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***PwC submission on the Follow-up Consultation Paper: Updates to registered bank disclosure statements arising from Stocktake***

Dear Jeremy and Ashley

Thank you for the opportunity to submit our views on the abovementioned consultation. Our comments in this submission focus solely on the assurance engagement requirements. We trust that our comments will be helpful to the Reserve Bank of New Zealand (“the Reserve Bank”) in determining their next steps.

Our submission relates solely to matters in respect of the Registered Bank Disclosure Statements (New Zealand Incorporated Registered Banks) Order 2014 (‘Local OIC’) and the Registered Bank Disclosure Statements (Overseas Incorporated Registered Banks) Order 2014 (‘Branch OIC’) (and together the ‘Orders’ – as amended) in our role as external auditor, and our submission should be read in this light. We are not making a submission in respect of what disclosures should or should not be required in the Orders.

PwC New Zealand<sup>1</sup> is part of the global network of PwC firms. Our firm has extensive experience across a range of professional services that are valued by a wide variety of entities and individuals that participate in capital markets and investment activities in New Zealand. In responding to this consultation, we draw on our areas of expertise as Chartered Accountants providing assurance and other related services.

Member firms of the global network of PwC firms provide advice and are the external auditor to a number of registered banks in New Zealand. PwC New Zealand, on behalf of the Auditor General, is also the external auditor of the Reserve Bank.

We understand the submission is subject to the Official Information Act 1982, and we have no objection to the release of any information contained in our submission, or its publication on the Reserve Bank’s website.

If you have any queries in relation to this submission, please do not hesitate to contact me.

Yours faithfully



PricewaterhouseCoopers

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<sup>1</sup> This response is being filed on behalf of PwC New Zealand, a separate legal entity within the network of member firms of PricewaterhouseCoopers International Limited. References to “PwC”, “we” and “our” refer to PwC New Zealand.

## Appendix I – Our key submissions

### Form of the information in audit reports and review statements

Schedule 1 of the Orders sets out matters to be included in an auditor’s report or review statement (together ‘audit and review reports’). Among other matters, Schedule 1 of the Orders requires an audit and review report to include:

#### *Local OIC*

Full year audit of disclosure statements	Half year review of disclosure statements
Audit opinion that the financial statements are prepared in accordance with generally accepted accounting practice	Review conclusion on the interim financial statements in accordance with NZ IAS 34
Audit opinion on the supplementary information (excluding supplementary information relating to capital adequacy)	Review conclusion on the supplementary information (excluding supplementary information relating to capital adequacy).
Review conclusion on the supplementary information relating to capital adequacy	Review conclusion on the supplementary information relating to capital adequacy.

#### *Branch OIC*

Full year audit of disclosure statements	Half year review of disclosure statements
Audit opinion that the financial statements are prepared in accordance with generally accepted accounting practice	Review conclusion on the interim financial statements in accordance with NZ IAS 34
Audit opinion on the supplementary information (excluding supplementary information relating to credit and market risk exposures and capital adequacy)	Review conclusion on the supplementary information (excluding supplementary information relating to credit and market risk exposures and capital adequacy)
“Audit opinion” on the supplementary information relating to credit and market risk exposures and capital adequacy <sup>^</sup>	Review conclusion on the supplementary information relating to credit and market risk exposures and capital adequacy <sup>^</sup>

<sup>^</sup> This requirement is discussed below in our submission under the heading “Other amendments to Schedule 1 of the Orders”

As a result, to satisfy these requirements, audit and review reports for registered banks in New Zealand are very long in length and may as a result, be confusing to users. Reports on banks in other jurisdictions are largely comparable with audit and review report requirements for non-bank entities.

We believe this is partially due to other jurisdictions requiring the supplementary information to be separate from the financial statements – like a Pillar 3 report. We encourage you to consider changes to the audit and review report requirements to allow audit and review reports for banks to be comparable to non-bank entities. This could be achieved through separating the supplementary information required to be disclosed in the Disclosure Statement to be separate from the financial statements prepared in accordance with generally accepted accounting practice (GAAP). The auditor’s report for the financial statements should also be separate from the audit or review report for the supplementary information, i.e., splitting the Disclosure Statement into distinct parts with audit or review opinions as required by the Orders on each.

This allows an auditor’s report on a bank’s financial statements to be comparable to non-bank entities in New Zealand. This also provides for greater ease of comparability and consistency with banks in overseas jurisdictions.

## 1. Other amendments to Schedule 1

We have identified four separate matters in Schedule 1 of the Orders to bring to your attention to consider for amendment.

### **a) Amending ‘true and fair value’ to ‘present fairly, in all material respects’**

Schedule 1 of the Orders requires an auditor’s report to state on the financial statements of a bank to “give a true and fair view” of the matters to which they relate. This true and fair view requirement for the auditor’s report was previously set out in section 16 of the Financial Reporting Act 1993 (‘FRA 1993’). This is no longer applicable for registered banks as they now report under the Financial Markets Conduct Act 2013 (‘FMCA 2013’).

The current market practice in New Zealand and overseas is for financial statements to “present fairly, in all material respects” consistent with auditing and assurance standards. Whilst we acknowledge that International Standard on Auditing (New Zealand) 700, *Forming an Opinion and Reporting on Financial Statements*, regards ‘true and fair value’ and ‘presents fairly, in all material respects’ as being equivalent, we recommend that Schedule 1 of the Orders is amended to ‘presents fairly, in all material respects’ to be consistent with standard industry practice in New Zealand and overseas for audit reports.

### **b) Branch OIC – full year audit requirement on credit and market risk exposures and capital adequacy**

Schedule 1, clause 2(1)(j) of the Branch OIC sets out the auditor’s requirements for credit and market risk exposures and capital adequacy. This clause effectively places an “audit” requirement on the matters required by Schedule 9 of the Branch OIC.

The main disclosure requirements of Schedule 9 of the Branch OIC are:

- Residential mortgages by loan-to-valuation ratio.
- Market risk capital charges.
- Capital ratios of registered bank and its overseas banking group.

For the Local OIC, these equivalent disclosures are required by Schedule 9 or 11, however Schedule 1 of the Local OIC requires a review conclusion and not an “audit” requirement.

It has been generally accepted, through market practice, that auditors also provide a review conclusion and not an audit opinion on these matters with respect to the Branch OIC. This is for the same reasons that the Local OIC require auditors to provide a review conclusion over the equivalent disclosure information. We therefore recommend this clause is amended to require a review conclusion to align with the Local OIC and accepted market practice.

### **c) Local OIC – Internal models**

Schedule 1, clause 2(1)(k)(ii) of the Local OIC sets out the requirements for the auditor’s review report for registered banks who have been accredited by the Reserve Bank to use internal models for credit risk and operational risk.

We recommend the following clause is deleted: “*and with the bank’s internal models for credit risk and operational risk as accredited by the Reserve Bank of New Zealand*”

Our rationale for this amendment is because:

- The requirement for registered banks who have been accredited by the Reserve Bank to apply internal models for credit risk and operational risk which have been approved by the Reserve Bank, is included in their conditions of registration that is already captured in this clause;

- In practice, registered banks do not use internal models for all credit risk exposures. Whilst internal models are used for certain portfolios, banks may use the standardised approach for market risk exposures, credit valuation adjustments, and other non-material portfolios; and
- The internal models for credit risk and operational risk are not 'accredited' by the Reserve Bank, but internal models are 'approved' to be consistent with the terminology used in BS2B (Section 1.3A).

**d) Review report on disclosures of overseas capital adequacy information**

For a registered bank who has an overseas bank parent, both the Local OIC and Branch OIC requires the disclosure of capital adequacy information in relation to the overseas banking group. Schedule 1 of the Orders requires our review conclusion to state the information is prepared in accordance with BS2A or BS2B.

Overseas banking group capital adequacy information is not prepared in accordance with BS2A or BS2B, and this requirement for our review report should be amended to state that they are prepared in accordance with the appropriate banking supervisory authority in its country of domicile or the conditions of registration.

**2. Liquidity ratios**

We recommend a limited assurance review scope for both full year and half year liquidity ratios on the requirements in Schedule 1 of the Local OIC and Schedules 4 and 5 of the Local OIC.

While the liquidity ratios are largely auditable, there are key considerations that need to be taken into account such as:

- Complexity of liquidity models;
- Granularity and sophistication of documented policies and procedures around liquidity risk management frameworks between banks;
- Comparability to similar requirements already in place for capital adequacy standards;
- Comparability to similar jurisdictions which require independent reviews of liquidity risk management frameworks, rather than an audit; and
- Overall cost versus benefit of an annual audit.

Please see our expanded response under Question 2 of Appendix II.

**3. Concentration of credit exposures – CET1 ratio**

In terms of the audit and review requirements in Schedule 1 of the Local OIC and furthermore Schedule 13 of the Local OIC with respect to the change in denominator from Equity to Common Equity Tier 1 (CET1) capital, we recommend a limited assurance review scope for both the full year and half year information.

While Equity is calculated in accordance with generally accepted accounting practice and is audited, CET1 is calculated in accordance with BS2A and BS2B, as applicable, and is not subject to an audit requirement.

Please see our expanded response under Question 3 of Appendix II.

## **Appendix II – Our responses to questions in the follow-up consultation document: Updates to registered bank disclosure statements arising from Stocktake**

### ***Question 1: Do you have any comments on the proposed drafting changes to the Orders in Council to implement these disclosure changes for both locally incorporated banks and overseas branches?***

We have no comment.

### ***Question 2: Do you have any comments either on the nature of the proposed disclosure of regulatory liquidity ratios, or on the drafting changes to the local Order in Council to implement the proposed new disclosure?***

We have no comment on the nature of the proposed disclosure of regulatory liquidity ratios, but have given consideration to the question of the draft changes to the Local OIC to implement the proposed new disclosure, especially the proposed auditing requirements.

When answering this question, we have assumed that Section 4 of Schedule 4 of the Local OIC and Section 6 of Schedule 5 of the Local OIC refers to the BS13 Liquidity Policy (“BS13”). As a result, we have assumed that the one-week, one-month and core funding ratios referred to in these schedules are the ratios as referred to in BS13. We recommend the Reserve Bank define that these liquidity ratios are calculated in accordance with BS13.

Schedule 1 of the Local OIC requires a bank to provide an audit report on the liquidity ratios as stipulated in Schedule 4.

We understand that the main drivers the Reserve Bank consider when considering changes to the disclosure regime are:

- Encouraging investor participation by providing comparative information about banks
- Reduction/re-balancing of compliance costs
- Promoting market discipline
- Timeliness of information to market

We believe that, whilst the liquidity ratios are technically auditable in most instances, the following points need to be noted:

- The complexity of the liquidity models in banks will increase the cost of an audit, whilst a limited assurance review may achieve the Reserve Bank’s objectives in a more cost effective way, which is also consistent with the current review requirements for capital adequacy.
- In practice, it is possible that the sophistication and granularity of the documented processes and procedures around the liquidity risk management framework (including more sophisticated models), will differ between, for example, the larger and smaller banks, especially where more sophisticated models (run outside of Excel) don’t have any ‘spreadsheet risk’. As a result, the comparable fee and effort of audit between banks could differ substantially.
- Having reviewed requirements in comparable jurisdictions (such as the United Kingdom, United States of America and Australia), we have found that the ratios and liquidity requirements are not typically subject to an audit, but rather an independent review of the liquidity risk management framework.

We therefore recommend a limited assurance review scope be adopted for liquidity risk for both the annual and half year disclosure statements.

***Question 3: Do you have any comments on the proposed changes to the disclosure of concentrated credit exposures, whether on the content of the changes or in the way the changes are drafted in the local Order in Council?***

We have no comment on the nature of the proposed disclosure changes, but have given consideration to the question of the draft changes to the Local OIC to implement the proposed new disclosure, especially the proposed auditing requirements.

In Schedule 1 of the Local OIC, for the full year disclosure statement, auditors are required to perform an audit of supplementary information disclosed in Schedule 13 of the Local OIC.

The proposed change to use CET1 capital as the denominator for the concentration measures, rather than equity creates an issue in respect of auditing this requirement. CET1 capital is calculated in accordance with BS2A and BS2B, as applicable, and disclosed in accordance with Schedule 9 and 11 of the Local OIC, which is subject to a review requirement.

There are certain matters in the calculation of CET1 capital which are not derived from audited financial information and accordingly is not subject to audit, particularly in relation to any regulatory adjustments.

For example, a required deduction in calculating CET1 capital is the total expected loss being higher than total eligible allowances for impairment, which is calculated in accordance with BS2B. This calculation is partially derived from the calculation of expected losses from a bank's internal models approved by the Reserve Bank for credit risk which are only subject to a review requirement. An audit requirement would require significant cost.

We therefore recommend a limited assurance review scope be adopted for the proposed disclosure requirement for both the annual and half year disclosure statements.

***Question 4: Do you have any comments on the proposed drafting changes to remove the references to FIRB and QRRE?***

We have no comment.

***Question 5: Do you have any comments on the proposed drafting changes to the branch Order in Council to implement these disclosure changes for branches only?***

We have no comment.