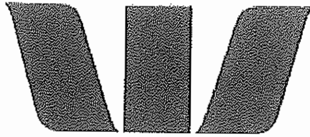

Westpac New Zealand Limited

Submission to the Reserve Bank of New Zealand on the Consultation Paper: Review of the Capital Adequacy Framework for locally incorporated banks: calculation of risk weighted assets

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1. INTRODUCTION

1.1 This submission to the Reserve Bank of New Zealand (**Reserve Bank**) is made on behalf of Westpac New Zealand Limited (**Westpac**) in respect of the *Consultation Paper: Review of the Capital Adequacy Framework for locally incorporated banks: calculation of risk weighted assets* (**Paper**). Thank you for the opportunity to provide feedback. Please find our comments on the Paper and specific responses to the questions raised.

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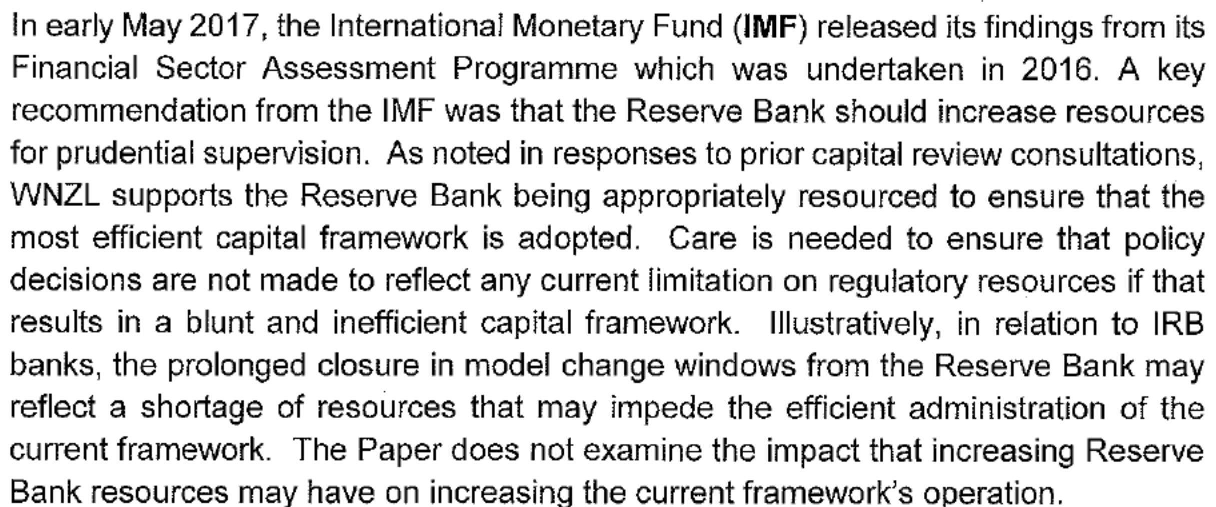
2. EXECUTIVE SUMMARY

WNZL continues to support the review of the capital adequacy framework and acknowledge the intention of the Reserve Bank to achieve a framework that reinforces its three pillars of "self, market and regulatory discipline".

Some of the proposals contained in the Paper appear inconsistent with those in the recently released comparable consultation by the Australian regulator. This gives rise to concerns of partial mis-alignment of regimes for New Zealand registered banks that are accredited to use internal-rating based (**IRB**) models. Given those banks are owned by Australian ADIs (regulated by APRA), in the absence of a compelling distinction between the two countries, the Reserve Bank should seek to align the frameworks to reduce inefficient IRB processes, reporting requirements and increase comparability between the two jurisdictions.

New Zealand's capital framework for credit, operational and market risk should support international consistency. To this end, the Reserve Bank will be aware, and should remain cognisant, of the work already undertaken that independently confirms New Zealand banks are well capitalised relative to international peers.[1] Any subsequent Quantitative Impact Study (**QIS**) will be equally critical to inform decision making on capital instruments and adequacy. That QIS will require significant resource commitment by both the Reserve Bank and participating banks.

[1] See PwC Report available on NZBA website.



In early May 2017, the International Monetary Fund (**IMF**) released its findings from its Financial Sector Assessment Programme which was undertaken in 2016. A key recommendation from the IMF was that the Reserve Bank should increase resources for prudential supervision. As noted in responses to prior capital review consultations, WNZL supports the Reserve Bank being appropriately resourced to ensure that the most efficient capital framework is adopted. Care is needed to ensure that policy decisions are not made to reflect any current limitation on regulatory resources if that results in a blunt and inefficient capital framework. Illustratively, in relation to IRB banks, the prolonged closure in model change windows from the Reserve Bank may reflect a shortage of resources that may impede the efficient administration of the current framework. The Paper does not examine the impact that increasing Reserve Bank resources may have on increasing the current framework's operation.

Our detailed submission is set out below. **Earlier submission remains relevant**.

3. RESPONSE TO CONSULTATION QUESTIONS

General Questions

Question 1.1: This consultation paper lays out some arguments for the use of internal models to determine capital requirements. Are there other arguments that should be considered?

The Paper notes that the Basel Committee on Banking Supervision (**BCBS**) established the internal models approach in 2006. It does not address the fact that the BCBS also modified the standardised approach essentially retaining the relative simplicity of Basel I while increasing the risk sensitivity.

In contrast to the standardised approach, the IRB approach represents a major development from Basel I building on the investment that banks have made in economic capital and systems to better assist in identification, measurement and management of credit risk.

As such, a body of knowledge is built up through banks investing in statistically accurate models. This promotes robust risk management frameworks and controls and improves data management – for credit risk this also leads to a more accurate picture of customers and asset classes that inform decisions such as pricing and risk appetite.

Question 1.2: This paper has commented on studies used by supervisors and other stakeholders to assess the consistency and accuracy of results produced by internal capital models. Do you agree with the Reserve Bank's

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conclusions about these studies? Are there other methods for assessing consistency and accuracy which should also be considered?

It seems correct to conclude that overseas studies are not necessarily reflective of New Zealand conditions. However, WNZL considers this supports retaining aspects of the current regime rather than modifying it.

The Reserve Bank cites "incentive incompatibility" as a key theoretical weakness of the internal approach. In paragraph 20, the Reserve Bank cites evidence from a study of European Banks conducted by the Institute of International Finance, claiming that "...risk weights had in fact plateaued when the internal model approaches were introduced."

Moreover, in paragraph 33, Reserve Bank references a study conducted by Mariathasan and Merrouche (2014), the study suggested the only plausible explanation of lower risk weights following the IRB approach relates to strategic risk modelling, particularly in countries with weaker supervisory regimes. An alternative explanation includes portfolio re-allocation, improved risk measurement and faulty risk modelling.

Whilst accepting these conclusions of overseas studies in New Zealand, the Reserve Bank's broad approach has been to adopt the Basel standards, where appropriate, and implement them with a conservative bias. These include changes within the mortgage portfolio, via LGD floors and correlation requirements, and the Agribusiness portfolio.

That conservative bias has resulted in New Zealand IRB banks remaining highly capitalised relative to international peers (for example, the S&P Risk Adjusted Capital in addition to PwC's New Zealand international comparison previously noted).

Given a more conservative experience in New Zealand, the experience of European banks should not be used as a benchmark for New Zealand. WNZL maintain that variability in the adaptation of the Basel standards remains a fundamental driver in international differences in risk weights, and related credit metrics produced from the IRB approach.

Question 1.3: A key issue in this paper is whether or not the differences between risk weights across 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 of portfolios – within an asset class – is substantially different across banks, or not substantially different?

The differences between risk weights across IRB and standardised banks can be justified by the underlying risk of portfolios.

WNZL believes current reporting standards appear insufficient to expose underlying portfolio dynamics. For example, since November 2015, RBNZ required New Zealand banks to include an Owner-Occupier / Property Investor flag as rating covariates in their Capital calculations. However, the breakdown of owner occupancy is not overt within Disclosure Statements. This in turn masks risk sensitivities of portfolio dynamics should any bank have a disproportionate concentration within investment property.

Question 1.4: This paper has summarised BCBS changes (or proposed changes) to capital requirements for credit risk and operational risk. Do you consider that the summary accurately reflects what has been changed (or proposed)?

Yes.

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 which 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?

Subject to the overarching comment that the Reserve Bank should align with international and Australian norms, it is entitled to make changes to reflect local conditions. The Pillar 3 report compiled by the Bank of International Settlements, noted in Grant Spencer's speech *"Review of bank capital requirements"*, evidences that New Zealand banks are substantially more conservative in the calculation of RWAs when compared with other jurisdictions. This conclusion is further supported by the work undertaken by PwC in October 2017 outlined in the paper *"International comparability of the capital ratios of New Zealand's major banks"*.

A. Credit Risk Responses

Question 2.1: Several options are presented for limiting the use of IRB models. Under three of those options IRB models would be replaced by the standardised approach for bank, sovereign, and large corporate exposures. For these exposures do you consider that internal models can provide more information about risk than external credit ratings? Why or why not?

Sovereign exposures could benefit from the use of an external credit rating, given risk stability. However, the same reasoning does not apply to conclude that external ratings provide more information relative to the IRB approach to bank and large corporate exposures.

In paragraph 124, the RBNZ states "A drawback of reliance on external ratings is that errors by rating agencies could have wider consequences. Poor external rating practices were implicated in the global financial crisis, and in the aftermath the United States made changes to its banking regulation to reduce reliance on external ratings".

The use of external ratings to standardised exposures for bank and large corporate could have the effect of concentrating risk due to [assumed] rating stability. WNZL believes that private information related to the customer remain relevant for the use of expert judgment. Standardisation of banks and large corporates would eliminate the use of expert judgment, and jeopardise independent risk taking amongst banks.

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?

The current standardised approach for residential mortgages is insufficient to differentiate risk drivers as it takes a blunt view of risk sensitivities. Within BS2A (See Table 4.11), standard residential mortgages are currently only partitioned by LVR at origination and occupancy status only – owner occupied or investment property.

Mortgages are a relatively homogenous retail product. However, there are stronger risk drivers besides those identified by the standardised approach. For example, serviceability remains a critical dimension in the underlying risk of mortgages that does not feature in the risk elements of the standardised approach.

Thus, removing the IRB approach in favour for the standardised approach would detriment risk capture of the underlying residential mortgage portfolio. More specifically, it eliminates the possibility for banks to identify and moderate risk accordingly to their risk appetite and profile.

Other retail exposures are relatively small but, similar to residential mortgages, serviceability remains a key risk driver to profile the portfolio of other retail products.

Therefore, the IRB approach should be retained for retail exposures:

- IRB Banks are better placed to measure risk across the portfolio with a large investment in models and research. The Reserve Bank can and has over time introduced a number of changes to the framework.
- In contrast, the standardised approach is very simplistic and overly conservative.

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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 ratings. 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 the BCBS failed to find variables which reliably distinguished risky exposures from less risky exposures)?

Question 2.4: 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?

As with other aspects of this review, where the floor should be set (and the level of the floor) should reflect not only New Zealand geographical factors but also the approach adopted internationally (and in particular by APRA).

Question 2.5: Do you consider that current public disclosure 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?

Disclosure statement information on capital by asset class could be more prescriptive to enable better comparison across banks (for example, in relation to Agri or the mix of investors and owner-occupiers). Dual reporting of IRB and standardisation could provide greater transparency.

Question 2.6: 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)

Refer to the responses in 2.2 and 2.3 above.

Question 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 capital requirement, would there be other effects of moving away from a zero risk weight?

Contrary to the BCBS, the Reserve Bank are proposing a standardised approach for Sovereigns. As a result the BS2A would apply which is consistent with the BCBS standardised approach with zero risk for highly rated exposures. As in all standardised risk weights, the onus is on the Reserve Bank to demonstrate the rationale for the weightings.

Question 2.8: Would any of the options for credit risk have consequences that are not discussed in this paper? If you are responding to this consultation paper on behalf of a bank it would be helpful if you would provide quantitative estimates of the effect on capital ratios and other relevant metrics (though a more formal quantitative impact study is also planned for a later stage of the review).

The wider impacts of this on the economy are not considered within the review. IRB modelling provides benefits for banks and customers beyond the capital reflex: in terms of more granular risk analysis resulting in better pricing and risk decisions.

The Paper states that:

- A risk floor could be aggregated or fine-grained;
- The level of the floor would be calibrated at the conclusion of the review; and
- In addition, Reserve Bank have not commented on the removal of the 1.06 scalar as per the BCBS;

As such, it is not currently possible to quantify estimates in any reasonable way. The more formal quantitative impact study will provide better guidance on the potential increase or decrease in Credit RWA at both a portfolio and total level.

Question 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.

WNZL prefers Option 2 for credit risk modelling and retain the status quo in terms of standardised exposures. That approach will bring capital modelling and regulation closer to international standards as proposed by the BCBS.

We note that APRA has begun consultation on revisions to the capital framework. On early review it does appear that this does differ to the options currently being explored within the RBNZ consultation.

B. Operational Risk Responses

Question 3.1: The BCBS has replaced AMA with a new standardised approach for operational risk. Do you agree with the BCBS's assessment of internal operational risk models (i.e. that they have not evolved so that there is an accepted approach which produces accurate and consistent outcomes)? Please explain why you hold this view.

Yes. While each bank will have similar inputs, each will utilise different modelling techniques, which leads to outcome variability.

Question 3.2: If the AMA was replaced, banks currently using AMA would not have to meet all the procedural and systems requirements currently contained in that approach (the new standardised approach is essentially formulaic). Do you consider that similar requirements should be imposed in any new approach? Should such a requirement apply only to banks formerly using AMA, or to all banks? Please provide reasons for your view.

Like credit risk, prudential operational risk management makes sound business sense beyond any capital consequences. Those requirements (assuming scaleability) should apply to all registered banks consistent with the Reserve Bank's overall purpose to maintain New Zealand's financial stability.

Question 3.3: Would any of the options for operational risk have consequences that are not discussed in this paper? If you are responding to this consultation paper on behalf of a bank it would be helpful if you would provide quantitative estimates of the effect on capital ratios and other relevant metrics (though a more formal quantitative impact study is also planned for a later stage of the review).

A key non-financial consequence, should Option 2 be introduced, would be a reduction in operational risk management good practice. The financial consequences will result in higher Operational risk capital levels being required.

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

WNZL supports Option 3 – to follow the BCBS framework, but also require advanced risk management.

C. Market Risk Responses

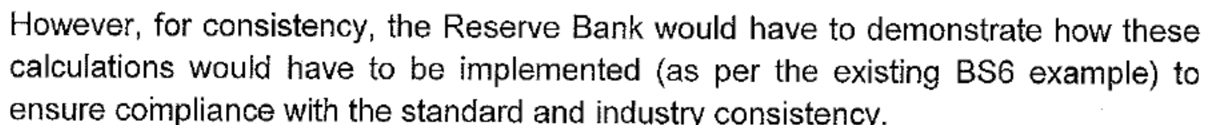
Question 4.1: New Zealand's market risk standard is rudimentary and quite old. Do you have any specific concerns about risks the standard is omitting, or under or overstating? Would the new standardised approach recently introduced by the BCBS be an improvement? Or the simplified standardised approach proposed by the BCBS?

No material concerns about the risks the current market risk standard is omitting.

Admittedly, the current methodology does not capture the effect of counterparty defaults on derivatives, but as stated in the Paper, this is captured partially in credit capital – so the shortcoming is offset.

Given what is stated above, any benefits of the new approach would be greatly outweighed by the implementation cost of changing the current methodology.

Question 4.2: The new standardised approach introduced by the BCBS requires more complex calculations than the current New Zealand approach. In your view, would it be practical to apply it in New Zealand? (E.g. would the necessary information and expertise be available to undertake the calculations?). Would you have the same view about the simplified standardised approach?



However, for consistency, the Reserve Bank would have to demonstrate how these calculations would have to be implemented (as per the existing BS6 example) to ensure compliance with the standard and industry consistency.

Clear guidelines may make the approach practical. The simplified standardised approach would be easier to implement.

Question 4.3: Would any of the options for market risk have consequences that are not discussed in this paper?

None other than what is already captured here.

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

The status quo should be maintained.