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19 March 2018

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Prudential Supervision Department
Reserve Bank of New Zealand
PO Box 2498
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New Zealand

Genworth Financial Mortgage Insurance Pty Ltd Submission:

Review of the Capital Adequacy Framework for locally incorporated banks: calculation of risk weighted assets.

Dear Mr Woolford,

Thank you for providing Genworth Financial Mortgage Insurance Pty Limited (Genworth) with the opportunity to participate in the consultation regarding locally incorporated bank capital and the considerations required for risk weighted assets.

Genworth has focused on several key themes in its response to the consultation paper (attached), most particularly the need to ensure that capital risk weightings appropriately reflect the risk retained on banks' balance sheets and the benefits of sharing risk more broadly across the local and global financial systems.

We look forward to further engagement as you work your way through these issues. Please do not hesitate to contact us with any questions relating to our submission.

Yours sincerely,

Georgette Nicholas
Chief Executive Officer and Managing Director
Genworth Mortgage Insurance Australia Limited

Genworth Financial Mortgage Insurance Pty Limited ACN 106 974 305

Submission:

Review of the Capital Adequacy Framework for locally incorporated banks: calculation of risk weighted assets

March 2018

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1. Executive summary

The role of the prudential regulator is to ensure the soundness of the local banks and therefore the local financial system. Operating in a relatively concentrated, yet open economy, New Zealand banks have balance sheets which have significant concentrations to particular sectors of the economy. The Reserve Bank of New Zealand (RBNZ) has, to date, managed this risk well and has been ahead of many other global regulators in implementing most of the currently proposed Basel III amendments.

One area where New Zealand banks are significantly exposed is to the residential mortgage market. Around 48% of banks' balance sheets represent loans backed by residential property. During the Global Financial Crisis (GFC), we observed the impact of excess exposure to residential property in different global economies. New Zealand (and Australia) came through that crisis relatively unscathed. Nevertheless, the lessons learned were the importance of reducing bank balance sheet leverage and maintaining robust underwriting standards around residential real estate.

In the 1990s and early 2000s there was a competitive market for lenders mortgage insurance (LMI) in New Zealand. Banks shared risks associated with higher loan to valuation mortgages with other parties. In this scenario, both the bank and the LMI provider held capital to support housing risk in the market. However, without appropriate capital recognition of the risk mitigation benefits of the LMI cover to internal ratings based (IRB) banks, the cost of the LMI to the bank became uneconomic.

Today, the LMI market in New Zealand effectively no longer exists. Both Genworth and QBE withdrew from the market due to lack of scale. New Zealand banks manage higher risk loans by applying a "low equity" fee to borrowers with a higher loan to valuation ratio. While the additional costs of higher defaults may be funded through this fee, it does not shift any of the associated risk off the bank's balance sheet. The result is that the New Zealand market has lost the risk and capital benefit of LMI.

Under our main product, Genworth brings capital to any high loan to valuation ratio (HLVR) loan equivalent to a 22% risk weight, on average. Put another way, our LMI cover contributes approximately $2 million in capital for every $100 million of high LVR loans covered by LMI.

The LMI market has changed significantly over recent years. The industry has recognised that different banks, financial systems and security types may require different LMI solutions. In recent years in Australia, Genworth has worked with banks and other lenders to provide a broader range of risk sharing solutions. These have included, for example, providing mortgage insurance to the "micro markets" – smaller cohorts of loans with homogenous risk characteristics. This has helped banks better manage their risk profile as their risk appetite has shifted or economic conditions changed.

In the current stock take of the appropriate risk weights for the New Zealand banking system, Genworth recommends that the Reserve Bank of New Zealand ensure that the:

- current approach to recognising the risk sharing benefits of LMI continues to be represented in the prudential capital regime for the Standardised approach
- parameters which are used to harmonise the outputs from IRB banks' models appropriately reflect the risk offset that takes place with the use of LMI and other risk mitigating strategies, and
- regulatory regime remains sufficiently flexible to recognise the genuine benefit of risk sharing across organisations and borders.

In its submission Genworth has not responded to every question in the RBNZ consultation paper, but has limited its submission to those questions directly relevant to LMI. These are summarised below.

Q 2.1	***IRB modelling remains relevant*** Incentives should remain for banks to continue to develop and enhance IRB models for internal risk modelling and capital calculation purposes. The existing RBNZ approach to be more prescriptive on key input parameters to the IRB models is consistent with the direction of global regulators. Global regulation is also heading towards a floor on the output of the IRB model vis-à-vis the Standardised approach.
Q 2.2	***Input parameters to IRB models*** We support: • Aligning the existing PD floor of 0.03% with the post-crisis Basel III minimum of 0.05% • Maintaining the current LGD floor segmentation (LVR and security purpose) while incorporating the benefits of risk mitigation tools such as LMI.
Q 2.2 Q 2.6	***More granularity in the Standardised model*** There is merit in providing more granularity in the Standardised methodology to achieve a more accurate representation of the residual risk remaining on banks' balance sheets. In particular, we support: • Introducing a segment for loans not meeting operational requirements in both the IRB and Standardised approaches.
	Alignment of risk weights with Basel III post crisis requirements The current risk weighting approach recognises differences in risk across loan to valuation ratios and security purpose – owner occupied versus investment. This results in a relatively higher risk weight for an investment loan with a higher LVR. In introducing the BCBS parameter, the RBNZ should ensure that the risk mitigation benefit of LMI continues to be incorporated.
Q 2.4	***Prudent use of a floor on the IRB capital requirement.*** The use of two Output Floors (one for mortgage assets and one for total bank assets) of between 80% and 90% would significantly reduce the difference in capital requirements between the IRB and Standardised approaches. This would minimise the incentive to engineer a lower capital requirement whilst still promoting the use and development of sophisticated, risk sensitive capital models.

These changes will promote more accurate reflection of credit risk mitigation strategies across both internal and standardised models. The impact of this will be greater sharing of risk across the financial system as banks look to solutions such as LMI to mitigate balance sheet risk. This will promote greater interest from LMI providers and other parties with credit risk mitigation solutions to participate in the New Zealand market.

2. About Genworth

Genworth is a leading provider of LMI in Australia with over 50 years of experience in Australia and over 10 years of experience providing LMI to the New Zealand market. Genworth Mortgage Insurance Australia Limited is a listed ASX200 company and approximately 52% of its shares are held by Genworth Financial Inc. (GFI) in the United States. GFI is a global corporation that provides LMI in the United States, Canada and Mexico, and previously across Europe, South Korea and Japan. Genworth works closely with numerous key stakeholders, forums and associations in Australia including local governments and regulators, industry associations including the ICA and the MFAA. GFI works closely with governments, regulators and insurance councils across the globe.

3. Background

The GFC caused prudential authorities around the globe to reassess their approach to the way risks are measured, monitored and controlled across the financial system. For many economies, the GFC highlighted shortfalls in the way capital was allocated against lending for residential property.

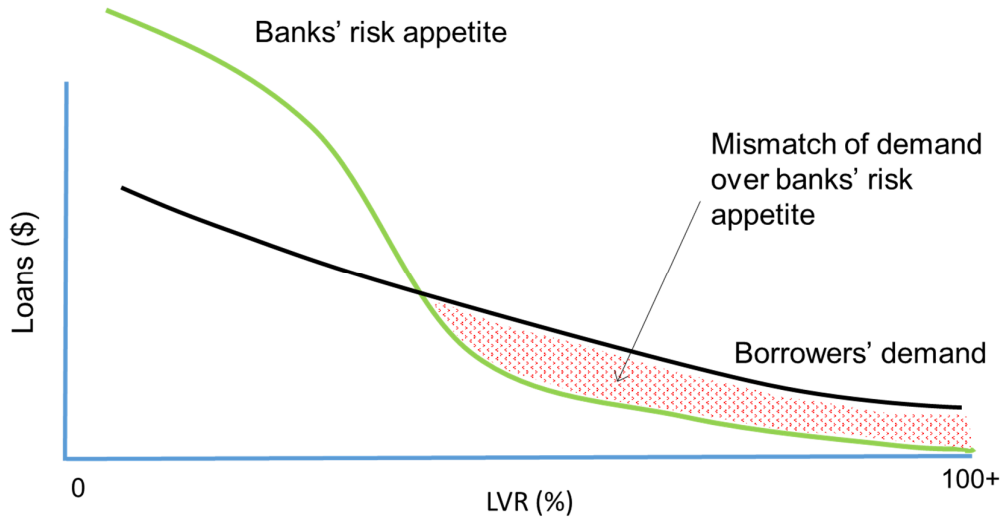
Like other global regulators, including our Australian prudential regulator, the Australian Prudential Regulatory Authority (APRA), the RBNZ is considering whether the New Zealand capital prudential framework is optimal from the perspective of a) capital adequacy and b) implementation efficiency.

In the context of residential lending, Genworth believes that capital requirements should accurately reflect the residual risk to the banks' balance sheet. The existing RBNZ capital adequacy framework contains significant granularity in both IRB and Standardised approaches and is largely aligned with the recent reforms published by the Basel Committee on Banking Supervision (BCBS) in December 2017 and discussion papers published by national regulators. However, there is still some opportunity to further enhance the framework to maintain market discipline, continue prudent lending and apply appropriate risk weights to banks' assets.

Residential mortgage risk and the financial system

Lending against residential property is a core exposure of the New Zealand financial system; 48% of the New Zealand banks' balance sheet exposure to loans backed by residential property.

Most banks have a very large appetite to lend to borrowers where the loan is small relative to the value of the underlying property. Conversely, there are a relatively large number of consumers – individuals and families – with an appetite to borrow a larger proportion of the value of the underlying property. These HLVR loans expose the bank, and ultimately the financial system, to higher risk.



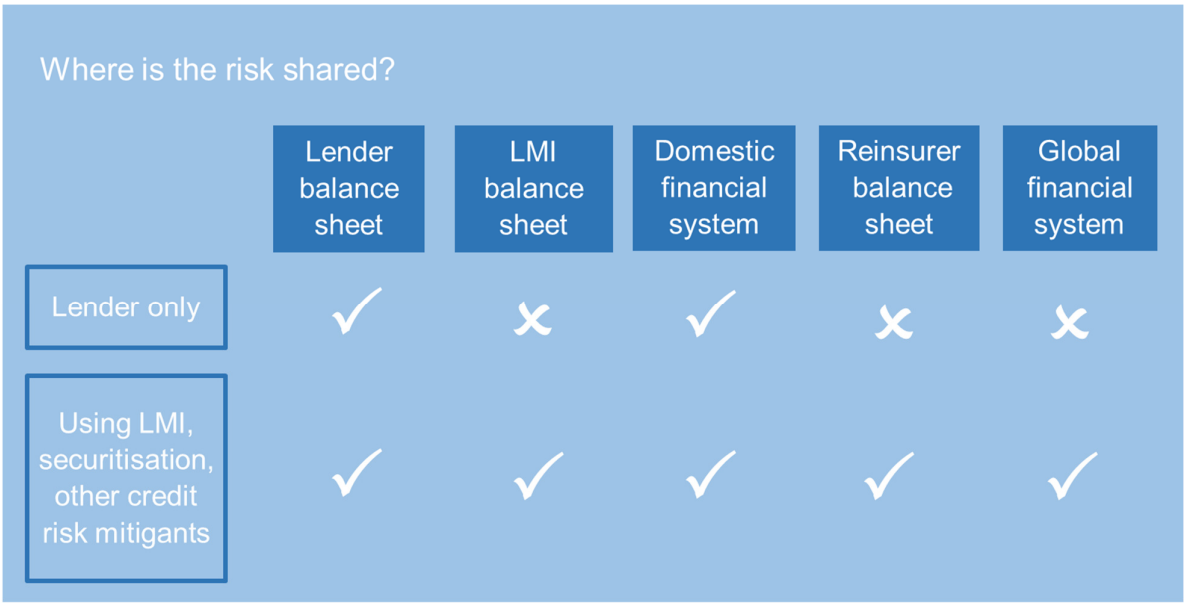
There are benefits to both consumers and to the broader economy in ensuring that the demand for HLVR can be met. Home ownership is important to individuals and families. For most New Zealanders, the family home will represent their largest financial asset. Many will need a HLVR loan from a lender to secure a mortgage as an entry point into the housing market or to move to a

bigger home as their family grows. Consumers should have access to such loans at a fair and reasonable cost. From the perspective of banks, meeting HLVR demand provides business opportunities, but only if they are able to a) offset that portion of the risk which is above their risk appetite and b) effectively allocate against regulatory capital. Banks should be able to pass on the additional costs of these higher risk loans to consumers.

Mitigating residential mortgage risks

Whilst HLVR loans are riskier there are different market mechanisms which allow a bank to offset additional risks associated with HLVR loans while allowing the bank to maintain prudent lending standards, sound capital ratios and robust risk controls. LMI is clearly one of these. In other markets, solutions which fill this gap include: government guarantees, securitisation of loans and structured reinsurance arrangements.

These mechanisms have the benefit of sharing the risk across the financial system.



Globally, the accelerated growth in lending/housing markets and concentration of risk on banks' balance sheets have led to macro-prudential intervention. Regulators have looked to protect and stabilise their markets by tightening underwriting standards around affordability and verification or placing concentration limits on HLVR loans, investment lending and interest only segments etc. Better mechanisms to share risk, along with recognition of the risk mitigation of these mechanisms through the capital standards applied to banks, will help maintain and promote financial stability and mitigate the need for macro-prudential measures.

Currently, most New Zealand banks absorb the risk of HLVR loans on their own balance sheet. Prior to the introduction of Basel II, banks in New Zealand used LMI but have more recently chosen to retain this risk on their own balance sheets and to pass the cost through to the consumer via an annual "low equity" fee. Securitisation in New Zealand has been very limited and confined to non-regulated lenders and lower loan to valuation portfolios. As such, most residential property mortgage risk is being retained by New Zealand banks and the domestic financial system.

4. Disclosure and transparency

Genworth agrees and acknowledges that there are some concerns with the use of internal IRB models for assessing credit risk weights. There may be an incentive to engineer a lower capital assessment under the IRB approach thereby reducing capital costs. Another key concern is that the historical data used in models may under-predict actual risks, as was the experience in the immediate period prior to the GFC.

There are three actions that have sought to mitigate these concerns:

1. Regulators have sought to standardise certain terms within the IRB models to align model calibration as well as introduce floors for certain parameters.
2. Across jurisdiction, there have been initiatives to harmonise standards, while still leaving room for national discretion to be applied.
3. A general promotion of the benefit of transparency around how the risk weights are calculated within an IRB model and explanation of the differences which result between an IRB model and the Standardised approach.

Genworth supports these initiatives.

5. Question 2.2

One of the options for credit risk would also involve removing the IRB approach for retail portfolios, on the grounds that the standardised approach is quite risk-sensitive for mortgages and other retail exposures are relatively small. Do you agree that the standardised approach for mortgages is risk-sensitive? If not, how could it be made more risk-sensitive? Do you agree that other retail exposures are relatively small? Are there other grounds for retaining or dropping the IRB approach for retail exposures?

Genworth supports the continued use of IRB models alongside the Standardised methodology, but recognise with respect to mortgage-related risks, both can be improved to provide output which more accurately reflects residual balance sheet risks.

A. Standardised approach for mortgages

The RBNZ risk weight requirements under the Standardised approach are already reasonably granular and generally consistent with the BCBS post-crisis reforms to Basel III. However, one area where they could be improved is to bring the New Zealand standards in line with the BCBS segmentation for loans which do not meet operational requirements.

The need for segmentation for loans not meeting operational requirements may have been more relevant to other economies, perhaps reflecting poorer underwriting standards around pre- and post-GFC underwriting years. However, it prevents further deterioration of underwriting standards in softer market conditions exacerbating any pro-cyclicality. And while the segmentation may require some fine tuning in the calibration of risk weights particularly on very low LVRs it has the benefit of sending a strong message on poor underwriting assessments.

The table below shows Genworth's lenders' performance in New Zealand across owner-occupied and investment lending products for origination years 1999 to 2013. (Note that 96% of these loans were written between 2002-08.)

Investment loans have underperformed owner-occupied loans, with an average loss ratio of 39%. This is 2.5 times higher than the lower risk owner occupied loans, Non-standard loans have performed much worse than the standard loans. The average loss ratio for non-standard loans of 138% is 7.4 times higher than the standard equivalent.

New Zealand loss ratio – Owner-occupied vs. Investment & standard vs. non-standard loans[1]

	Standard loans		Non-standard loans		
	New insurance written[2] %	Ever-to-date loss ratio[3] %	New insurance written[2] %	Ever-to-date loss ratio[3] %	Standard vs non-standard ratio
Loan type					
Owner-occupied.(OO)	76%	16%	10%	120%	**7.7x**
Investment (Inv)	11%	39%	3%	197%	**5.1x**
Total	**87%**	**19%**	**13%**	**138%**	**7.4x**
OO vs Inv ratio		**2.5x**		**1.6x**	

[1] NZ FLOW portfolio excl. mortgage managers and bulk (as at February 2018)
[2] NIW = new insurance written is the aggregation of all loan amounts underwritten (sum insured)
[3] Loss ratio = losses incurred (paid claims + reserves) divided by premiums

When compared to our significantly larger experience in Australia we find consistent evidence of varying performance across key product segments, albeit at lower levels as compared New Zealand experience.

Australia loss ratio – Owner-occupied vs. investment & standard vs. non-standard loans[1]

	Standard loans		Non-standard loans		
	New insurance written[2] %	Ever-to-date loss ratio[3] %	New insurance written[2] %	Ever-to-date loss ratio[3] %	Standard vs non-standard ratio
Loan type					
Owner-occupied.(OO)	70%	18%	10%	45%	**2.5x**
Investment (Inv)	16%	31%	4%	105%	**3.4x**
Total	**86%**	**21%**	**14%**	**57%**	**2.8x**
OO vs Inv ratio		**1.7x**		**2.4x**	

[1] Australian portfolio excluding mining towns and bulk (as at February 2018)
[2] NIW = new insurance written is the aggregation of all loan amounts underwritten (sum insured)
[3] Loss ratio = losses incurred (paid claims + reserves) divided by premiums

B. Mortgages under an IRB approach

For a bank to receive IRB model accreditation, there must be an appropriately sophisticated risk model. This model must ensure that it fully captures risks remaining on the balance sheet. The net risk position reflects the benefit of offsetting credit risks to other parties through, for example, LMI and reinsurance arrangements. In addition, to ensure that the resulting capital requirement is appropriately prudent, minimum levels for key risk inputs should be agreed for use within the internal model.

Minimum Probability of Default (PD) inputs

We note that the current RBNZ standards require a minimum PD of 0.03%, while the post-crisis reforms to Basel III requires a minimum PD of 0.05%.

PD data is proprietary to banks' lending books. They are calculated using historical data and estimate the percentage of each cohort of the current lending book which will go into default in the coming 12 months. A challenge confronting local banks is that the New Zealand market has not experienced an economic downturn sufficient enough to fully calibrate PDs for each portfolio cohort.

In New Zealand, the PDs will rely heavily on banks' internal credit scores. This differs to the US, for example, where positive credit ratings, such as FICO scores, are used to develop PD rates. (The prevalence of this data has underpinned the development of financial market instruments in the US including securitisation programmes.)

Absent a full dataset on borrowers' credit history, it is difficult for Genworth to analyse PDs at a granular level. We believe that it would be more prudent to adopt the higher PD floor consistent with the BCBS requirements.

Recommendation

Increase the minimum PD from 0.03% to the global minimum specified by the BCBS of 0.05%.

Minimum Loss Given Default (LGD) assumptions

The RBNZ has been ahead of other global regulators in introducing LGD floors for residential mortgages that are sensitive to LVR and security purpose (owner-occupation or investment). This approach provides greater confidence in the output of internal models as well as recognising key drivers to the performance of residential mortgage assets.

The RBNZ should also consider the relative importance of:

- recognising the risk sensitivity unique to each bank as measured by its internal model;
- complying with global minimums set by the BCBS; and
- preferring to reduce variability and increase transparency of the outputs across banks' IRB models.

To ensure consistency with other regulators, we believe that LGD floors should not be set below the Basel minimum of 5%. However, it would be prudent to set a higher LGD floor for loans with increased risks. This might include higher LVR loans for example. It is reasonable however, that the size of the floor recognises any risk mitigation strategies which improve the banks' balance sheet position (such as LMI).

A blanket LGD floor has proved to be ineffective as a regulatory tool in other jurisdictions due to its lack of risk sensitivity. In UK and Australia, the blanket floor has meant that lenders have the potential to originate increased volumes of higher risk (HLVR) loans with no implicit increase in risk weighted assets (RWAs), effectively absorbing the blanket LGD floor buffer.

The table below illustrates the impact of two different portfolio risk profiles on a bank's weighted average LGD under the existing RBNZ LGD floors and the APRA blanket 20% LGD floor. Note that as a portfolio becomes more heavily weighted towards HLVR loans, the weighted average LGD calculated under the RBNZ existing factors increases reflecting the higher risk. In contrast, there is no change to the weighted average LGD under the APRA blanket LGD floor methodology.

	HLVR share of portfolio	Weighted average LGD
LGD floor by LVR band (existing RBNZ factors)		
Conservative loan portfolio	5%	21%
Higher risk loan portfolio	30%	24%
Blanket LGD floor (existing APRA floor)		
Conservative loan portfolio	5%	20%
Higher risk loan portfolio	30%	20%

Data from the Genworth portfolio shows that LVR and security purpose are key determinants of severity of loss on a secured residential risk. HLVR loans have less initial equity and are more susceptible to default in the event of house price fluctuations and/or economic shocks.

LMI provides risk transfer and diversification to lenders with most cover relating to high LVR lending. LMI providers, such as Genworth, are prudentially regulated. Their capital requirements are set to withstand 1 in 200 year stress events. LMI providers typically diversify their risk offshore through the use of reinsurance. This provides foreign liquidity to support a New Zealand based downturn. The combination of capital and reinsurance promotes stability across the wider financial system however it is not currently recognised within the IRB capital framework.

Analysis undertaken by Genworth shows that for HLVR loans, on average, LMI contributes capital and reinsurance liquidity to the financial system equivalent to a 22% risk weight, representing 30% of the capital required to be held by IRB accredited banks. Recognising LMI in the IRB capital framework by reducing the LGD floors for HLVR loans by 30% will strengthen the NZ financial system by diversifying risk outside of NZ banks and the NZ financial system. This proposed reduction in bank capital requirements for IRB accredited lenders is consistent with the reduction currently provided to banks under the Standardised approach.

The tables below show the current LGD floors required in the Capital Adequacy Framework (Internal Models Approach) along with our proposed LGD floors which segment loans that are supported by LMI (or other risk mitigants) from loans that are not, recognising the capital contributed to the financial system by LMI (or other risk mitigants).

LGD floors – Non-property investment residential mortgage loan

LVR	Existing requirements	Proposed requirements	
		No LMI	With LMI
95% and over	38.00%	38.00%	26.50%
90-94%	38.00%	38.00%	26.50%
85-89%	33.25%	33.25%	23.25%
80-84%	33.25%	33.25%	23.25%
70-79%	28.50%	28.50%	20.00%
60-69%	19.00%	19.00%	13.25%
Under 60%	10.00%	10.00%	7.00%

LGD floors – Property investment residential mortgage loan

LVR	Existing requirements	Proposed requirements	
		No LMI	With LMI
95% and over	40.00%	40.00%	28.00%
90-94%	40.00%	40.00%	28.00%
85-89%	35.50%	35.50%	25.00%
80-84%	35.50%	35.50%	25.00%
70-79%	31.00%	31.00%	21.75%
60-69%	21.50%	21.50%	15.00%
Under 60%	12.50%	12.50%	8.75%

(Source: RBNZ, Capital Adequacy Framework (Internal Models Based Approach) BS2B, November 2015; APRA, GPS 116, Capital Adequacy: Insurance Concentration Risk Charge, January 2013; and Genworth estimates)

Recommendation

Given the risk transfer, diversification and system capital benefits of LMI, we recommend the RBNZ appropriately reflect LMI (and other eligible risk mitigants) in the LGD floors on the same basis as in the Standardised approach. This means having different floors based on whether LMI (or other eligible risk mitigants) are supporting the loan.

Varying correlation coefficients by risk segment

RBNZ has been ahead of other global regulators in introducing correlation factors for residential mortgages that are also sensitive to LVR and security purpose (owner-occupation or investment).

We believe that increasing the minimum correlation factor based on LVR and having a separate set of factors for investment loans is consistent with the benefits provided by including LGD floors.

IRB formulas assume that the relationship between stress conditions and expected conditions can be estimated using a single equation; a correlation factor is used adjust the results for certain asset classes to adjust for stress conditions. In the case of residential mortgage loans, the single correlation factor assumes that HLVR response rates will be similar to that of low LVR loans. Historical data suggests that this is not the case and the differences are material. Under stress, the cure rates on 90-day delinquent HLVR loans can change drastically compared to the cure rates of delinquent low LVR loans, reflecting the loss of borrower net equity when there is a severe drop in property prices.

Recommendation

RBNZ should maintain their existing position on segmenting correlation factors by LVR and security purpose.

6. Question 2.6 – Standardised approach

This paper suggests that New Zealand's standardised approach is already relatively risk-sensitive ("fine-grained"). Do you agree or disagree with this statement? Are there aspects of the BCBS' new standardised approach which should be introduced here? If so, why should they be introduced? (You might wish to cross-refer to your responses to Questions 2.2 and 2.3, which address specific aspects of the standardised approach which could be relevant for IRB banks).

The Standardised approach provided in the post-crisis reforms to Basel III recommends introducing risk weights that are sensitive to LVR by lowering risk weight for lower LVR loans and conversely increasing risk weights for higher LVR loans. Previously under Basel III all loans had a risk weight of 35% regardless of LVR.

As always, these BCBS requirements are a global minimum and individual country regulators have discretion as to how these reforms will be implemented, including increasing the risk weight to be more specific aligned with the individual country circumstances.

The RBNZ has previously chosen to be more conservative given New Zealand's circumstances and major bank concentrations.

Genworth have calculated prudent risk weights for both owner occupied and investment loans. These are shown in the table below alongside the Standardised risk weights under Basel III and the current RBNZ requirements. The Genworth recommended risk weights follows the RBNZ's existing practice of setting the risk weight requirement at the global minimum when the loans are supported by LMI and increasing the risk weight requirement for HLVR loans that are not supported by LMI.

Owner-occupied lending

	Basel III requirements		Current RBNZ requirements		Genworth recommended	
LVR	Current	Revised	With LMI	No LMI	With LMI	No LMI
>100%	35%	70%	100%	100%	100%	100%
90.01-100%	35%	50%	50%	75%	50%	75%
80.01-90%	35%	40%	35%	50%	40%	50%
60.01-80%	35%	30%	35%	35%	30%	35%
50.01-60%	35%	25%	35%	35%	25%	25%
0-50%	35%	20%	35%	35%	20%	20%

Investment lending

LVR	Basel III requirements		Current RBNZ requirements		Genworth recommended	
	Current	Revised	With LMI	No LMI	With LMI	No LMI
>100%	35%	105%	100%	100%	105%	105%
90.01-100%	35%	75%	75%	90%	75%	90%
80.01-90%	35%	60%	50%	70%	60%	70%
60.01-80%	35%	45%	40%	40%	45%	50%
50.01-60%	35%	35%	40%	40%	35%	35%
0-50%	35%	30%	40%	40%	30%	30%

The current RBNZ approach recognises the risk transfer and system capital benefits of LMI by providing different risk weight requirements on mortgage assets depending on whether they are supported by LMI.

The table below shows the reduction in risk weights that a lender using the Standardised approach received for using LMI, along with the capital held by an LMI provider on an equivalent loan. In all LVR bands, except for the 80.01-85% LVR band, the capital held by an LMI provider exceeds the reduction in capital received by the bank.

LMI benefit – Owner-occupied

LVR	Potential RBNZ requirements			LMI capital risk weights equivalent[1]	Net impact on system risk weights
	With LMI	No LMI	Reduction		
95.01-100%	50%	75%	25%	41.0%	16.0%
90.01-95%	50%	75%	25%	25.5%	0.5%
85.01-90%	40%	50%	10%	16.0%	6.0%
80.01-85%	40%	50%	10%	7.5%	-2.5%
70.01-80%	30%	35%	5%	7.1%	2.1%
60.01-70%	25%	25%	0%	2.3%	2.3%
0-60%	20%	20%	0%	1.5%	1.5%

[1] Excludes buffers held above minimum capital requirement

LMI benefit – Investment

LVR	Potential RBNZ Requirements			LMI Capital RW Equivalent[1]	Net Impact on System Capital
	With LMI	No LMI	Reduction		
95.01-100%	75%	100%	25%	41.0%	16.0%
90.01-95%	75%	100%	25%	25.5%	0.5%
85.01-90%	60%	75%	15%	16.0%	1.0%
80.01-85%	60%	75%	15%	7.5%	-7.5%
70.01-80%	45%	50%	5%	7.1%	2.1%
60.01-70%	35%	35%	0%	2.3%	2.3%
0-60%	30%	30%	0%	1.5%	1.5%

[1] Excludes buffers held above minimum capital requirement

(Source: RBNZ, Capital Adequacy Framework (Internal Models Based Approach) BS2B, November 2015; APRA, GPS 116, Capital Adequacy: Insurance Concentration Risk Charge, January 2013; and Genworth estimates)

Recommendation

Genworth recommend that the RBNZ maintains its existing practice of setting the risk weight requirement at the global minimums specified by the BCBS when the loans are supported by LMI and increasing the risk weight requirement for HLVR loans that are not supported by LMI and implement risk weights recommended in the table above.

7. Question 2.4 – Minimum output floor

In the options for limiting the use of IRB models, there would be a floor on risk weights produced by internal models. This floor would be set as a percentage of the corresponding risk weights under the standardised approach. The floor could be set on a portfolio-wide level (average risk weight of all exposures would be higher than some level), by asset class (e.g. average risk weight of residential mortgage exposures would be higher than some level), or by individual exposure (actual risk weight of single exposure would be higher than some level). What do you see as the advantages and disadvantages of each of these possibilities?

Overall the post-crisis reforms to Basel III has recommended a closer alignment of capital standards in the Standardised Approach with the IRB Approach in terms of providing more consistency, transparency and quantification of capital levels between the two approaches including having a risk weight floor for the IRB Approach relative to the Standardised Approach capital. This will ultimately assist in levelling the playing field between IRB and Standardised banks.

We agree a floor between the two approaches to credit risk is a sensible first step to close the gap between approaches, and believe local regulators should consider setting the floor at a level that provides no doubt that systemically important financial institutions are appropriately capitalised, whilst still maintaining a differential in the capital for IRB banks to incentivise effective risk modelling of capital for multiple uses within a bank.

Given IRB banks are systemically important to New Zealand, represent 89% of total banking assets for locally incorporated registered banks at 30 September 2017, it may be prudent that the RBNZ considers implementing an Output Floor that reflects the concentration of banking assets. Additionally, as residential mortgage assets represent 48% of total IRB bank assets at 30 September 2017, it may also be prudent to consider implementing a second Output Floor relating specifically to residential mortgage assets.

National regulators in Canada and the United States of America have implemented, or are in the process of implementing, Output Floors that exceed the Basel minimum of 72.5%. In Canada, the Office of the Superintendent of Financial Institutions is implementing a revised capital floor requiring regulatory capital for banks using internal models to be equivalent to higher than 75% of the regulatory capital calculated under the Standardised approach. In the United States of America, banks that use the IRB approach are already subject to additional credit risk capital requirements under the Collins Amendment to the Dodd-Frank Act. Under the Collins Amendment, U.S. banks must calculate credit RWAs under both the IRB and Standardised approach and are bound by the approach that yields the higher value for RWAs. Therefore, U.S. regulated IRB banks are already subject to an output floor of 100%.

Recommendation

Genworth believes that two Output Floors (one for mortgage assets and one for total bank assets) of between 80% and 90% would significantly close the gap between the two approaches whilst still maintaining an incentive for banks to maintain the highest quality of capital models.

8. Contacts

Our key contact people for matters relating to this submission are:

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