development policies."

This would provide coverage for a broader range of entities and is, therefore, less conservative than Option 1. It is also more complex than Option 1 as the wider coverage is difficult to neatly

¹⁶ eib.org/en/about/partners/development-banks/index.htm

¹⁷ The list can be found at this link: <https://www.rbnz.govt.nz/regulation-and-supervision/oversight-of-banks/standards-and-requirements-for-banks/disclosure-requirements>

define and may be interpreted differently across banks. However, to assist with interpretation, the Reserve Bank could provide a list of 'approved' entities.

Assessment against Principles

Annex A contains an assessment of the proposed change with the principles for assessing changes to the risk weighting framework set out earlier in this paper. The assessment shows that the change would improve transparency and help align exposures with risks.

Q6 Do you have any comments on the proposed options to define multilateral development bank and our preference for Option 1?

Sovereign Floor for Unrated Claims

Section C2.6 of *BPR131* sets the risk weight for an unrated claim on a bank (regardless of its original maturity) as the greater of:

- The risk weight for the claim under section C2.5; and
- The risk weight of the sovereign territory in which the bank is incorporated.

This is, in effect, a 'sovereign floor' for unrated claims on banks. During the exposure draft consultation, one bank noted that this sovereign floor does not extend to MDBs that are excluded from the list of lowest-risk multilateral development banks and supnationals in section C2.4(1). They believe that the sovereign floor should extend to those other MDBs that are treated, effectively, the same as bank exposures and have the same risk weightings as the longer-term bank exposures in section C2.5 to which the sovereign floor applies.

This would mean that if the MDB would otherwise qualify for a lower risk weight than the sovereign it is incorporated in, then the sovereign risk weight would apply. We are not proposing to make this change as a MDB will be based across several sovereign territories, so there is no unique sovereign risk weight that could be applied.

Assessment against Framework

Annex A contains an assessment of the proposed change with the framework for assessing changes to the risk weighting framework set out earlier in this paper. The assessment shows that the change would help align risk weights with actual risks and improve transparency.

Q7 Do you have any comments on our proposal to not extend a sovereign floor to unrated claims on multilateral development banks?

5 Reverse Residential Mortgage Loans

5.1 Background

Description of Reverse Mortgages

A reverse residential mortgage loan (RRML) is a loan secured by a residential property where no principal payments and generally no interest payments becomes due until the property is vacated or sold.

Recourse to other assets is normally not available to the reverse mortgage lender, which means that the lender bears any negative equity risk. Reverse mortgages are generally marketed to borrowers who are retired and have significant equity in their home. A reverse mortgage allows the borrower to access the equity without having to repay or service the loan whilst living in the property.

An RRML does not require regular repayments and is usually repaid when the property is sold. This means that the value of the loan increases with time, as the loan includes the original principle plus interest (compounded). This gives RRMLs a risk profile that is quite different from that of a standard mortgage since, in theory, compounding interest could turn a loan into negative equity.

As noted above, the risk profile of reverse mortgages is quite different from the risk profile of standard mortgages. We therefore consider it appropriate that reverse mortgages are treated differently from other, standard mortgages. This paper covers options for what this different approach should consist of.

In 2021 we deferred any consideration of changing the risk weights for reverse mortgages in our response to submissions on the consultation for the Exposure Draft of the Banking Prudential Requirements to implement the Capital Review decisions. Some stakeholders asked us to reconsider the risk weights that apply to reverse mortgages.

Overview of Treatment of Reverse Mortgages in Capital Adequacy Framework

In 2015, the Reserve Bank changed the treatment of reverse residential mortgage loans to the current approach with specific risk weights for RRMLs.

An LVR bucket for loans with an LVR between 61 and 80 percent was also introduced to allow for greater differentiation of risk in reverse RML portfolios. Additionally, the Reserve Bank adjusted the policy on the revaluation of properties securing reverse mortgages. The adjustment now requires reverse mortgage lenders to reassess property values every three years, with an anchoring approach that ensures this is done conservatively.

The same definition of reverse RML applies to both the IRB and the standardised approach, and the standardised risk-weighting in C3.10 of BPR131 applies.

BPR131 states the following: "a reverse mortgage means a residential mortgage for which payments of principal or interest are not due in accordance with an agreed repayment schedule, but rather on the occurrence of a specified trigger event, in which case the repayment of the loan is made from the proceeds of sale of the property."

The loan-to-valuation ratio (LVR) is measured in the same way as for a standard loan i.e. the loan value divided by the property value. But there is an important distinction for RRMLs, as the property value must be updated at least every three years. If the value at the time of the three year update is higher than when the loan was first originated, then the bank must only use 80% of the revised value in the LVR calculation. The bank must use the value at origination if this is higher than 80% of the revised value.

In addition, the following two conditions apply:

- A reverse RML may only be recognised in the RML category up to the value of the residential property used as security for the loan. Any excess of the loan over the property value is deducted from Common Equity Tier 1 capital in accordance with *BPR110: Capital Definitions*.
- A reverse RML for which the loan amount is greater than the property value gives rise to a RWA equal to 100% of the property value and a deduction from CET1 capital equal to the loan value less the property value. There is no separate treatment for defaulted reverse RMLs.

The following table outlines the risk weights applied to residential mortgage loans, including reverse RMLs and standard, non-property investment RMLs, as set out in BPR131.

Table 4: Risk weights for RMLs that are not 90 days past due

LVR Ratio	Non-property investment RML		LVR Ratio	Reverse RML risk weight
	Qualifying LMI	No qualifying LMI		
≤80%	35%	35%	≤60%	50%
>80% & ≤90%	35%	50%	>60% & ≤80%	80%
>90% & ≤100%	50%	75%	>80%	100%
Exceeds 100%	100%		Exceeds 100%	100%

Risk Profile of Reverse Mortgages

A standard mortgage loan exposes the lender to credit risk in the event of the borrower not meeting their repayment obligations and the collateral being insufficient to cover the outstanding loan amount. Reverse mortgages work differently. The total amount one can borrow under a reverse mortgage is normally capped at a certain percentage of the value of the residential property. The older the borrower, the higher the initial amount they can borrow. Interest is applied to the initial loan plus any previous interest (compound interest) but no repayments are made until the borrower vacates the property. At that point, the lender is repaid the initial loan, i.e. the principal, plus any interest that has accumulated in the intervening period.

This gives reverse mortgage loans a risk profile that is quite different from that of a standard mortgage. In theory, compounding interest could turn a loan into negative equity. Under the terms of typical reverse mortgage contracts, the risk of the property falling into negative equity cannot be passed on to the borrower or the borrower's estate. Once the value of the security has been realised, the borrower or their estate is under no obligation to repay any outstanding amount of the loan. Therefore, one of the key risks for a reverse mortgage would be a situation where the borrower stays in the property longer than was anticipated. Alternatively, if the value of the property does not grow as quickly as anticipated, or falls, the lender may be exposed to a loss.

Box 1: Illustrative example of reverse mortgage

The following illustrative example shows how a 30 percent loan on a property valued at \$500,000 could turn into a loss for the lender. The example assumes a 30 percent fall in the value of the property. Clearly, the more conservative the initial loan amount, the lower the probability of the lender incurring a loss, *ceteris paribus*.

Value of the house: \$500,000

Initial loan: \$150,000

Annual interest rate: 6%

Length of loan: 15 years

Loan including compound interest after 15 years: \$360,000

Fall in value of property: 30%

Value of property after 15 years: \$350,000

Negative equity/loss: \$10,000

This example only illustrates how a single loan could turn into negative equity, there are also risks at the portfolio level. At a portfolio level, the long and uncertain maturity profile of reverse mortgage assets presents a challenge that requires assumptions for several factors. If an assumption, such as the expected path of house prices, turns out to be incorrect, then a lender could suffer unexpected losses.

While arrangements whereby the reverse mortgage has to be repaid after a certain period of time or stay below a set LVR are theoretically possible, they are not the norm and would most likely be to the disadvantage of the borrower, and thus undermine the attractiveness of a reverse mortgage.

Therefore, different risk weights are currently applied to reverse RMLs compared to standard RMLs. Banks currently calculate the capital requirements for their reverse RML portfolios using the standardised (BPR131) approach.

Australian Approach

APRA’s approach to reverse mortgages is covered in APS112 – Capital Adequacy: Standardised Approach to Credit Risk.¹⁸

APRA treat reverse mortgages as non-standard loans and applies the following risk weights:

Table 5: APRA Risk weights for RMLs

LVR Ratio	Risk weight for non-standard loan
≤60%	50%
>60%	100%

This means that the risk weight applied by APRA to reverse mortgages is the same as the New Zealand framework for LVRs less than or equal to 60%, with a risk weight of 50%. In Australia, all reverse mortgages with an LVR of greater than 60% receive a risk weight of 100%. This is somewhat more conservative than the New Zealand framework, where the 100% risk weight is only applied to reverse mortgages with a risk weight of 80% or more – in New Zealand reverse mortgages with LVRs greater than 60% but less than 80% receive an 80% risk weight, compared with 100% in Australia.

While the risk weights are more conservative in Australia based on LVRs, Australia does not apply the discount to property revaluations that are a feature of the New Zealand system. This means that a reverse mortgage in New Zealand may have a higher LVR than the equivalent loan in Australia, depending on the approach to loan valuations.

5.2 Problem Definition

During the Exposure Draft process some stakeholders raised several issues regarding the standardised risk weights for reverse residential mortgage loans. They stated that the risk weights for RRMLs, which were carried over to BPR131 from BS2A, do not accurately reflect the risk profile of reverse mortgage lending. Stakeholders also raised concerns with the repricing methodology that was introduced after the 2015 consultation on reverse mortgage lending, which discounts any subsequent RRML property valuation by 20%. BPR131 requires these RRML property valuations to be updated every three years.

In our Response document we noted that the submitter requested several changes, which would effectively treat RRMLs with an LVR of less than 30 percent in the same way as ‘standard’ mortgage loans and remove the requirement to discount subsequent RRML property valuations.

Stakeholders have provided feedback to the Reserve Bank, since the 2015 changes, that the current treatment of RRMLs do not accurately reflect the risk of reverse mortgages and should be amended. In response, we have considered two primary changes to the treatment of reverse RMLs in *BPR131*.

¹⁸ [Final Prudential Standard APS 112 - Capital Adequacy: Standardised Approach to Credit Risk \(apra.gov.au\)](#)

First, we have considered whether the standardised risk-weighting for RRMLs (see Table 4) is too conservative and does not accurately reflect the risk profile of the underlying mortgages. We consider that RRMLs should be treated as a separate asset class from standard residential mortgage loans, due to their unique features. However, we have considered whether the subsequent capital charges should be either identical or only marginally higher than those for standard RMLs.

Second, we have considered whether the repricing methodology introduced after the 2015 consultation remains appropriate, which discounts any subsequent reverse RML valuations by 20%. If the LVR ratios and risk ratings outlined in *BPR131* already capture the possibility of future short-term house price devaluations, such a discount may be unnecessary.

5.3 Policy Options

The options we have considered are:

- Option 1: Status quo of specific risk weights for reverse mortgages.
- Option 2: Exposure-based on net present value calculation – adjust the exposure amount by calculating a net present value of the expected future accrued interest, which would be added to the principal loan amount. An NPV calculation would effectively narrow the gap between the capital treatment of standard and reverse mortgages by compensating for the lack of interim repayments in reverse mortgage contracts.
- Option 3: No policy for non-standard mortgage products – this would return to the approach where reverse mortgages and other mortgages have the same treatment.
- Option 4: Remove discount on property valuations, but retain all other features of the current framework.

Option 2 is to retain the current risk weight categories and calibration for residential mortgages, but to adjust the exposure amount by calculating a net present value of the expected future accrued interest, which would be added to the principal loan amount. This adjustment to the exposure amount would apply to both standardised and IRB banks. The NPV calculation would effectively narrow the gap between the capital treatment of standard and reverse mortgages by compensating for the lack of interim repayments in reverse mortgage contracts. However, to do so would require a calculation that is complex and subject to uncertainty.

Option 2 would revert back to the pre-2015 treatment of RRMLs where the capital requirements for standard mortgages would apply to RRMLs. These risk weights are calibrated for standard, amortising mortgages which potentially misrepresents the risks associated with RRMLs. Banks accredited for the IRB approach would also use the standardised risk weights for standard mortgages in their capital calculation, as risk weights cannot meaningfully be estimated for RRMLs under the current capital adequacy framework.

This option would see banks facing uncertainty regarding the capital treatment of reverse mortgages and would be a reversal on a previous policy decision intended to ensure the capital requirements for RRMLs accurately reflected their risk characteristics.

Option 4 would involve the smallest set of changes, removing only the discounting of the property revaluations.

5.4 Assessment of Options

Assessment against Framework

Annex A contains an assessment of the proposed changes with the framework for assessing changes to the risk weighting framework set out earlier in this paper.

We consider that Option 1, the status quo, is closest to representing the additional risks associated with reverse mortgages.

Option 3, removing the distinction between reverse and standard mortgage loans, would see banks facing uncertainty regarding the capital treatment of reverse mortgages and would be a reversal on a previous policy decision intended to ensure the capital requirements for RRMLs accurately reflected their risk characteristics.

We understand that previous bank experiences with losses associated with reverse mortgages has been very rare and that negative equity outcomes are highly unusual. This might appear consistent with removing the distinctions between standard and reverse RMLs, or lowering the RRML risk weights in some way.

We are reluctant to put too much weight on this information at the current time. Information about risks is still limited as the current approach has only been in place for six years. We have little information about risks in a declining housing market. House prices have consistently increased throughout most of the period of the new approach and older information is unlikely to be a good guide.

Interest rates have also been increasing. In the absence of information about the risks of RRMLs in such an environment we do not consider that changing the RRML risk weights at this time would support financial stability. Option 2, the NPV alternative, is also complex and less transparent than the existing approach.

While Options 2 and 3 might address access to capital barriers, they do so at the expense of driving risk weights away from underlying risk, therefore adding to financial stability risks.

Option 4, removing the discount on property valuations but retaining all other features, involves the smallest set of changes other than the status quo. Stakeholders have argued that the LVR ratios and risk ratings in BPR131 already capture the possibility of future short-term house price devaluations, so such a discount is unnecessary. However, we believe the 20% discount helps minimise any asymmetric revaluation behaviour across a housing cycle, which could understate the risks that lenders face from the reverse mortgage lending.

While we do not consider a change in risk weights to be appropriate at the current time, we will revisit this in five years.

Q8 Do you have any comments on the approach to reverse mortgages described in this paper?

6 Cross-Method Guarantees

6.1 Background

The recognition of guarantees as a credit risk mitigant in the risk-weighted assets calculation has separate approaches under the standardised and internal ratings-based (IRB) approaches. The two methodologies are fully standardised and fully IRB, respectively. This could cause complications for IRB banks when the guarantor is subject to the standardised approach while the underlying exposure is subject to the IRB approach (or vice-versa).

This has not been a significant issue for IRB banks in the past. However, as of 1 January 2022, they are now only able to use the standardised approach for bank and sovereign exposures. To address this, *BPR133: IRB Credit Risk RWAs* outlines that the standardised methodology applies to the whole risk-weighting calculation if either the guarantor or the underlying exposure is subject to the standardised approach.

6.2 Problem Definition

During the consultation in 2021 for the Exposure Draft of the Banking Prudential Requirements to implement the Capital Review decisions some stakeholders queried how guarantees would be recognised as a credit risk mitigant.

The recognition of guarantees as a credit risk mitigant in the risk-weighted assets calculation has separate approaches under the standardised and internal ratings-based (IRB) approaches. The two methodologies are fully standardised and fully IRB, respectively. This could cause complications for IRB banks when the guarantor is subject to the standardised approach while the underlying exposure is subject to the IRB approach (or vice-versa).

This has not been a significant issue for IRB banks in the past. However, as of 1 January 2022, for bank and sovereign exposures they are now only able to use the standardised approach. To address this, *BPR133: IRB Credit Risk RWAs* outlines that the standardised methodology applies to the whole risk-weighting calculation if either the guarantor or the underlying exposure is subject to the standardised approach.

During the exposure draft consultation, one bank noted that in the case of a corporate exposure covered by an IRB model, the ability to recognise a sovereign or bank guarantee would be of little use under this approach. This is because it would involve having to switch to the standardised corporate risk-weighting approach for the underlying exposure.

In our *Response to Submissions*, we agreed that a more nuanced solution could be implemented. However, we outlined that we do not believe it would be appropriate to allow a modelled probability of default to be used for a guarantor that is a sovereign or a bank. This would defeat the purpose of switching bank and sovereign exposures to the standardised approach. It could also mean that an exposure to a corporate borrower, guaranteed by a bank, would be eligible for a lower risk weight than a direct exposure to the same bank.

There may be a solution that retains the IRB approach for the underlying exposure and also uses the IRB guarantee methodology, but with an adaptation to allow the applicable standardised risk weight for the guarantor to be applied to the covered portion of the exposure.

Under this change, the risk weighting for unexpected loss – recognising a guarantee from, for example, a bank covering a loan to an IRB corporate exposure – can be done within the IRB guarantee treatment by one of two possible approaches:

- Approach (a): adjusting the loss given default, while still using the risk-weight function for the underlying exposure. This effectively remains part of the modelling for the underlying borrower, while factoring in the effect of the guarantee; or
- Approach (b): applying the standardised risk weight for the guarantor to the protected part of the exposure. This is the revised part and has to be done instead of using the risk weight function for the guarantor and the probability of default for the guarantor (since it is a standardised entity and not covered by the approved model).

However, it is less clear how to adapt the expected loss (EL) calculation. The expected loss calculation for a guaranteed IRB exposure relies on the probability of default, loss given default and exposure at default with the same adjustments as applied in deriving the risk weight for unexpected losses. Under this change, while it works if it is the loss given default that has been adjusted (i.e. approach (a)), it is not clear how to arrive at the correct probability of default to use in approach (b).

6.3 Proposed Options

To address this, possible solutions for the EL calculation include:

- Option 1: Only allowing the loss given adjustment option – i.e. approach (a);
- Option 2: In the case of using the guarantor's standardised risk weighting on the covered part of the exposure, specifying that the underlying probability of default must be used for calculating EL;
- Option 3: Specifying that expected loss is only needed for the uncovered portion of the exposure, which would reduce the exposure at default accordingly. This would mean that a fully guaranteed exposure essentially becomes standardised and there is no EL at all, just a standardised-type RWA; or
- Option 4: Specifying what probability of default to use in expected loss calculations for each standardised risk weight, instead of allowing banks to continue to be fully modelled for the purpose of their providing guarantees.

Option 1 is the simplest approach. However, the loss given default adjustment approach is not available for farm or mortgage lending, which would leave no IRB guarantee available in those cases.

Option 2 is attractive as it directly aligns with the probability of default. However, specifying that the underlying probability of default must be used would then mean that the expected loss does not reflect any benefit from the guarantee at all.

Option 3 appears to be an effective way of aligning the risk of the exposure more closely with the actual risk. In particular, the guarantee reduces the expected loss, so only the uncovered portion requires the expected loss

Option 4 is complex. It would require substantial additional work to set the probability of default rates at appropriate levels. However, it would provide a nuanced response and we are open to suggestions from banks about how such an approach could be implemented.

Our current preference is for Option 3, which is consistent with the principle that capital requirements should be set in relation to the risk of bank exposures and that of transparency, while not being as complex to implement as Option 4. We are seeking feedback from banks on whether Option 3 would be practical to implement. If not, we could revert to Option 1 or any other options or refinements that are put forward.

We will consider alternatives put forward by banks during the consultation if banks identify an option that addresses the problems discussed above. In particular, we want to avoid outcomes where an exposure to a corporate borrower, guaranteed by a bank, would be eligible for a lower risk weight than a direct exposure to the same bank.

Assessment against Framework

Annex A contains an assessment of the proposed change with the framework for assessing changes to the risk weighting framework set out earlier in this paper. The assessment shows that the change would increase transparency.

Annex 1 has a detailed assessment against the principles set out in this paper. Option 4 potentially has the closest alignment with actual risks, but is more complex.

Q9

Do you have any comments on our proposal to specify that expected loss is only needed for the uncovered portion of the exposure (i.e. Option 3)?

7 Business Growth Fund

7.1 Background

In Budget 2022 the Government announced that the Budget has set aside \$100 million over ¹⁹the coming year for Crown investment as a minority shareholder in a Business Growth Fund, investing alongside banks.

The aim of this Consultation Paper is not to seek views about the role of the BGF. Instead, the aim of this paper is to seek feedback about how any bank exposures to the BGF should be treated. This will help seek the parameters for risk weighting any bank investments into the BGF. The following sections of this Consultation Paper provide an outline of the BGF, based on the information currently available, then cover the options we have considered for incorporating the BGF into the prudential framework.

7.2 Overview of the BGF

The Government has identified that New Zealand's capital markets, and in particular the smaller end of the debt finance and private equity markets, are underdeveloped. Issues extend across both debt and equity finance.²⁰

For debt finance, the Government identified that SMEs are faced with a narrow range of lenders, pay internationally high interest rates, and typically to access credit and working capital must risk personal assets to get loans (e.g. offer their home as collateral). And for equity finance they found that SMEs often lack the capability, investor readiness, and willingness to relinquish control to access significant equity capital. This is a problem where equity is the most appropriate source of expansion capital. These issues either mean that SMEs are not on the radar of the small number of private equity firms or they are grounds for investors providing funding which is contingent on capability improvements.

What is a Business Growth Fund?

BGFs are independent bank-centred funds (usually independent from government) where the fund is set up to provide a source of long-term patient minority capital (most likely in the form of equity) to SMEs that are positioned for growth.

'Patient' in this context means that the fund intends to hold the investment for a sizable length of time (e.g. up to 10 years), rather than buying and selling stakes on a regular basis to make profits, and minority in this context means not taking a controlling stake in the business.

They operate in a number of countries including the United Kingdom, Ireland, Canada, and Australia. The Australian BGF, which is similar to the model that the Government is considering, operates independently from the participating banks, with its own Chief Executive and governance structure. These BGFs have all come about differently depending on the characteristics and finance challenges in each jurisdiction.

¹⁹ beehive.govt.nz/release/unleashing-business-potential-across-nz

²⁰ MBE has released information about briefings to Ministers regarding the BGF at the following locations:

mbie.govt.nz/dmsdocument/22869-options-to-improve-small-and-medium-sized-enterprises-access-to-finance-proactiverelase-pdf

mbie.govt.nz/dmsdocument/22872-options-to-improve-small-and-medium-sized-enterprises-access-to-finance-minute-of-decision-proacticerelase-pdf

mbie.govt.nz/dmsdocument/22875-improving-access-to-growth-funding-slide-pack-proactiverelase-pdf

BGFs are often accompanied by an adjustment to the risk weighting of the banks' equity investment into the fund within the relevant jurisdiction's capital adequacy framework. This is intended to help incentivise bank contributions to the fund by making the capital treatment more favourable than would otherwise be the case. Table 1 outlines treatment in different countries.

Table 6: International BGFs

Country	Established	Capital treatment	Government involvement
Australia	2019	Risk-weight 250% Common Equity Tier 1 (CET1) capital limit of 2%	Contributed \$100m
United Kingdom	2011	100%	No government financial contribution

These BGFs have all been setup, to varying degrees, to:

- Increase the level of investment and availability of patient minority capital to SMEs;
- Allow banks that own the BGF to refer SMEs to it in cases where the banks believe that equity finance would be more appropriate than additional debt finance;
- Support job creation, prevent SMEs from selling too quickly and enable them to scale up and become larger firms to support economic growth;
- Invest in established SMEs with a track record of revenue growth and profitability – typically 10-30 SMEs each year;
- Invest minority economic interests of between 10-49 per cent of total, fully-diluted, share capital in SMEs for an average investment duration of five to seven years; and
- Partner SMEs they invest in with capability support (e.g. strategic advice, investment readiness, and talent network referrals).

Australia is unique in that the Federal government committed up to \$100 million alongside six banks to create a \$540 million fund, with the ambition to have a \$1 billion fund in time.

7.3 Problem Definition

The design of the BGF is outside the purpose of this Consultation Paper. This paper is focused on ensuring that the approach to risk weighting set out in the prudential capital framework treats the risk weights associated with bank investments into a BGF in an appropriate way.

Under the current regulations, equity investments generally receive a 400% risk weight to reflect the higher risk associated with equity investments compared with other exposures, such as mortgage lending. This means banks need to hold significantly more capital for equity investments than for most other exposures.

This dynamic may discourage banks from investing in the BGF. For example, a \$10m investment in the BGF would result in a risk weighted exposure of \$40m, if the investment receives a 400% risk

weight. The higher the risk weight then the more capital that a bank must have associated with that exposure, in order to meet capital requirements.

The section below discusses our objectives in considering what an appropriate risk-weight treatment is, and provides policy options for stakeholder feedback.

7.4 Proposed Options

When considering an appropriate risk-weight treatment we considered the following:

- Nature of the underlying risk of the investment;
- Impact in financial stability and efficiency of the financial system; and
- Risk of precedent and fund proliferation.

Overseas experience suggests that a lower risk-weight helps incentivise banks to contribute funding to a BGF, although the risk weight is still high relative to less risky exposures.

The risk of an individual equity investment is the same, but as the banks are not making individual investments and it is instead invested on their behalf, the risk posed to the bank is lower. The pooling of resources across banks into a BGF may also allow for more diversification in investments and help reduce risk – we will continue to assess these dynamics as more detailed policy work on a BGF is undertaken. However, as there is still risk associated with equity investments we propose a cap on contributions as a percentage of CET1 capital to mitigate the risk, consistent with the approach taken for the Australian BGF.

Two initial options are listed below. We are interested in stakeholder feedback about these options.

- Option One: maintain the status quo with a 400 percent risk-weight for equity investments.
- Option Two: a 250 percent risk-weight for equity investments into the BGF with each bank’s contribution limited to two percent of its CET1 capital.

Table 7: Policy options for a New Zealand BGF

	Option One	Option Two
Risk-weight	400%	250%
Contribution cap (as % of CET1)	n/a	2%

Box 2: Illustrative example of the impact of different risk weights

Domestic Systemically Important Bank (DSIB) invests \$100m into a BGF.

Option 1: Risk weight is 400%

Risk weight = $\$100\text{m} * 400\% = \400m of risk weighted assets

Capital needed for exposure = $18\% * \$400\text{m} = \72m .

Cost of capital to bank assuming average cost of capital (across all forms of capital) of 8% = $\$72\text{m} * 8\% = \5.76 million

Note that the 18% capital ratio used above is the full capital requirement plus prudential capital buffers once all Capital Review decisions are phased in.

If the bank used the \$100m to fund other exposures, e.g. residential mortgages, this might receive a risk weight of around 50% (depending on LVRs). This would mean a risk weighted asset of \$50m, with associated capital of \$9m, well below the \$72m above. The additional \$9 million would have a cost of \$720,000 based on the assumptions above.

Option 2: Risk weight is 250%

Risk weight = $\$100\text{m} * 250\% = \250m of risk weighted assets

Capital needed for exposure = $18\% * \$250\text{m} = \45m .

Cost of capital to bank assuming average cost of capital (across all forms of capital) of 8% = $\$45\text{m} * 8\% = \3.6 million

The reduction in risk weight would reduce the cost to the bank.

Risk of Equity Investments into a Business Growth Fund

The current risk-weight treatment reflects the risk of a single equity investment and does not account for the risk pooling that would occur for something such as a BGF. The bank's capital would be invested into a diversified pool of equity assets with the risk of their investment being that of the total fund, rather than a single equity asset. Therefore, we have identified options for an appropriate risk-weight treatment that could reflect the characteristics and risk profile of the overall fund.

However, how much lower this risk weight would be compared to a single equity investment (which receives a 400% risk-weight at present) would be a function of the risk characteristics of the fund – market, credit, concentration, liquidity and any other idiosyncratic risks inherent in the operation of the fund.

Given the novelty of the fund, the final risk weight will need to be a calibrated assessment, and to best meet our core prudential requirements. Therefore, while we have proposed a risk-weight of 250% we will work alongside MBIE as they undertake more detailed policy work before determining a final calibration. We will also consider feedback from stakeholders. In particular, we are interested in any information stakeholders can provide about the possible diversification impacts of pooling investments and the risk profile associated with such investments.

Financial Stability

Financial stability has been a key consideration in our assessment of the appropriate risk weight. As discussed above, the diversification that arises from a fund like a BGF suggest an adjusted risk-weight is appropriate, there is still risk associated with these investments. As such, we consider it necessary to place a cap on the total amount of bank capital that could be invested in the fund. This is aligned with the approach taken with the Australian BGF where there is a two percent cap in CET1 contributions to the BGF (with any additional investments subject to the standard risk-weight treatment rather than the lowered 250%). Our proposal is to adopt the same cap as APRA, namely 2% of CET1. Note however that with the increase in CET1 over the coming years, the current cap on exposure associated with a 2% limit will increase over time.

While financial stability considerations have been a main consideration for considering the appropriate risk weights, there may be wider impacts on the productive economy. If a BGF is successful in achieving its objectives it may help facilitate market development and enable a more efficient allocation of capital.

Managing Policy Precedent

Any changes to capital risk-weight treatment should not undermine financial stability objectives. If the risk weighting is adjusted, this assessment would be specific to the BGF and reflect an assessment that diversification is reducing risk, and not applied to all equity investments.

However, additional to the cap on contributions to the BGF, it may be appropriate to set an overall cap on contributions by banks, not just to a BGF, but any similar vehicle. Although not currently a concrete proposal, one could envisage a "green" equity fund similar to the BGF. Such a fund may also benefit from diversification but would also likely be risky in the sense that the banks have equity exposures to a fund that engages in inherently risky lending. For the time being the Reserve Bank could be the gatekeeper by requiring specific risk weightings for each of these funds. This would help manage the risk of exposure to a proliferation of funds of this type. Over time, however, it may become necessary to consider an overall cap to any such growth funds to which banks may have an equity exposure.

Additionally, if the BGF were to change through time in size or nature, we would need to assess if the changes to risk-weight treatment remain appropriate from a financial stability perspective. This would be alongside guidance that any contributions to a BGF above the CET1 cap would be subject to the standard risk-weight treatment of 400%.

Market and Credit Risk

There is a possible interaction between investments in a BGF and with the market risk framework set out in BPR140, including if the investments into the BGF would be exposed to price movement risk. However, we propose that equity investments into the BGF should be exempt from any market risk requirements as the expectation would be that the bank's investment would be long-term, rather than regular buying and selling of equity stakes.

Assessment against Framework

We have assessed these options against the principles set out in this Paper. The assessment is shown in Annex 1. Option 2 might see a deviation from the framework's focus on underlying risk. This would be small, given the diversification across investments that would come from greater scale than a single bank would achieve. The payoff would be increasing access to capital for SMEs. This supports considerations 4 and 7.

- Q10** Do you have any comments on proposed changes to risk weights?
- Q11** Do you have any comments on the impacts of a BGF on diversification of risk by pooling investments across banks within the BGF?
- Q12** Are there are other issues associated with the BGF that we should consider?

8 Qualifying Central Counterparties

Part G of *BPR131: Standardised Credit Risk RWAs* sets out the risk-weighting treatment for counterparty credit risk (CCR) exposures arising from derivative transactions and securities financing transactions (SFTs) that are settled via a central counterparty (CCP). This treatment allows banks to apply lower risk weights to their exposures to a qualifying central counterparty (QCCP) than those to a non-qualifying CCP.

8.1 Proposal 1: Definition of QCCP

Currently, a QCCP is defined in *BPR131* as a counterparty that meets the Principles for Financial Market Infrastructures (FMIs) set by the Committee on Payments and Market Infrastructures (CPMI) and the International Organisation of Securities Commissions (IOSCO). *BPR131* also states that the Reserve Bank determines whether a CPP meets those Principles.

The Financial Market Infrastructures Act 2021 (the FMI Act) became law in May 2021 and governs a framework to set out regulatory standards and designate FMIs (including CCPs), among other things. Designations under the FMI Act are likely to be made at some point in 2023. To recognise the new designation framework under the FMI Act in the *Banking Prudential Requirements*, we are proposing to change the definition of a QCCP in *BPR131* to:

“A qualifying central counterparty (QCCP) is:

- (1) A CCP that is a designated Financial Market Infrastructure under the Financial Market Infrastructures Act 2021; or
- (2) Any other CCP determined by the Reserve Bank as complying with the CPMI/IOSCO Principles for Financial Market Infrastructures.”

This change will provide banks with certainty on which CCPs are QCCPs under the *Banking Prudential Requirements*. It will also help incentivise relevant CCPs to become designated under the FMI Act.

Assessment against Framework

Annex A contains an assessment of the proposed change with the framework for assessing changes to the risk weighting framework set out earlier in this paper. The assessment shows that the change would increase transparency.

Q12 Do you have any comments on our proposed definition of qualifying central counterparties?

8.2 Proposal 2: Conditions to Apply Lower Risk Weights

For a bank that is a client of a clearing member of a QCCP, subsection G2.2(3) in *BPR131* sets out conditions that allow banks to apply lower risk weights (i.e., 2% or 4%) to their exposures to the clearing member who clears a contract through the QCCP.

One of the conditions requires the bank to be in a position to provide, upon request, an independent, written, and reasoned legal opinion to the Reserve Bank that concludes that there is a high level of certainty that, in the event of a legal challenge, the other conditions are met under the relevant laws of the relevant jurisdictions.

This condition was set out based on an interim standard published by the Basel Committee on Banking Supervision (BCBS) in July 2012 for the capital treatment of bank exposures to central counterparties. Since then, the BCBS has been making changes to the standard to establish a capital treatment that ensures banks' exposures to central counterparties are adequately capitalised, while also preserving incentives for central clearing.

To better align with the latest BCBS version of this condition, we are proposing: -

- to merge the current conditions (a) and (b) in G2.2(3) into one condition,
- to replace the “an arrangement” text in the current condition (b) with “arrangements”, and
- to change the first part of the current condition (c) to:

“the bank must have conducted a sufficient legal review (and undertake such further review as necessary to ensure continuing enforceability) and have a well-founded basis to conclude that, in the event of legal challenge, the relevant courts and administrative authorities would find that the arrangements referred to in paragraphs (a) would be legal, valid, binding and enforceable under relevant law, including the law of the jurisdictions of the following: [...]”

This change will clarify each bank’s responsibility for establishing a sufficiently robust basis to apply the lower risk weights. It will also help preserve incentives for central clearing and it will bring our requirement in line with the international approach. The Reserve Bank is seeking feedback on our proposed change.

Assessment against Framework

Annex A contains an assessment of the proposed change with the framework for assessing changes to the risk weighting framework set out earlier in this paper. The assessment shows that the change would increase transparency.

Q13 Do you have any comments on our proposed changes in the conditions in G2.2(3) of BPR131 for a bank to apply lower risk weights to its exposures to the clearing member of its QCCP?

9 Financial Policy Remit

The Financial Policy Remit, issued by the Minister of Finance on 30 June 2022, to take effect on 1 July 2022, emphasises the desirability of a strong, efficient and inclusive financial system, with a low incidence of failure of regulated entities. It also signals that we should encourage a competitive financial system and have regard to Government priorities on climate change, financial inclusion, cyber resilience and supporting sustainable house prices. This section outlines how we have had regard to the Financial Policy Remit in the policy proposals in this Consultation Paper. The full text of the Remit is available on the website of the New Zealand Gazette.²¹

Most of the proposals in this Consultation Paper focus on technical elements of the prudential framework, and will have little impact on the matters specified in the Financial Policy Remit.

The regulatory and supervisory costs of the proposals in the Consultation Paper are expected to be small and are proportionate to the risks and benefits to the financial system. We will continue to assess costs and benefits, including considering stakeholder views, prior to when final decisions are made

The proposals in this Consultation Paper are not expected to have a significant impact on the following matters specified in the Financial Policy Remit:

- The competitiveness of the financial system,
- The sustainable long-term growth of the economy.
- The sustainability of house prices or investor demand.
- Risks related to climate change

The table below shows the parts of the Financial Policy remit that are relevant for this Consultation Paper, and summarises the expected impacts.

Component of Financial Policy Remit	Connection with proposals in this Consultation Paper
"It is desirable to have a financial system that is strong, efficient and inclusive, with a low incidence of failure of entities regulated by the Reserve Bank."	<p>Risk weighting is a key part of the prudential framework. It helps ensure that risks are accurately captured and reflected in a bank's capital ratio. This process helps supports a strong financial system.</p> <p>The following proposals in the Consultation Paper relate largely to improving transparency of the risk weighting framework, so that it is well understood by stakeholders:</p> <ul style="list-style-type: none"> • Sovereigns and multi-lateral banks • Qualifying Central Counterparties

²¹ The text of the Financial Policy Remit is available here in the NZ Gazette: [gazette.govt.nz/notice/id/2022-go2497](https://www.gazette.govt.nz/notice/id/2022-go2497)

Component of Financial Policy Remit	Connection with proposals in this Consultation Paper
	<p>The following proposals in the Consultation paper help ensure risks are accurately reflected in the framework:</p> <ul style="list-style-type: none"> • Kāinga Ora loans. • Risk weights for exposures to the Business Growth Fund. • Cross-method guarantees • Reverse mortgages. <p>Accurately reflecting risks in the prudential framework help support a strong financial system.</p>
<p>“encouraging new investment and financial innovation that raise the productive potential of the economy”</p>	<p>The proposals regarding the risk weighting of exposures to the Business Growth Fund may have a small positive impact on new investment that raises the productive potential of the economy, and a more efficient and inclusive financial system, by encouraging greater access to capital for New Zealand firms</p>
<p>Financial inclusion</p>	<p>The proposed changes to the risk weighting of loans covered by lenders mortgage insurance provided by Kāinga Ora may help support financial inclusion by increasing the access to credit for people who are eligible for the First Home Loans programme.</p>

Annex A: Comparison of Options (Preferred Options Highlighted)

Principle	Key: ✓ means more enhanced delivery of principle compared with status quo; X means less alignment with principle than status quo; - means same as status quo					
	Purpose of framework					
	Kāinga Ora FHLs	Sovereigns, PSEs & MDBs	BGF	QCCP (two separate proposals)	Reverse mortgages	Cross-method guarantees
1. Approach to risk weights must readily absorb losses before losses are imposed on creditors and depositors	Option 1: - Option 2: - Option 3: -	Only preferred options summarised: -	Option 1: - Option 2: -	All proposed changes assessed to have the same impacts as status quo	Option 1: - Option 2: - Option 3: - Option 4: -	Option 1: - Option 2: - Option 3: - Option 4: -
2. Approach to risk weights should be set in relation to the risk of bank exposures, where that risk captures all elements of risk that the bank could face	Option 1: X Option 2: ✓ Option 3: ✓	Only preferred options summarised: ✓	Option 1: - Option 2: -, if diversification achieved	All proposed changes assessed to have the same impacts as status quo	Option 1: - Option 2: X Option 3: X Option 4: X	Option 1: ✓ Option 2: - Option 3: ✓ Option 4: ✓
3. Risk weighting should reflect risks inherent in the New Zealand financial system and the Reserve Bank's regulatory approach, while also by promoting the efficiency of the financial system, encouraging innovation and boosting competition	Option 1: - Option 2: - Option 3: -	Only preferred options summarised: -	Option 1: X Option 2: ✓	All proposed changes assessed to have the same impacts as status quo	Option 1: - Option 2: X Option 3: X Option 4: X	Option 1: - Option 2: - Option 3: - Option 4: -
4. Approach to risk weighs should help remove barriers to credit without reducing financial stability.	Option 1: - Option 2: - Option 3: ✓	All options assessed to have the same impacts as status quo	Option 1: - Option 2: ✓	All proposed changes assessed to have the same impacts as status quo	Option 1: X Option 2: - Option 3: - Option 4: -	Option 1: - Option 2: - Option 3: - Option 4: -

Principle	Key: ✓ means more enhanced delivery of principle compared with status quo; X means less alignment with principle than status quo; - means same as status quo					
Implementation of framework						
	Kāinga Ora FHLs	Sovereigns, PSEs & MDBs	BGF	QCCP (two separate proposals)	Reverse mortgages	Cross-method guarantees
5. Where there are multiple methods for determining risk weights, outcomes should not vary unduly between methods.	Option 1: - Option 2: - Option 3: -	Only preferred options summarised: -	Option 1: - Option 2: -	Proposal 1: - Proposal 2: -	Option 1: - Option 2: - Option 3: - Option 4: -	Option 1: - Option 2: - Option 3: - Option 4: -
6. The approach to risk weights should be practical to administer, minimise unnecessary complexity and compliance costs.	Option 1: - Option 2: - Option 3: -	Only preferred options summarised: -	Option 1: - Option 2: -	Proposal 1: - Proposal 2: -	Option 1: - Option 2: - Option 3: - Option 4: -	Option 1: - Option 2: - Option 3: - Option 4: -
7. The approach to risk weights should be transparent to enable effective market discipline	Option 1: - Option 2: - Option 3: -	Only preferred options summarised: ✓	Option 1: - Option 2: -	Proposal 1: ✓ Proposal 2: ✓	Option 1: - Option 2: - Option 3: X Option 4: -	Option 1: - Option 2: - Option 3: - Option 4: -

Annex B: Questions on Standardised Credit Risk RWAs

Generic questions	Generic response
<p>BPR requirements point to “other debt issues with short term rating grades” when applying the overrides – is it possible to refer directly to short term issuer rating? This would avoid the risk of error associated with a manual process of searching for other debt issues in the market.</p> <p>Would directly referring to the short-term rating lead to the same (or more conservative) outcome as what is intended by the BPR?</p>	<p>To clarify how we envisage BPR131, we highlight the following:</p> <ul style="list-style-type: none"> • If there is an issue-specific short-term credit rating, then this should be used, and section C2.9 applies. • If there is no issue-specific short-term rating, then B1.5 applies – the claim is “unassessed” and the long term issuer credit rating applies, if there is one, with the weighting determined by table C2.5. • If there is no issue-specific short term rating and no long term issuer credit rating then the claim is “unrated”. <p>This last category of “unrated” is the only group where the overrides in section C2.10 of BPR131 apply. This is covered in the guidance to B2.1, which covers “unrated” claims and states: “typically, if a borrower has a long-term issuer rating, most claims on the borrower that do not have an issue-specific credit rating will have a credit rating inferred from the issuer rating.”</p> <p>Therefore, we would not expect many claims to end up as “unrated” since B1.5(2) is intended to cover <u>all</u> claims without an issue-specific rating. This does <u>not</u> envisage a class of claims that do not fall within the scope of the long-term issuer credit rating because they fall within the scope of a short-term, issuer rating.</p> <p>Banks should follow the BPR131 process, even if another process may generate a more conservative outcome than BPR131.</p>
<p>How is the issue date with respect to calculating the original maturity for undrawn facilities without a maturity date to be interpreted?</p> <p>In which circumstances would the CCF increase over time?</p>	<p>We would generally expect the issue date to be the point at which the documents are issued to a customer, as this is when the commitment starts.</p> <p>Section D2.2(3) of BPR131 is relevant for the assessments that banks should make in terms of issue dates. There may also be cases where banks need to apply some degree of judgement to ensure compliance with the principles underlying BPR131.</p> <p>In principle, there is no particular problem with cases where a CCF increases over time. For example, if a customer is offered an open-ended lending facility, and that offer is open for one year after it is made,</p>

Generic questions

Generic response

then the CCF could increase over time. In such a case the CCF could increase from 20% while the offer is open, but the customer has not signed up to it, to a CCF of 50% once the customer has signed up for a lending facility which lasts for more than one year.

Should the original maturity for facilities cancellable on notice reflect that notice period?

For example, an overdraft or revolving loan could have a condition that allowed for cancellation with 14 days notice. Is it appropriate to treat such facilities, with no maturity date, as having an original maturity equivalent to the notice period.

BPR001 has the following definition of original maturity:

“original maturity of a financial instrument is the time between the issue and the maturity date of the instrument, or if the instrument has no specified maturity date, the time between the issue date and the earliest date on which the bank can cancel the facility or withdraw its funds.

Guidance: Instruments with no specified maturity date include for example credit cards, overdrafts and non-term deposit accounts.”

There will be cases where banks need to apply a degree of judgement to ensure they comply with BPR131 in regard to notice periods on facilities. In some situations there may be effectively multiple commitments. For example, if overdraft or revolving loan facility can be cancelled with 14 days’ notice. In this case it may be appropriate to view this as two commitments, the original offer to provide an overdraft, and the overdraft itself once the customer has signed up for it. This is covered by BPR131 section D2.2(3), which says that the CCF for a commitment to provide a commitment should be the lower of the two CCFs. So, for example, an offer of an overdraft that stands open for 3 months gets 20% CCF (original maturity 3 months), while the overdraft itself once granted, if it has say a 14 day cancellation period, would also get a 20% CCF.

Banks should consider the exact nature of the commitment when making such assessments and the principles behind BPR131. For example, we would not expect to see ‘notional’ reassessment dates where commitments are automatically rolled over after one year in order to qualify for a lower CCF. Such an approach would be outside the intent of BPR131.

In general, the rationale for the 0/20/50% CCFs for commitments is that the longer the period the bank is obliged to honour the commitment, the more risk that the creditworthiness of the borrower will deteriorate. On this rationale, it is the notice period that should determine the CCF, when there is no fixed end-date.

Should the greater of individual LVR or Aggregated group basis be used in the calculation of the LVR ratio for RMLs?

BPR131 C3.5 describes the standardised approach to calculating a Loan-to-Valuation ratio.

Generic questions

Generic response

"Loan value is the total current amount of— a. all claims secured by way of first ranking mortgage over residential property; and b. all undrawn commitments to the borrower that when drawn down will be secured by way of first ranking mortgage over residential property."

And

"Property value for a standard RML, or a reverse RML at the time of origination, is the total value of the residential property that is security for the loan, determined, when the loan is originated, under a residential property valuation policy that meets the eligibility criteria in section C3.6."

BPR131 states that the loan value includes "all claims". Likewise, property value is the "total value of the residential property". Aggregating the amounts is therefore required.

However, if there are circumstances where there is a preference to use a higher LVR based on the disaggregated values of individual loans and individual properties then this is also acceptable, so long as it does not lead to a lower LVR than specified in BPR131, but this is not a requirement of BPR131.

How does one determine the credit-conversion factor (CCF) for a residential mortgage loan (RML) that is an off-balance sheet exposure? What about where the drawdown is not certain?

BPR131 D2.2 (1) provides the credit conversion factor (CCF) for an off-balance sheet exposure. Rates vary based on the type of transaction.

RML commitments, that are uncertain and have an original maturity of more than one year, would qualify for a 50% CCF.

If drawdown was certain then a 100% CCF would apply.

How are loans to be treated that have been on the books for less than 12 months, but have not been fully drawn down (including revolving mortgages)?

An appropriate treatment of revolving mortgages and loans that have been on the books for less than 12 months, but not fully drawn down, would be to classify them as 'other types of commitments'. The CCF for the undrawn amount would then be either 50% (if original maturity is more than 1 year) or 20% (if the original maturity is less than or equal to 1 year).

Can non-RML purpose loans be reported as RML loans when determining standardised RWA's if they are secured by residential real estate?

BPR131 provides a definition of 'residential mortgage loan' (RML) and loan value.

As a general principle, all lending linked via the residential real estate security should be included in the numerator for the calculation of the required LVR – so, including the lending that is not for house

Generic questions	Generic response
<p>In other words, how does cross-collateralisation apply in this case?</p>	<p>purchase. This means that total lending secured by the property is included in the LVR calculation, and the total lending secured by the property receives a single risk weight.</p> <p>There are however some important caveats to this assessment:</p> <ul style="list-style-type: none"> • The treatment described above is only acceptable if the ‘non-RML’ exposure is legally secured by a residential property, irrespective of the loan purpose. If the non-RML exposures are not legally secured by the collateralised property then they should not be included in the LVR calculations or treated as if the exposures are RML. • There should be no ‘double-counting’ of security. Security that is already securing a completely separate loan should not also be used in the RML, unless there is a portion of the security that is not already allocated. For example, if security of \$500,000 was held against a separate loan of \$100,000 there would still be \$400,000 of security that could be allocated.
<p>Can the RML risk weights be applied to non-RML exposures with ‘linked residential real estate’?</p>	<p>Lending that is not for the purpose of purchasing residential property but that has ‘linked RRE’ collateral falls within the definition of RML. The risk weights for RML are set out in BPR131 Table C3.10. However, this table should only be applied to RML loans, in line with the general principles described in the previous question. If the approach underpinning the exposure is not consistent with the principles described above, then the RML risk weights in Table C3.10 should not be applied.</p>
<p>When applying the credit valuation adjusted (CVA) capital charge calculation, which formula should be used if there are no eligible hedges?</p>	<p>Where there are no eligible hedges, BPR131 requires banks to use the formula in F2.2 in BS2A.</p> <p>An explanation of the BPR131 formula is available here (in the <i>Explanatory Notes for BPR130-BPR160</i> document, pp. 14-15):</p> <p>Exposure draft for Capital Review implementation changes - Reserve Bank of New Zealand - Te Pūtea Matua (rbnz.govt.nz)</p>
<p>Under which circumstances can the internal rating of the counterparty be mapped to another external rating in order to calculate the credit valuation adjustment (CVA) capital charge?</p>	<p>BPR131 F2.1 (1) (b) states that when calculating a CVA capital charge a bank may “if it is accredited to use an IRB model to determine an internal rating for the counterparty, either use the level 4 rating, or, subject to the Reserve Bank’s approval, map the internal rating of the counterparty to another external rating.”</p>

Generic questions	Generic response
<p>If a credit card facility has an outstanding unused balanced and has no annual review, can a 0% CCF still be applied? Or does a 100% CCF apply if original maturity cannot be inferred?</p>	<p>The guidance note to section D2.2 in BPR131 states that “A credit card facility with standard terms is normally eligible for a 0% CCF, provided that any outstanding unused balance is subject to review at least annually.”</p> <p>The intention of the guidance is to confirm that credit cards can be eligible for a 0% CCF.</p> <p>The guidance should be applied in conjunction with the text in D2.2 of BPR131, which states that a 0% CCF applies for any “other commitment that cancels automatically when the creditworthiness of the counterparty deteriorates or which can be cancelled unconditionally at any time without prior notice.”</p> <p>We would consider a credit card that cancels automatically to qualify for a CCF of 0%, and that it is reasonable for a bank to conclude that in these circumstances a credit card effectively provides scope for continuous review, even if an annual review process is not directly specified.</p> <p>If the credit card does not have this feature then we would consider it would most likely be classified as an “other commitment” and eligible for a 20% or 50% CCF, unless any outstanding unused balance is subject to some other form of review at least annually.</p>
<p>Will the updated definition of commitment in part D2.1(4) of BPR131 also apply to BPR133 (i.e. will it include, “and accepted by the borrower”)?</p>	<p>The definition we added is based on the definition of a “commitment” in BS19 for the purposes of LVR restrictions (section 11, paragraph 3). Where possible we have sought to have similar definitions for concepts covered by other rules. The definition is similar to the definition in APRA APS112 (see pg 28).</p> <p>There is a somewhat different approach to determining exposure measurement for contingent liabilities in BPR133, including the scope for the bank to use its own internal estimates for some CCFs, as part of an approved model. However, to the extent that the definition in BPR131 is relevant, it would be reasonable to use it in BPR133, noting of course that any model changes must be approved by the Reserve Bank.</p>
<p>What does the revised wording for retail SME (section B4.3 in BPR133) mean for current treatment of retail SME?</p> <p>The old wording was: <i>A loan extended to a small business and managed as a retail exposure is eligible for retail treatment where the banking</i></p>	<p>The intention of the addition of the text, “and that does not qualify as an RML”, is to confirm that any lending that meets the definition of a Residential Mortgage Loan (RML) should be managed under the rules that apply to the residential mortgage subclass. Banks should apply robust processes to determine whether a loan meets the definition of an RML. Such an assessment should also have reference to BPR131 C3.2(2) and (3) – these parts of the RML definition mean that a loan cannot be classified as an RML if the property is predominantly used for farming or commercial activity.</p>

Generic questions

Generic response

group's total business-related exposure to the borrowing enterprise (on a consolidated basis, where applicable) is less than NZD 1 million.

The new wording is: *A loan that is extended to a small business and managed as a retail exposure, and **that does not qualify as an RML**, is eligible for retail treatment where the banking group's total business related exposure to the borrowing enterprise (on a consolidated basis, where applicable) is less than NZD 1 million.*