Kiwi bank.

19 March 2018

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By email: CapitalReview@rbnz.govt.nz

Dear Ian

Submission: Review of the Capital Adequacy Framework for locally incorporate banks: calculation of risk weighted assets, December 2017 (Consultation Paper)

Kiwibank welcomes the opportunity to submit on the above Consultation Paper. Our key submissions are set out below. Responses to some of the questions posed by the Consultation Paper are attached.

Kiwibank believes the Reserve Bank should use the current framework review to transition to using the new Basel Standardised methodologies for all NZ locally incorporated banks. While that option has been discounted in the Consultation Paper, Kiwibank believes that decision should be reconsidered. The cumulative impact of the many variations and overlays the Reserve Bank has imposed on top of the existing and proposed Basel IRB and Standardised methodologies means the Reserve Bank, as well as local or global stakeholders, cannot easily and accurately assess the comparative capital strength of the NZ banks against their international peers. The local rules around calculating risk weights mean the NZ banks significantly understate their capital strength when compared to each other, and to those banks in other jurisdictions which do follow the Basel approaches. There is nothing in the Consultation Paper that would address this fundamental problem of how to accurately assess and compare the capital adequacy and financial strength of the NZ banks.

Adopting the new Basel Standardised approach would provide a number of advantages:

- The Reserve Bank, along with depositors, investors, rating agencies and other stakeholders, would be able to more accurately assess and compare the capital adequacy of all NZ banks in a way that is far more transparent and consistent as well as supporting global comparisons.
- 'Capital conservatism' could then be set more objectively with the next stage of the framework review used to set minimum capital ratios (above current minima) to levels that meet the Reserve Bank's assessment of the capital required to cover the additional risks inherent in the NZ economy. As long as that minimum ratio setting was supported by empirical evidence, Kiwibank believes that approach would be a far more effective means to achieve the objectives of the review while also meeting the requirement to maintain a resilient and efficient financial system.
- A single capital calculation would support competitive neutrality within the NZ banking environment by placing all the banks on the same risk weights and would remove the capital advantages currently

available to the IRB banks. This would have the effect of improving retail banking competition to the benefit of all New Zealanders.

The Consultation Paper is predicated on maintaining the capital and risk weight differentials between the IRB and Standardised banks. We recognise that dual approach may have some value in maintaining greater risk sensitivity in the corporate portfolios and it permits greater consistency with the Australian regulatory approach. However, Kiwibank believes those advantages are outweighed by the uneven competitive landscape this creates within the NZ banking system. If the decision is made to retain the dual capital adequacy assessment approaches, Kiwibank recommends removing or, at the very least, significantly reducing the risk weight differentials applying across the retail portfolios. The lack of local and global evidence supporting risk weight differentials between IRB and standardised banks for the retail portfolios (mortgages, SME and Credit Cards) supports the move to a common approach to calculating capital against these portfolios.

In our response to the Issues Paper, Kiwibank noted that capital conservatism should only be considered a possible outcome rather than an objective of the Reserve Bank's review of the NZ capital framework. We also noted that the practical issues of a lack of transparency and consistency with international capital measures would prove to complicate any assessments of capital adequacy and relative conservatism. Analysis undertaken by PwC show the New Zealand IRB banks are already conservatively capitalised compared with IRB banks in other jurisdictions. Our analysis indicates that same position also applies to the Standardised banks in New Zealand. Kiwibank recommends that any move the Reserve Bank might make to introduce further capital conservatism only be determined after a full analysis of the current state and international comparisons, and by an objective view of the additional risks that need to be addressed through additional capital, in order to sustain the NZ financial system.

We would be happy to discuss our response with you. If you wish to do so, please contact me or Loretta DeSourdy, Head of Regulatory Affairs.

Kiwibank consents to the publication of this submission provided that certain information is withheld to protect the privacy of individuals. We have provided a blacklined version for this purpose.

Kiwibank's Response to Questions:

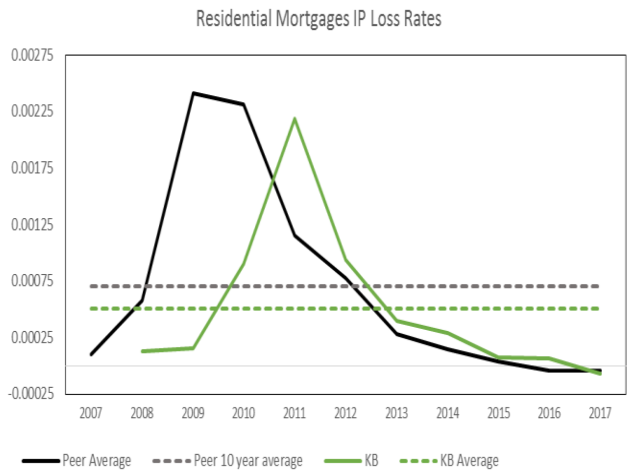
As Kiwibank is a Standardised bank, we have responded only to questions directly related to proposed changes to the Standardised risk weight calculations or where we have a particular view or interest. Our responses are as follows:

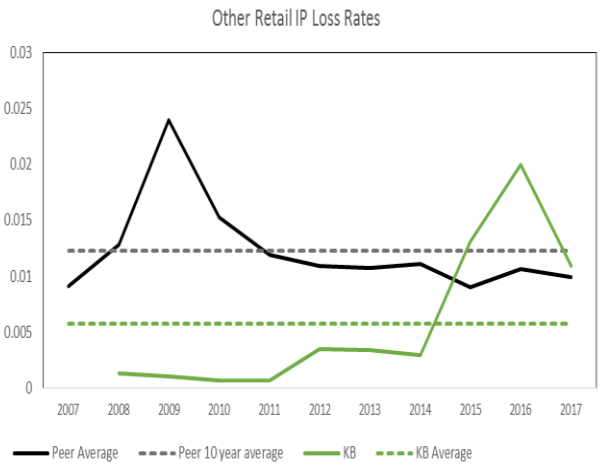
Question 1.3: A key issue in this paper is whether or not the differences between risk weights across the banks, including those between IRB and Standardised banks, are justified by differences in the underlying risk of portfolios. Are you aware of evidence that the underlying risk – within an asset class – is substantially different across banks, or not substantially different?

We note that two of the Reserve Bank's framework review principles are that capital should be set in relation to the risk of bank exposures and, where there are multiple models for determining capital requirements, outcomes should not vary unduly between banks. The current internal models regime generates very different capital outcomes for residential mortgage, SME and credit card portfolios compared to the Standardised calculations. The Consultation Paper indicates there is little if any overseas evidence to support that difference. We believe the same situation applies in NZ.

Since it was established in 2001, Kiwibank has not identified any material differences between the risk profiles of its residential mortgage, SME, and card portfolios, and those of the IRB banks. That period includes the GFC which is the only significant credit event impacting NZ over the last 25 years. Portfolio homogeneity is difficult to prove as we do not have access to the underlying customer demographic data in other bank portfolios. However, our monitoring of the relative risk performance of those portfolios, through industry bodies and through published Disclosure Statements, suggests Kiwibank's Standardised portfolios actually have a lower loss and delinquency performance than those of our peers using internal models.

The following charts set out Kiwibank's mortgage and other retail loss rates compared to the 4 IRB banks since each of the banks started providing asset class loss data in their Disclosure Statements.





While we recognise that any number of factors will impact that portfolio risk performance, our experience demonstrates to us these portfolios are relatively homogeneous in practice. We do not believe the NZ retail markets are large enough to allow the banks to maintain mass market scale while also seeking differentiation by limiting their business to specific sub-segments with potentially different risk profiles. As a result, we do not see internal models providing any greater risk differentiation from a capital calculation perspective beyond that already available under the Standardised regime.

Kiwibank believes internal credit models provide effective credit risk measurement and risk discrimination within the retail portfolios which allow banks to better optimise portfolio risk rewards. Kiwibank has invested in developing these credit models in order to lower costs and to better manage credit risks within the portfolio and at origination. While the banking industry has adopted modelling for credit risk measurement due to the weight of empirical evidence supporting those models, we do not see any evidence that this also translates into better estimates of the capital required to support retail portfolios in a downturn. There simply is not the length of experience to empirically support those models.

Despite the homogeneous nature of these portfolios in NZ, the effect of those capital model differences is to provide the IRB banks with significant capital and competitive advantages over the locally owned Standardised banks. Those competitive advantages reinforce the existing high concentration of retail banking amongst the IRB banks which generates additional systemic risks for the banking system as a whole. The Reserve Bank's preferred options in the Consultation Paper do little to minimise those capital differences. Kiwibank recommends the current risk weight differentials applying between the IRB and Standardised banks should be removed for the mortgage, SME and card portfolios, in the absence of any definitive empirical evidence that risk profile differences do actually exist in the NZ market.

Question 1.5: The Reserve Bank has in the past followed Basel standards, but has made exceptions where it has been appropriate for New Zealand's circumstances. For example, in 2015 the Reserve Bank announced it would drop the F-IRB approach to improve the clarity of the capital standards, because the F-IRB approach was not being used in New Zealand and (even if it were being used) there is flexibility to modify the A-IRB approach in a way that achieves the same outcomes. Over time these sorts of changes have taken the New Zealand standards somewhat further from the Basel standards. Do you have any comments on the Bank's approach to adopting the Basel standards?

Kiwibank reiterates its previous submissions that NZ's capital calculation standards should be aligned more tightly with the Basel standards. Closer alignment would improve transparency and comparability and aid the local and global understanding of the strength of NZ bank capital. That would also aid improved market discipline. The current Reserve Bank capital standards for both IRB and Standardised calculations deviate significantly from the Basel standards. The IRB calculations, in particular, are very complex and the effect of the NZ regulatory overlays are probably only really understood by the Reserve Bank and the banking teams responsible for carrying out the actual calculations. Investors, analysts and the ratings agencies should not be expected to try and interpret the various add-ons that are currently applied. Those stakeholders can effectively only look at and compare the headline capital ratios or they have to undertake their own proprietary calculations to make some sense of the different methodologies. The ratings agencies have already been forced to take this latter approach.

The current Reserve Bank standards materially understate the actual strength of the NZ banking system compared to overseas jurisdictions. The current NZ approach to measuring standardised risk weights is very conservative and means capital ratios appear low compared to international bank capital ratios. Estimates of the effect of the cumulative additional risk weight overlays that the Reserve Bank has implemented vary. In the initial Issues Paper the Reserve Bank estimated that NZ IRB bank capital ratios would be uplifted by 1-2% to achieve a like-for-like comparison with international ratios.[1] However, a review of NZ IRB bank capital ratios undertaken by PwC, and based on APRA's approach to understanding internationally harmonised capital ratios, stated that "An upward adjustment of approximately 6% is reasonable in order to restate the Common Equity Tier 1 (CET1) ratios of the NZ major banks to an internationally comparable basis."[2]

While no equivalent study has been undertaken for the Standardised banks, the fact that the Reserve Bank has applied similar additional overlays to the Basel Standardised risk weights suggests NZ Standardised banks would also see a material uplift in capital ratios compared to Standardised banks in other jurisdictions. We have undertaken an internal assessment of the difference in capital ratios between the current Reserve Bank's BS2A Standardised approach and the new Basel Standardised methodology. That indicates Kiwibank would experience a 3-4% increase in its CET1 ratio if it was able to move to the new Basel Standardised methodology.

While the Reserve Bank's application of additional conservatism may have been appropriate during a period where the Basel Standardised methodology was too simplistic, the new Basel approach to measuring credit risk provides additional risk differentiation calibrated to experience across multiple jurisdictions. That would appear to provide a better empirical base for the Standardised metrics that NZ should also use. As an additional benefit, having aligned methodologies allows effective comparisons of portfolio risk profiles across similar economies giving NZ banks and the regulator a better assessment of the potential impacts of a changing credit cycle on NZ, as banks in other economies will be operating in differing parts of the credit cycle.

We support the Reserve Bank's recommendation that all NZ banks be required to report capital ratios calculated on a Standardised basis. However, Kiwibank recommends these should all be calculated against the new Basel Standardised methodologies. Reporting would then be undertaken on a completely comparable basis supporting the Reserve Bank objective of improved transparency and market discipline as well as having the added benefit of growing depositor financial literacy. The current Reserve Bank initiative to report key financial metrics via a quarterly dashboard appears the ideal vehicle to report comparable capital ratios for all banks in NZ.

[1] Reserve Bank of New Zealand - Review of the Capital Adequacy Framework for Locally Incorporated Banks – Issues Paper May 2017. Footnote 47 page 31

[2] PwC International Comparability of the Capital Ratios of New Zealand's major banks – October 2017 page i

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 grounds for retaining or dropping the IRB approach for retail exposures?

We support the removal of the IRB approach for retail portfolios as set out in our response to question 1.3. The new Basel Standardised approach provides more risk sensitivity as it allows for more LVR bands than the current Reserve Bank approach and should be adopted in its stead. That new methodology aligns better with our actual loss experience where LVRs drive almost all the differences in provisions and write-offs between individual exposures. We believe the Whole Loan Approach within Residential Real Estate would more than sufficiently cover owner occupier borrowers while the Income Producing Residential Real Estate LVR based factors provide sufficient sensitivity for investor mortgage loans. While we believe the differential between those two sets of LVR based factors is larger than would be experienced in the NZ market, the desire to align to the new Basel Standardised approach, without trying to create a special NZ version, outweighs that potential concern.

We agree that the other retail exposures are relatively minor in comparison to residential mortgages so the simple regulatory retail transactor and revolver approach would be sufficient for calculating capital for the credit card portfolio.

Question 2.3: One of the options for credit risk would involve entirely replacing the IRB approach with the standardised approach. This paper notes that the standardised approach is not very risk-sensitive for exposures to corporates without external credit rating. Would the lack of sensitivity for unrated corporates pose a significant problem? Why or why not? How might the lack of sensitivity be remedied within the standardised approach (noting that BCBS failed to find variables which reliably distinguished risky exposures from less risky exposures)?

Kiwibank operates under the Standardised methodology for corporate exposures which provides no differentiation for different risks. If BCBS is unable to identify variables which reliably differentiate risk in larger economies then we wonder how the NZ internal models are able to do so empirically.
However, we acknowledge the potential downside of applying single risk weights for corporate exposures. NZ needs to support the formation of new businesses to generate income and wealth and it needs to ensure the continued access of existing business to bank funding. Widening the capital allowance between residential mortgages and corporate exposures may disadvantage the productive sector at the expense of over-allocation of lending into residential investment.

In a similar vein the importance of rural lending to the NZ economy suggests those exposures should be separately assessed for capital compared to other corporate exposures. Most rural exposures are backed by land security so will have a very different loss given default and risk weight profile than ordinary corporate exposures. If the decision was made to entirely replace IRB with the Standardised approach the Standardised Credit Risk Weight Assessment Approach could be used to assess capital requirements for rural lending.

Question 2.5: Do you consider the current public disclosures by banks provides enough information/not enough information / too much information about the way in which capital requirements have been determined under the IRB approach? What further information, if any, would be desirable and what would you use it for? If you favour less disclosure or no more than at present, what are your concerns about additional disclosure? Do you have any comments on the Reserve Bank's preferred option of dual reporting of IRB and standardised outcomes?

Kiwibank believes the issues around the current capital reporting regime for IRB banks are not caused by the volume of information but by the lack of conformity of the disclosures between the IRB banks. The banks use differing approaches to how they present PDs and LGDs and how these are banded so that comparisons are basically impossible to make. Kiwibank reviews these disclosures to try and benchmark portfolio risk performance and to identify any changes in portfolio quality which might impact the wider market. However, we find the current disclosures do not really support those reviews. Kiwibank believes the current specific instructions for the provision of LVR reporting provide a more appropriate reporting template than the current risk weight disclosures. The IRB banks should be required to provide capital requirements and risk weight information using the same format and the same definitions otherwise their results will remain unable to be usefully compared. Transparency and clarity are not possible in the current reporting environment.

As indicated earlier, Kiwibank recommends all NZ banks move to the same reporting standard. If the option of dual reporting is retained we caution that will only be effective if all the banks follow the same reporting formats. At its simplest, that reporting could be achieved via the dashboard as that will provide a simple common format incorporating the headline capital ratios that all stakeholders actually focus on.

Kiwibank recommends the full BCBS new Standardised methodology replaces the current Reserve Bank variant of the Standardised methodology. The BCBS's new Standardised methodology is more risk sensitive than the Reserve Bank methodology and it will provide the international alignment and comparisons that are not possible under the current regime. We consider that the Reserve Bank should not apply additional overlays to achieve conservative capital outcomes that are not backed by empirical evidence. If capital conservatism remains an objective of this review (and Kiwibank has previously submitted that might not be the most efficient outcome for the NZ banking system) then it would be better achieved and would be more transparent via the Pillar 2 imposts available within the current capital regime rather than implementing another raft of risk weight adjustments.

Questions 2.7: The Reserve Bank is planning to reconsider the zero risk weight for highly rated sovereign exposures in the standardised approach for credit risk. Do you consider that a zero risk weight is justified? If so what is the justification? If not, why not? Apart from a change in the capital requirement, would there be other aspects of moving away from a zero risk weight?

Kiwibank reiterates its concerns that the Reserve Bank should aim for alignment with Basel standards and not continue to deviate from them. We believe the zero risk weight for highly rated sovereigns (and multi-lateral development banks) should remain.

The Reserve Bank advises they apply differentials to the Basel standards where there are unique factors within the New Zealand economic and banking environment. That situation does not apply to highly rated sovereigns as these are off-shore entities independently rated by the ratings agencies. BCBS did review the risk weights applying to these sovereigns within their overall capital framework review but their paper[3] confirmed the existing treatment that no risk weight should be applied. The default probabilities were assessed as being extremely small so that any material risk weights would overstate the actual risk. If the Reserve Bank has analysis indicating the Basel assessment is wrong we would be keen to understand that. Further, if the Reserve Bank ultimately decides to apply a risk weight to highly rated sovereigns then the same treatment should be applied to both IRB and Standardised banks as the underlying risk profile must be the same for this asset class.

Apart from the capital requirement, this proposed change could also have an impact on the composition, and potentially the size, of bank's liquidity portfolios. The proposed increased capital requirement would increase the overall cost of holding liquidity and will encourage a substitution out of the higher quality liquid assets, such as sovereign and multi-lateral development banks, into lower quality assets, while continuing to operate within the constraints of the Reserve Bank's Liquidity Policy (BS13). In extremis, banks may also consider reducing their liquidity buffers in order to reduce the costs of carrying the portfolio. This is a potential impact that concerns us as liquidity is more important to banking system resilience in a crisis than credit quality. We would not be comfortable supporting any proposal that would have the practical effect of encouraging a reduction in the quality of liquidity balances.

Questions 2.9: What are your preferred options for the IRB approach (including options for increasing transparency) and the standardised approach for credit risk? Please tell us why you prefer these options.

We note the Consultation Paper prefers the status quo option for the Standardised approach. Kiwibank's preferred approach for credit risk is to replace both the current Reserve Bank IRB and Standardised approaches with the new BCBS Standardised approach. That approach:

- aligns with international capital standards;
- supports effective comparison of capital adequacy across all the NZ banks;
- removes the risk weight differentials that apply between IRB and Standardised banks that maintain an uneven competitive banking landscape and are not supported by empirical evidence;
- provides sufficient risk sensitivity for the NZ banking portfolios which are dominated by retailed exposures; and
- is transparent and simple to administer, understand, and calculate.

While implementing the new BCBS Standardised methodology as is was one of the options offered by the Reserve Bank another option was to implement the new standard after calibration (with raised minimum loss give default parameters)[4]. That option merely serves to maintain the current approach where risk weights are not comparable and NZ continues to deviate from Basel standards. We are not aware of any empirical evidence that indicates historic NZ residential mortgage loss rates have ever approached those

3 BCBS: Basel lll. Finalising post-crisis reforms December 2017 page4

4 Reserve Bank of New Zealand - Review of the Capital Adequacy Framework for Locally Incorporated Banks: calculation of risk weighted assets December 2017. Footnote 71 page 39

Question 3.4: What is your preferred approach for operational risk? Please tell us why you prefer this option.

implied by currently mandated risk weights. Rather Kiwibank would prefer that NZ apply internationally set risk weights and then apply minimum capital ratios. This could be addressed in the Reserve Bank's forthcoming consultation paper on ratios.

Kiwibank prefers Operational Risk Option 2 – Follow BCBS framework (replace all approaches with the new standardised approach). As BCBS have identified (and the Reserve Bank clearly concurs) there is a lack of global confidence in the outputs of internal models for operational risk. In the absence of empirical support, requiring all banks to use the Basel Standardised operational loss methodology at least puts them on an equivalent basis.

Kiwibank does not believe any move away from internal models will weaken existing operational risk controls and standards. Three lines of defence models are now generally well embedded and will continue to support the effective implementation of risk and compliance standards in NZ banks.

Question 4.4: What is your preferred option for market risk? Please tell us why you prefer this option.

Kiwibank supports Market Risk Option 1 – Status Quo. NZ banks operate relatively simple market trading functions so market risk in the NZ banking environment is relatively low. We agree the current approach is rudimentary but a more complete review of the market risk options is required before any decision to change methodologies is made. The new Basel standards maintain differential treatments between trading and banking books which is at odds with the current Reserve Bank methodology. Consultation on potential changes to market risk methodologies has not even been started and could not be completed within the timeframes sought for the framework review. We believe a considered review, appropriate to the NZ market and cognisant of the new Basel approaches, would best serve this area of banking capital requirements.