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MEMORANDUM FOR FSO Committee

FROM Financial Policy
(Primary author: Cavan O'Connor-Close)

MEETING DATE 21 August 2013

SUBJECT **Housing review stage two: residential property valuations; and model change application process**

FOR YOUR Decision

It is recommended that the Committee:

1) **Notes** the effect an LVR restriction might have on banks' incentives for revaluating residential properties;
2) **Agrees** that we should use non-prescriptive means as discussed in the paper to make it more difficult for banks to revalue residential properties to reduce capital or game an LVR restriction; and
3) **Notes** our existing model change approval process;
4) **Agrees** the updated requirements be incorporated into BS2B and thus become part of internal models banks' conditions of registration.

Residential property valuations

Introduction

1. At the recent FSO discussion of the housing review: stage 2, it was decided that the Reserve Bank did not want to become overly prescriptive in its treatment of valuations. To recall, BS2A and BS2B currently require banks to use valuations done at mortgage loan origination. In practice, banks revalue residential property upon the occurrence of a credit event. FSO decided that this should not change.

2. Since then, [redacted] which was extensively discussed at MFC on 31 July. Redacted: OIA section18(c)(i), referring to RBNZ Act s105 This underlines the scope banks currently have to revalue properties when it is convenient for them to do so and the additional incentives that an LVR restriction might provide.

Issues

3. Clearly, a higher valuation reduces the LVR of the remaining loan. Redacted: OIA section18(c)(i), referring to RBNZ Act s105 The crux here is that an LVR restriction is imposed precisely because house price growth has become excessive, leading to a significantly overvalued housing market with the potential for a sharp downward correction at some point. Using the asset price increase to continue lending into such a market further exacerbates the problem.

4. Aside from the potential the current relaxed stance on valuations has on an LVR restriction, its also has implications for our capital requirements. Our capital requirements rest on a through-the-cycle approach which means that we do not want short term fluctuations in underlying economic drivers to affect capital through reduced LVRs and LGDs. Part of this is that a significant rise in asset prices, which may be excessive and therefore not last, should not lead to a reduction in the amount of capital banks hold for each risk unit. Such an outcome would weaken banks' resilience for when the market correction takes place. The BCBS proposals since the GFC also stress the benefits of capital requirements being calibrated to through the cycle outcomes.

Proposed policy response

5. FSO clearly rejected the idea of including a monetary threshold in the definition of a credit event in BS2A and BS2B. We propose that BS2A and BS2B stress the requirements that valuations are done at origination. If FSO agree that it would be useful to reduce the gaming potential, one could envisage an option whereby a

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Redacted: OIA section18(c)(i), referring to RBNZ Act s105

revaluation is only allowed if the loan amount is substantially restructured. That could mean a substantial percentage increase in the loan amount of, for example, at least 20 percent.

6. If there is a concern that asset prices become outdated after a period of time, one could also envisage giving banks scope to revalue the property after a period of time of, for example, three or five years. Such a revaluation would have to be carried out by an independent valuer and thus have transactions costs attached.

7. Proposals along these lines could easily still be included in the consultation document.

Model change submission process

Background

8. Internal models banks have to seek approval from us for any new models or changes to existing model they wish to employ. The process for this, including information requirements we have, was set out in a letter to the four IM banks in November 2009. We have recently updated these requirements in a letter we sent banks to inform them of the re-opening of the model change submission window on 11 July 2013. The additions to the 2009 letter are highlighted in yellow in the next section.

9. The model change process and the requirements are as follows:

Types of changes

Banks are to advise the Reserve Bank of all proposed changes to their estimates and models *ex ante*. There are two types of changes:

a. Periodic changes driven by new data (e.g. changes reflecting compositional changes in the loan book). The Reserve Bank should be informed of these, so it can consider whether they need to be approved. In principle compositional changes are not likely to need approval. Notification of these changes provides the opportunity to check for plausibility to satisfy the Reserve Bank that they do relate to compositional shifts, and to track changes through time.

b. Changes to model structures, estimates or judgments (including any changes proposed to PD, LGD and EAD estimates). These changes are subject to the formal submission timing set out described below.

Content of submissions

Submissions must clearly set out the following in relation to each proposed change:

a. The rationale for the change, including the reasons as to why the new model is an improvement on the existing model, and supporting material.
b. 'Before' and 'after' comparisons with respect to the risk parameters affected (PD, LGD, EAD). These comparisons should cover at least four consecutive periods, e.g. quarters or at the half year.

c. The risk weighted asset[2] and regulatory capital impacts, and how these impacts are calculated.
d. Any linkage to the bank's ongoing accreditation requirements.
e. Confirmation that what is proposed is consistent with the bank's conditions of registration.
f. Any known industry-wide issues relating to the change.
g. A comparison with the capital outcome under the standardised approach.

The issue

10. Although banks may only use approved models as per BS2B, the model change submission requirements are currently not part of BS2B. Their current status as merely an attachment to a letter does not reflect the importance we attach to model change and restricts the action available to us when a bank implements a model change without our prior approval.

11. That has not been an issue in the past but we have had cases where banks have made changes without our approval. Redacted: OIA section18(c)(i), referring to RBNZ Act s105 However, our requirements are clear and those changes should have been submitted to us. Redacted: OIA section18(c)(i), referring to RBNZ Act s105

12. While OIA s18(c)(i), refer RBNZ Act s105 a genuine mistake, it may indicate that some banks do not attach sufficient importance to model changes. In addition, the introduction of an LVR restriction may provide banks with more incentives to make adjustments to their models and to game the model change approval process.

Proposal

13. Our proposal is to incorporate the model change process and the content requirements of submission in BS2B and to make adherence a condition of registration. Specifically, we want to ensure that banks only use approved versions of a model and we would like to have better oversight of what the currently approved model and its version are. We therefore envisage a compendium that banks have to fill out, similar to that used for OBR.

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[2] Information on risk weighted assets should include the impact in terms of dollars (e.g. 'increase from $10m to $12m') and as a percentage of exposures (e.g. 'increase from 20% to 24%').