Appendix I - Response to submissions from consultation on standardised approach

Background

We received a number of submissions on the draft document: *Capital Adequacy Framework (Standardised Approach)* (BS2A). The main points raised in submissions and our responses to those points are set out below.

Property valuations for residential mortgages

Introduction

A number of submissions were made with regard to the valuations to be used for calculating loan-to-valuation ratios for loans secured by first mortgages over residential property. Submissions highlighted practices that rely variously on purchase prices, rating valuations and property specific valuations provided by independent valuers. Questions were raised both in relation to the types of valuation that could be used and the timing of valuations.

Discussion

In response to submissions we have decided to allow banks to set their own policies for determining when independent valuations are required and when purchase prices can be used to determine loan-to-valuation ratios for residential mortgages. For example, some banks may have a policy which requires independent valuations for loans which exceed a certain percentage of the purchase price of the property over which the loan is secured, but which allows the use of purchase price for other loans secured over residential property. In all cases banks' policies must be approved by their boards of directors.

The document requires valuations at origination to be used in order to reduce the potential pro-cyclical effects on capital of movements in property valuations over time. Accordingly, we have decided to retain the requirement that valuations for loan-to-valuation ratio purposes be set at origination. However, some changes have been made in response to submissions to clarify that requirements to use a valuation as the date of the loan do not mean a valuation dated the same day of the loan. It is intended that bank policies should provide for the use of valuations available at, or appropriately proximate to, the time of origination of the loan, though in most situations the valuation used would either be an independent valuation determined before the loan is drawn down or the sale price of the property.

Where a bank customer increases the size of an existing loan secured by mortgage over residential property, an updated valuation may be used but only if the extension of additional credit is subject to the same credit assessment processes that would apply for a new loan. Valuations may not, however, be updated when a customer draws down on an existing commitment to lend by way of residential mortgage.

Summary of response

The amendments made to BS2A allow banks to determine their own policies on use of valuations and to ensure a degree of flexibility on the timing of independent valuations used for loan-to-valuation ratio purposes.

Lender's mortgage insurance – 40% threshold

Introduction
Submissions welcomed the recognition of lender's mortgage insurance as a credit risk mitigant but some submitters considered the threshold requirement of 40% cover for recognising the insurance to be too conservative.

Discussion
We consider 40% cover to be prudent for New Zealand's circumstances. The requirements provide a risk sensitive framework of risk weights for housing that recognises qualifying lender's mortgage insurance when loan-to-valuation ratios exceed 80%. One of the main qualifications is that the insurance provide a minimum of 40% cover. We are satisfied that the requirements achieve an appropriate balance between risk sensitivity and simplicity.

Summary of response
No change to BS2A.

Lender's mortgage insurance – eligible guarantees

Introduction
Submissions recommended that lender's mortgage insurance should be recognised on similar terms to guarantees as a risk mitigant, allowing a 20% risk weight to be used.

Discussion
The risk weights associated with lender's mortgage insurance reflect a number of considerations. These include those associated with exposure concentration risk and the underlying differences between insurance and guarantees such as the timing of payments.

Summary of response
No change to BS2A.

Lender's mortgage insurance – required level of financial strength ratings

Introduction
Submissions recommended that the minimum insurance financial strength rating for qualifying lender's mortgage should be AA minus rather than A (and equivalents).

Discussion
The requirements are, in our view, appropriate for New Zealand's circumstances. Requiring, as submitted, higher ratings would limit the range of lender's mortgage insurance providers and could have undesirable implications for the level of competition in the market. Moreover, a reduced range of providers would be likely to lead to an undesirable increase in contingent credit exposure concentration.

Summary of response
No change to BS2A.

Lender's mortgage insurance – Housing Corporation

Introduction

Submissions recommended that Housing New Zealand Corporation (HNZC) should be recognised as a provider of qualifying lender's mortgage insurance.

Discussion

We consider that these submissions have merit. To qualify, under the terms of the draft document, a provider of lender's mortgage insurance was required to have an insurer financial strength rating of A or better (and equivalents). Although HNZC does not currently have an insurer financial strength rating, the quality of the credit risk mitigation provided by the HNZC mortgage insurance scheme appears to be sufficiently high. Factors in favour of change include that the current issuer credit rating is of sufficiently high quality, that the current size of HNZC's insurance portfolio is small relative to the size of its business and that 100% cover is provided under HNZC's scheme, which compares with the 40% minimum qualifying requirement for lender's mortgage insurance.

Summary of response

Changes have been made to recognise lender's mortgage insurance provided by HNZC.

Lender's mortgage insurance – risk weights for loans 90 days past due

Introduction

Submissions propose that if qualifying lender's mortgage insurance is in place for a residential mortgage loan, the risk weight for the loan should not change when it is 90 days past due or impaired.

Discussion

The approach in the draft requirement provided a risk weight of 100% for all residential mortgages when they fall 90 days past due. The position in submissions – to allow the same risk weights for 90 days past due loans, when qualifying lender's mortgage insurance is in place, as would apply if the loans were not past due – provides a reasonable reflection of the underlying risk in such circumstances.

Summary of response

Changes have been made to the risk weight for 90 day past due residential mortgages with qualifying lender's mortgage insurance. With insurance in place, the risk weighting for a 90 days past due residential mortgage is now the same as that which would apply if the loan was not past due.

Unsolicited ratings

Introduction
One submission noted, among other things, that unsolicited ratings are a fundamental element in the independence of rating opinions and that excluding unsolicited ratings from use for regulatory capital purposes raises substantial barriers for entry of new participants in the rating industry.

Discussion
The Basel II framework states that as a general rule banks should use solicited ratings from eligible rating agencies. This reflects an underlying concern about the quality of credit assessments used for capital adequacy purposes. Solicited ratings generally incorporate information not in the public arena and therefore should be of better quality than unsolicited ratings.

Unsolicited ratings have been in use in the market for many more decades than the Basel framework for capital adequacy. It is therefore difficult to see how the conservatism associated with the use of solicited ratings for capital adequacy purposes would have any significant effect on the use of unsolicited ratings in the wider commercial marketplace.

Summary of response
No change to BS2A.

Risk weights for local authorities

Introduction
One submission noted that many securities issued by local authorities are unrated and as a consequence the risk weight for these securities has increased from 20% under Basel I for all local authority securities to 100% under Basel II for unrated local authority securities.

Discussion

We consider a change is warranted for local authorities and have amended BS2A in line with the option provided under the Basel II framework that provides for all local authorities to be rated one category less favourable than of the rating for claims on the sovereign country of the local authority. This simplifies the treatment of local authorities, and results in a more appropriate risk weight for local authority claims compared with those for other types of claim. We note that this now provides a different position to that established in APRA's equivalent draft standard in APS-112.

Summary of response
Changes have been made so the risk weight that applies for all local authorities in a country is one category less favourable than the risk weight that applies for the sovereign of the country.

Minor or technical amendments

A number of minor or technical amendments have been made in reviewing BS2A in light of submissions.