RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

# Summary of submissions: Updates to registered bank disclosure statements arising from Stocktake

**February 2018**

Ref #7402795

## Introduction: purpose of consultation

1. On 14 November 2017 the Reserve Bank published "Follow-up Consultation: Updates to registered bank disclosure statements arising from Stocktake" with a feedback deadline of 12 January 2018. The main change proposed was to remove the requirement for any bank to publish off-quarter disclosure statements, to coincide with the start date of the new Bank Financial Strength Dashboard ("Dashboard"). Other proposed changes were to implement some of the other disclosure improvements identified in the Regulatory Stocktake (carried out by the Reserve Bank over 2014-16), and to make changes to better align future full and half year disclosure statements with the Dashboard. The consultation was accompanied by red-lined copies of the disclosure Orders in Council (OICs) showing the specific drafting changes needed.

2. More specifically, the changes we consulted on were:

   - removal of off-quarter disclosure statements from both locally-incorporated banks and branches;
   - new disclosure of the three regulatory liquidity ratios, as period averages over the two quarters making up the first or second half of the year (as applicable) (local banks only);
   - amendments to the disclosure of concentrated credit exposures to align better with the Dashboard (for local banks only);
   - removal of the disclosure of concentrated credit exposures for branches;
   - removal of the asset maturity ladder (for both locals and branches);
   - clarification that a bank's own credit ratings disclosed should be those applying at the signing date rather than the reporting date (for both local banks and branches);
   - tidying up an inconsistency between the branch and the subsidiary of a dual-registered bank that uses the internal ratings-based (IRB) approach to credit risk modelling, in how the bank discloses the breakdown of mortgage lending by loan to value ratio (LVR) (this affects the branch Order in Council (OIC) only); and
   - removal of redundant terms, and minor updates consequential on changes in the financial reporting framework.

## Feedback on the consultation

3. We received three responses to the consultation, from PWC, the NZBA, and ASB. (ASB also noted that they support the points made in the NZBA submission.) None of the submitters requested that their submission be withheld, so all three submissions are being published on our website at the same time as this summary.

4. The submitters were generally happy with the drafting as such of the proposed changes to the OICs.

5. The following were the main issues raised:

*Liquidity ratios*

*General concerns*

6. NZBA and ASB raised concerns that readers of disclosure statements will not have the necessary context to be able to meaningfully interpret the values of liquidity ratios published by banks. In addition, they are concerned at the lack of prescriptive guidelines around the calculation of the ratios, and they understand that banks may not always be calculating their ratios consistently. If the ratios are to be published, they recommend that the Reserve Bank provides standardised calculations, after consultation with banks.

7. **Response**: We have gone ahead with adding liquidity ratios to the disclosure statement requirements. We still believe that it is important for the Dashboard to include some form of liquidity metrics from the start, and we agree that the same information should be included in disclosure statements. The Dashboard will include functionality allowing explanations of the metrics to be provided, and these will be pitched at a prudent non-expert.

8. BS13 does provide detailed specifications of how the liquidity ratios must be calculated. A bank is allowed to make simplifying assumptions in calculating any of the three ratios, but only if that produces a "worse" figure, ie one that is closer to not meeting the minimum requirement for the ratio. We do not regard that as a major problem, as it incentivises banks to improve their calculations, and will never show a bank as more sound than it actually is. We do accept that there may be some other areas in which consistency of the calculations across banks can be improved: we are planning to carry out a detailed review of how banks calculate their liquidity ratios, and may add clarifications to BS13 if that exercise shows they would help.

*Averaging calculation*

9. ASB suggest also that the calculations should be averaged on an end-of-calendar-day rather than end-of-business-day basis.

10. **Response**: We believe using business day figures makes better sense, otherwise a bank's liquidity position at close of business on a Friday gets triple the weight compared to any other weekday in the calculation of the average. We note that the Basel Committee's analogous disclosure of a bank's Liquidity Coverage Ratio (LCR) requires a "simple average of daily observations over the previous quarter", and that APRA have implemented this for Australian banking groups. While there can generally be some advantages from aligning our approach with APRA's, they are not obvious in this case as long as the New Zealand subsidiaries continue to use the BS13 methodology to calculate their daily liquidity ratios, rather than the LCR methodology used by their parent groups.

*Referring to BS13*

11. PWC also note that the drafting of the requirement to publish liquidity ratios does not refer to BS13, and suggest that this be added for clarity.

12. **Response:** The calculation instructions as currently drafted are "must calculate the ratio at the close of each business day in the period in accordance with the conditions of registration relating to liquidity risk management…". We believe that this provides sufficient clarity about the methodology to use, as the condition of registration that this refers to provides the reference to BS13 (and to BS13A, the liquid assets annexe, which is also needed to define the calculation). The advantage of this approach is that it provides flexibility in the event that any bank has a bespoke condition that overrides some aspect of the standard BS13 calculations (this has arisen on at least three occasions since the policy was introduced): we think that a bank should disclose the ratios to which it is actually subject, rather than those calculated using a standard BS13 basis. This approach also matches the one we use generally with the disclosure of capital adequacy information. So while we can see that an explicit reference would be helpful, other things being equal, we have not accepted this recommendation.

*Auditor's opinion on liquidity ratios*

13. All three submitters raise concerns about the nature of the audit opinion that will apply to the liquidity ratios in the full year disclosure statement for locally-incorporated banks.

14. There are currently three types of opinion that are required on information that locally-incorporated banks publish in full year disclosure statements:

    a. whether or not the financial statements give a true and fair view of the matters to which they relate;

    b. whether or not the supplementary information that is required to be published under specified schedules in the OIC fairly states the matters to which it relates, in accordance with those schedules;

    c. in relation to capital adequacy information, whether or not anything has come to the auditor's attention which would cause the auditor to believe that the information is not in all respects prepared in accordance with the bank's conditions of registration [and with the bank's internal models for credit risk and operational risk as accredited by the RBNZ], and disclosed in accordance with Schedule 9 [11]. (Square bracketed words apply only to IRB banks.]

15. We proposed that the liquidity ratio disclosure would be contained in one of the Schedules that is covered by the type (b) opinion. Given that the liquidity ratios are regulatory in nature and not defined in New Zealand GAAP, and given the complexity of the modelling assumptions, the respondents argue that the liquidity ratios should be subject to an opinion of the same nature as the capital adequacy information, namely of type (c).

16. **Response**: We accept these points. The only existing regulatory disclosure information that is of comparable complexity to the liquidity ratios is the capital adequacy information, and that is already subject to the review-type opinion. To make this change, we have taken on board NZBA's suggested drafting approach, namely to move the required liquidity ratio disclosure from the "Additional financial disclosures" schedules (Schedules 4 and 5) into the capital adequacy schedules (Schedule 9 for standardised banks and Schedule 11 for IRB banks). All of the content of Schedules 9 and 11 is subject to the capital-type opinion, so this automatically includes the liquidity ratios in the same opinion.

*Concentrated credit exposures*

17. In the disclosure of concentrated credit exposures, we proposed changing the denominator of the ratios from equity to Common Equity Tier 1 (CET1) capital, to align with what is in the new reporting template for concentrated credit exposures, which will also provide the basis for the summary measures planned for the Dashboard. We argued that CET1 capital is a more suitable measure than equity of a banking group's ability to absorb losses, and no respondents disagreed with that.

*Consistency with connected exposure disclosure*

18. ASB made the point that this change is not consistent with the disclosure of exposures to connected persons (required by Schedule 13 of the local OIC), as those exposures are expressed as a percentage of Tier 1 capital rather than CET1 capital.

19. **Response:** we agree that it would be preferable for connected exposures and concentrated exposures to be measured using the same denominator. However, given

our doubts about the going-concern loss-absorbing capability of AT1 instruments and the current consultation on their future role as regulatory capital in New Zealand, we believe that CET1 capital is better in principle than Tier 1 capital as a yardstick for potential credit losses. We therefore believe it would be better to deal with this inconsistency the other way round, by making CET1 capital also the denominator for connected exposure ratio calculations.

20. We have flagged that we are planning to add connected exposures to the Dashboard in due course, but we want first to review the definition of connected exposures provided in the policy document BS8 Connected Exposures (as resources permit). That would affect connected exposure limits imposed by condition of registration, so will need full consultation. That review can include a consideration of changing the denominator of the connected exposure measure to CET1.

*Consistency with Dashboard*

21. ASB point out that if the Dashboard includes a figure for top 5 exposures as a percentage of equity and the disclosure statement does not, this will be a further inconsistency between the two, and NZBA make a similar point.

22. **Response**: we have not made any disclosure changes in response to this point. The Dashboard is intended to include simple summary metrics, whereas a disclosure statement (DS) allows room for more expansive information. We are aiming for the basis of measurement to be as consistent as possible between the two, but that does not mean presenting exactly the same information. The Dashboard will likely include a figure for the total number of large exposures overall, which will reconcile with the sum of the numbers of large exposures in each cell in the DS (divided up by size range, rating range, and counterparty type).

*Audit opinion on concentrated credit exposures*

23. The proposed change in the denominator for large exposures also gave rise to the following concern about the type of audit opinion to be given on the large exposure information, explained in detail by PWC and also expressed by ASB.

24. The problem in brief is that equity is a figure that features in the financial statements, and is thus subject to the standard audit opinion as a matter of course. CET1 capital is a regulatory concept, defined in the capital adequacy policy documents BS2A or BS2B. PWC pointed out that (for example) an IRB bank must deduct from CET1 the excess of expected losses over eligible provisions, where “expected losses” on non-defaulted exposures are defined by reference to various parameters that the bank estimates in its credit risk modelling approach. Hence the opinion ties back to the whole modelling approach.

25. **Response**: the point is reasonable, given that for capital adequacy information in general we have accepted that it only need be subject to a negative assurance rather than a positive assurance type opinion. However, as noted above, credit exposures to connected persons are currently disclosed as a percentage of Tier 1 capital, and we have not proposed changing either that definition or the audit opinion applying to them, which is a positive assurance form of opinion. As Tier 1 capital only differs from CET1 capital by the amount of any Additional Tier 1 instruments issued, the marginal cost of giving a positive assurance opinion on the CET1 capital figure should be low, given that such an opinion will still be required on the Tier 1 capital figure.

26. So we are not convinced that the additional cost arising from the change in denominator, in providing a positive assurance audit opinion on the large exposures information, is large enough to warrant losing the additional benefit of the stronger form of opinion on the large exposure information as a whole. Accordingly, we have left the nature of the audit opinion on this Schedule unchanged.

*General form of disclosure statement and auditor report*

27. PWC suggested it would be better if there was separation: (1) between the supplementary information required in disclosure statements and the financial statements prepared in accordance with GAAP; and (2) between the auditor's report on the financial statements and the auditor report or review report on the supplementary information. They also note that the OICs require the audit opinion on the financial statements to state that they give a "true and fair view" of the matters to which they relate, whereas the current standard practice is to state that they "present fairly, in all material respects …".

28. **Response**: We have not made any of the suggested changes in this round of OIC updates. None of these issues arise from the specific changes we consulted on. The first suggestion would mean a fundamental change in our disclosure regime, and we have no plans to consider it in the short term. However, we plan to give further thought to the second and third suggestions soon. We are conscious that the new international requirement for the auditor's report to contain Key Audit Matters (KAMs) makes the already long and complex auditor reports for New Zealand banks even harder to understand. We are looking at ways to address this problem, by re-framing the way that the OICs specify the auditor's report required to be included in a full-year disclosure statement.

*Auditor opinion on branch capital-related information*

29. Schedule 9 in the branch OIC requires a branch to publish: a breakdown of residential mortgage lending by LVR, using the LVR definitions in BS2A (Capital Adequacy Framework: Standardised Approach); a summary of the branch's market risk exposure also using the methodology in BS2A; and the most recent publicly available figures for the overseas bank's and/or overseas banking group's capital ratios.

30. The auditor's report for branches is split into three parts like the one for locally-incorporated banks, and the first two parts are the same as in the local case (see paragraph 13 above). But the third part, which applies only to the information in Schedule 9, is expressed in a positive rather than negative assurance form, as follows:

    - "whether or not the information relating to credit risk and market risk exposures and capital adequacy that is required to be disclosed under Schedule 9 is in all material respects prepared in accordance with BS2A and disclosed in accordance with Schedule 9".

31. PWC suggested that this requirement should be switched to a negative assurance form of opinion, to align with the equivalent opinion on locally-incorporated banks' capital adequacy numbers.

32. **Response**: We note that (as consulted on) we are changing the required LVR breakdown for any dual-registered branch associated with a locally-incorporated bank that is an IRB bank, so that it is calculated on a BS2B basis. This reinforces PWC's point about aligning the nature of the auditor's opinion across the locally-incorporated capital adequacy information and the branch capital-related information. Accordingly, we have

changed the opinion required on the branch Schedule 9 information from positive assurance to negative assurance.

*Specification of the calculation on which the auditor is to opine*

33. PWC have also noted a more generic problem with the audit opinions on capital adequacy information, both that disclosed by local banks, and that included in the Schedule 9 information for branches. The problem arises because of the amount of specific detail in how the OICs express the requirements for those opinions.

34. The branch Schedule 9 opinion requires the auditor to judge whether the information has "in all material respects prepared in accordance with BS2A". The problems with this are that: overseas bank capital adequacy ratios are calculated in accordance with the home country capital regime, not on a BS2A basis; and under another change we have made, the LVR breakdown for IRB dual-registered branches will be calculated on a BS2B rather than BS2A basis.

35. There are similar problems with the capital adequacy opinion for locally-incorporated banks. The required opinion refers to the information being prepared "in accordance with the bank's conditions of registration and [for IRB banks – ] with the bank's internal models for credit risk and operational risk as accredited by the Reserve Bank of New Zealand". The information within the scope of this opinion includes capital ratios of a bank's overseas banking group (if it has one), which are not calculated in accordance with the bank's conditions of registration, and the small amount of credit exposures that an IRB bank risk-weights using the standardised approach, which are thus not prepared in accordance with credit risk models.

36. **Response**: We note that, in the Schedules in question, every clause that specifies the information that must be disclosed has to specify exactly where the information comes from, such as "in accordance with the bank's conditions of registration relating to capital adequacy", or "most recently published information". So when the auditor gives a view (as required) on whether the information has been disclosed in accordance with the requirements specified in Schedule X, it is implicit that the required method has been used to derive that information. We accept that it is sufficient to specify that the auditor must give a view on whether the information required to be disclosed by Schedule X has been disclosed in accordance with Schedule X (or the equivalent negative assurance opinion). We have amended the opinion required on the capital adequacy schedules for locally-incorporated banks and on Schedule 9 for branches.

*Other minor issues*

37. The NZBA have made the following additional minor drafting suggestions.

38. On disclosure statement (DS) accessibility, the OICs specify that if any person asks for a copy of a bank's most recent disclosure statement, the bank must offer to provide a hard copy of its most recent full year DS and any subsequent half year or off quarter DS. NZBA suggest deleting the reference to the off-quarter DS.

39. **Response**: We have deleted this reference as it is no longer relevant.

40. NZBA pointed out that both Orders in Council have a section titled "Disclosure Statement not to contain any offer of securities", which contains out of date references to the Securities Act 1978 and the Securities Regulations 2009.

41. **Response**: We have replaced the references to "offer of securities within the meaning of section 2 of the Securities Act 1978" with references to the nearest equivalent under the replacement legislation, namely "offer of financial products within the meaning of the Financial Markets Conduct Act 2013". However, there is no single equivalent to the references to the Securities Regulations 2009: since these provisions are only permissive in nature (ie they only specify information that a disclosure statement may contain – effectively for avoidance of doubt), we have cut them without replacement.

42. The information that is required about any guarantor of the bank's obligations includes the guarantor's "current credit rating". The proposed changes already clarify that the applicable date for the bank's own credit rating is the signing date for the DS rather than the reporting date. NZBA suggested that to align with this change, the OICs should also clarify that the guarantor's credit rating should also be that applying at the signing date.

43. **Response**: It makes sense to apply the same clarification in this case, and it is also more logical to have the dates of the ratings aligned between the bank and the guarantor. We have made the changes suggested.

44. The local OIC requires a table summarising various features of each capital instrument that is included in a bank's regulatory capital figure as at the balance date. One such feature is whether the instrument is subject to phase-out from eligibility as capital under the RBNZ Basel III transitionals. Since all such instruments are given zero value from 1 January 2018, this statement is now redundant.

45. **Response**: We have removed all references to Basel III transitionals.

46. For disclosing the LVR breakdown of its mortgage lending, an IRB bank must, in the total exposure amount, include the credit equivalent amount of any off-balance sheet exposures as used in the capital calculation. The specification of this in the LVR policy document itself (BS19) adds the rider "except that, when incorporating any off-balance sheet exposures in the loan value, the registered bank may apply a credit conversion factor of 100% rather than using its own EAD [Exposure at Default]".

47. **Response**: We agree that the disclosed breakdown of housing lending by LVR should be consistent with the way that the LVR restrictions are actually applied. We have added this rider to the definition for disclosure purposes, to align with BS19.