RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

23 April 2020

Dear CEO

Over the past few weeks the Reserve Bank has received a number of questions from across the financial sector about the implementation of a number of recent policy decisions. This letter confirms the Reserve Bank's position on the appropriate approach that will apply in the following areas:

- Implementation of regulatory capital calculation for the Business Finance Guarantee Scheme by banks operating the Standardised and Internal Ratings Based (IRB) approaches to credit risk.
- Implementation of the mortgage deferrals programme by banks.
- A proposal from the New Zealand Bankers Association (NZBA) to extend the approach taken to the mortgage deferrals programme by banks to cover all SMEs and agriculture lending.
- The implementation of mortgage deferrals by Non-Bank Deposit Takers (NBDTs), including any extension of this beyond mortgages.

Implementation of the Business Finance Guarantee Scheme by IRB banks

On 24 March, the government announced a Business Finance Guarantee Scheme (BFGS) for small and medium-sized businesses. The Crown will carry 80% of the credit risk, with the other 20% to be carried by the banks. As such, in the event of default, the loss imposed on a bank would be 20% of what it would otherwise be.

These guarantees reduce the risk to banks in eligible BFGS loans, which needs to be reflected in the associated credit risk weighted asset estimates. The approach described in this letter reflects discussions with IRB banks in the past few weeks, to implement a consistent approach across all IRB banks.

- Eligible exposures could fall into either the Retail SME or Corporate asset classes.
- Within the Corporate asset class, BS2B 4.19 and 4.26 allow for PD or LGD substitution subject to meeting the requirements in sections 4.98-4.133. Similarly, BS2B 4.160 sets out an equivalent approach and requirements for the Retail asset class.
- PD adjustments are not appropriate for the BFGS, as such adjustments may compromise the integrity of banks' internal rating scales used for credit risk management, reporting, and risk-based pricing.
- Accordingly, adjustments should be made to recognise the risk-mitigating effect of the Crown risk share through lower LGD estimates.
- For BFGS exposures banks may apply their existing internal LGD estimates (where greater than 12%), or a fixed LGD of 12% - this reflects the following factors:
    - If a loss was realised on a BFGS loan, there would be a 0% loss rate for the bank on the 80% of the exposure covered by the Crown guarantee.
    - For simplicity, the residual 20% will be treated as unsecured (as any security must be exhausted before a claim is made).

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- Most IRB banks' unsecured LGD estimates for corporates are approximately 60%.
- The BFGS LGD is therefore ((80% * 0%) + (20% * 60%)) = 12%.

The Reserve Bank will require all IRB banks to take this approach to estimating credit risk for loans made under the BFGS.

If an IRB makes the above changes to their LGD models – and only the changes outlined above – each IRB bank should update its compendium of approved models and provide a copy, including any supporting documentation, to the Reserve Bank. That is, if these changes (and only these changes) are made then the Reserve Bank will treat them as approved models. As such, banks need not apply for model change approval, but it is important that the compendium is updated for tracking and monitoring purposes.

We have also had some questions about how banks should apply IFRS9 provisioning rules for the BFGS. BFGS loans should only be made to viable businesses. It is our understanding that this means the loans should be "performing" and therefore movement of these exposures to Stage 2 should not be needed at this time (refer to IASB guidance referenced below). If loans experience a significant increase in credit risk in the future, banks should follow their usual processes, incorporating the effect of the 80% guarantee.

Implementation of the Business Finance Guarantee programme by Standardised banks

As noted above, the Government will carry 80% of the credit risk, with the other 20% to be carried by the banks.

The approach to credit risk calculations for Standardised banks consists of the following:

- The full value of BFGS exposures should be reported as claims on corporates.
- Claims on unrated corporates are risk weighted at 100%, as provided for in tables 4.9 and 4.10 of BS2A.
- 80% of the loan is guaranteed by the Crown. Exposures to the Crown are risk weighted at 0%, as provided for in Section 28 of BS2A.
- Banks should therefore treat BFGS exposures as claims on corporates, risk-weighted at 20%, i.e. as if they were in rating grade 1 of tables 4.9 and 4.10 of BS2A.

As noted to the IRB banks above, we have also had some questions about how banks should apply IFRS9 provisioning rules for the BFGS. BFGS loans should only be made to viable businesses. It is our understanding that this means the loans should be "performing" and therefore movement of these exposures to Stage 2 should not be needed at this time (refer to IASB guidance referenced below). If loans experience a significant increase in credit risk in the future, banks should follow their usual processes, incorporating the 80% guarantee.

Implementation of the mortgage deferrals programme by banks

The Reserve Bank wrote to locally incorporated banks about the implementation of the mortgage deferral programme on 27 March 2020. As noted in that letter:

- For the purposes of BS2A 43(h) and BS2B 4.268-4.269, banks should treat these loans as performing (non-defaulted) loans, provided they were not otherwise recorded as in arrears, on a watch-list or impaired in any way at February 29, 2020 (i.e. loans that were 30 days or more past due).

- Banks should not treat the period of the repayment deferral, provided as part of a COVID-19 support package, as a period of arrears when determining whether a borrower is 90 days past due. The counting of days past due is stopped when the repayment deferral is granted.
- Banks should not treat loans granted a repayment deferral, as part of a COVID-19 support package, as a distressed restructuring.

In response to some of the questions we have received, this letter confirms the following:

- Deferrals can be of any length up to six months, as agreed between a bank and the borrower, and deferrals can include interest only loans.
- Banks should follow their usual processes for capitalising interest on deferred loans.
- The comments in the 27 March letter regarding IFRS9 provisioning remain valid: "given the sudden onset of COVID-19 and very high levels of uncertainty, it may currently be a challenge for banks to identify reasonable and supportable information and data needed for reliably measuring expected credit losses and the appropriate treatment of loans with COVID-19-related repayment deferrals under IFRS9. In the near term, banks should exercise careful judgement in ensuring they can reliably estimate expected credit losses."
- Recent guidance from IASB provides a discussion of IFRS9 issues in the current environment https://cdn.ifrs.org/-/media/feature/supporting-implementation/ifrs-9/ifrs-9-ecl-and-coronavirus.pdf?la=en

NZBA proposal to extend the deferrals programme to cover all SMEs and agriculture lending

The NZBA wrote to the Reserve Bank on 15 April 2020 with a proposal to extend the deferrals approach to cover all SME and agriculture lending.

This letter confirms that the Reserve Bank is comfortable with this approach and that, as with the mortgage deferrals programme:

- Banks should treat these loans as performing (non-defaulted) loans, provided they were not otherwise recorded as in arrears, on a watch-list or impaired in any way at February 29, 2020 (i.e. loans that were 30 days or more past due).
- Banks should not treat the period of the repayment deferral, provided as part of a COVID-19 support package, as a period of arrears when determining whether a borrower is 90 days past due. The counting of days past due is stopped when the repayment deferral is granted.
- Banks should not treat loans granted a repayment deferral, as part of a COVID-19 support package, as a distressed restructuring.

Implementation of mortgage deferrals by Non-Bank Deposit Takers, including any extension of this programme beyond mortgages

NBDTs have approached the Reserve Bank for guidance about whether NBDTs can also provide mortgage deferrals. NBDTs have also asked for the Reserve Bank to extend the regulatory guidance provided to banks regarding deferrals to also cover NBDTs.

There is no regulatory barrier to NBDTs providing mortgage deferrals under the Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010. The

Reserve Bank is comfortable with NBDTs providing deferrals for mortgage lending, or any other type of lending that they provide.

This letter also confirms that the regulatory approach for banks is not relevant for NBDTs.

The primary outcome of the approach described to banks in the letter of 27 March 2020, is to avoid the impact on banks' calculations of risk weighted assets if deferred loans were assessed under the normal processes for defaults. Without this intervention, the risk weights would be substantially higher. This has not altered the regulations, but has altered the way that banks should apply them, given the current environment.

The regulations for NBDTs do not impose such treatment in the calculation of NBDTs' risk weighted assets. As a result, loan deferrals do not result in an increase in risk weighted assets in the way that banks would be affected.

Some deferrals may result in an increase in LVRs for NBDTs, but we do not intend to seek to amend the Deposit Takers Regulations.

We thank you all for the work you have undertaken to-date to support households and businesses through these challenging times.

Yours sincerely

Toby Fiennes
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