Summary of RBNZ response to submissions on the draft capital adequacy framework (internal models based approach)(BS2B)

Introduction

In September 2007 the Reserve Bank of New Zealand released the draft document: "Capital adequacy framework (internal models based approach)" (BS2B) for consultation. The Reserve Bank received three submissions on the draft BS2B. This note provides a summary of our response to the main substantive issues raised in submissions.

Recognition of double default

Introduction

Some submissions sought clarification about the Reserve Bank's intention regarding the recognition of double default.

Discussion

Although the Basel II Framework recognises double default, it has not appeared to be a major issue for New Zealand banks. Consideration of this issue has not therefore been a priority for the Reserve Bank for the initial implementation of Basel II. However, the Reserve Bank does intend to revisit the recognition of double default in the future.

Summary of response

No change to BS2B.

Retail exposures to small and medium enterprises

Introduction

Two submissions were concerned that the definition of retail exposures to small and medium enterprises (SMEs) used in BS2B be aligned with the definition used in APRA's standard (APS 113).

Discussion

The definition of retail exposures to small and medium enterprises used in the draft BS2B is as follows (underlining added for emphasis):

> Loans extended to small businesses and managed as retail exposures are eligible for retail treatment where the banking group's <u>total exposure</u> to the borrowing enterprise (on a consolidated basis where applicable) is less than NZD 1 million

In APRA's standard the threshold applies to total business-related exposure.

Although in some cases there may be practical difficulties distinguishing "business related" exposures from other exposures to the same party, on balance, the Reserve Bank considers it would be best to align BS2B with APRA's standard in this instance.

Summary of response
The definition of retail SME exposures in BS2B has been aligned with APRA's standard.

Lease products

Introduction
Two submissions were concerned that the treatment of leases in B2SB should be aligned with the APRA standard.

Discussion
The draft BS2B required that leases which do not expose the lessor to residual value risk be treated as unsecured corporate exposures, whereas APRA's standard (APS-113) requires that leases are treated "in the same manner as exposures secured by the relevant collateral". The Reserve Bank considers it sensible to align with the APRA standard in this instance

Summary of response
BS2B now requires that leases that do not expose the lessor to residual value risk be treated in the same manner as exposures secured by the relevant collateral, consistent with the APRA standard.

Commitments - point of recognition

Introduction
One submission noted that the draft BSB2 document does not contain guidance on when a commitment to provide credit should be recognised. Clarification was sought as to whether a commitment should be recognised at the date the letter of offer is issued to the customer, or the date the letter of offer is accepted by the customer.

This issue is relevant to banks' own estimates of credit conversion factors (CCFs).

Discussion
The estimation of CCFs by banks adopting the internal models approach should be based on economic substance (i.e. likely impact on exposure at default - EAD) rather than on a legal test. On this basis, recognising a commitment only on the basis of "acceptance by customer" is insufficient as it does not capture those loans that have been offered (but not accepted) but which may eventually result in an

on-balance sheet exposure. It may be that CCF estimates for a particular portfolio in relation to offers that have not been accepted are very low. However this does not mean that such exposures should be excluded from consideration in the capital calculation.

The discussion above is intended to clarify the RBNZ requirements. Amendments to BS2B in this area were not considered necessary.

Summary of response
No change to BS2B.

Use of internal ratings

Introduction
One submission noted that two references to the "use test" in the draft BS2B document could be interpreted differently. These references are:

> "Internal rating and risk estimates from these systems and processes [those used for capital adequacy purposes] must be used for risk management purposes…" [section 4.221 of the draft BS2B].
>
> "Internal ratings and default and loss estimates must play an essential role in the credit approval, risk management, internal capital allocations, and corporate governance functions…." [section 4.260 of the draft BS2B].

Discussion
The Reserve Bank considers that these references should be consistent. The second reference above is preferable as it is less constraining and more aligned with APRA's standard.

Summary of response
BS2B has been amended so that references to the use test are more consistent and better aligned with APRA's standard.

Retail credit risk components – LGD estimates

Introduction
One submission referred to the loan-to-valuation ratios (LVRs) to be included in the calculation of loss given default (LGD) estimates for residential mortgages, and noted a concern that this was a material difference from the requirements of the Basel II framework.

Discussion
The Reserve Bank considers that the use of LVR risk pools is consistent with the Basel II Framework's requirements to meaningfully differentiate risk and to take account of collateral as set out in paragraphs 401 and 402.

While the imposition of a risk driver by the RBNZ is not first-best, its purpose is to ensure that banks' models are appropriately risk sensitive pending further development of these models.

Summary of response
No change to BS2B.

Risk quantification requirements specific to PD estimation – requirements for the retail IRB exposure class: Years of Observation

Introduction
One submission referred to the requirement in the draft BS2B that there must be at least five years of observations on any data source used in the quantification procedure. The concern was in the context of limited historical loss data and also in the case of new products.

Discussion
As the Reserve Bank has engaged with internal-models banks through the accreditation process it became apparent that it may be difficult for banks to make use of the best available data for modelling if there was a requirement that there must be at least five years of observation on any data source used. Banks' internal data series in relation to some retail portfolios are less than five years. Although this will generally be resolved over time, it would not be sensible to discard all internal data on this basis in the meantime.

Summary of response
BS2B has been amended to require that the total length of the underlying historical observation period used must be at least five years..

Borrower risk characteristics for the retail IRB exposure class

Introduction
Some submissions sought clarification regarding the use of application information and/or debt servicing burden as risk drivers.

Discussion
BS2B does not require that application information be included in banks' models, but it does require that borrower characteristics be taken into account in the model

development process. The examples of borrower risk characteristics provided in BS2B, including debt servicing burden, reflect the Reserve Bank's prior that application information is relevant. The Reserve Bank will require that internal models banks properly test the predictive power of debt servicing burden.

Summary of response
No change to BS2B.

<u>Risk quantification requirements specific to LGD estimation</u>

Introduction
Some submissions commented on the requirement that for residential mortgages downturn conditions should include a fall in average house prices of 30 percent. It was noted that this requirement differs from APRA's standard and the Basel II Framework. The submissions requested that the 30 percent requirement be removed to allow IRB banks more flexibility.

Discussion
Although the Basel II framework requires estimates to be calibrated to downturn conditions, it does not provide guidance on what constitutes a downturn event. The choice of what constitutes a downturn scenario is critical. LGD estimates in particular are very sensitive to this choice as it affects the proportion of defaults that result in material economic loss.

Given the significance of the downturn definition to capital requirements, it makes sense for there to be consistency across NZ banks in this area. The 30% figure is consistent with the Australian FSAP stress testing, the UK FSA benchmark for stress LGD measurement and IMF work on quantifying stress events (i.e. globally it appears to be developing as a benchmark for LGD modelling).

Summary of response
No change to BS2B.

<u>Integrity of the rating processes</u>

Introduction
One submission commented on the requirement in the draft BS2B document that "Rating assignments and periodic rating reviews must be completed or approved by a party that does not directly stand to benefit from the extension of credit".

It was noted that although this requirement is consistent with the Basel II Framework, it does not allow as much flexibility as the corresponding APRA requirement which is as follows: "Unless otherwise approved in writing by

APRA, rating assignments and periodic rating reviews must be completed or approved by a party that does not directly stand to benefit from the extension of credit. Independence of the rating assignment process may be achieved through a range of practices that will be reviewed by APRA" (APS 113 – 21).

Discussion

The separation of rating assignment and review from parties benefiting from the extension of credit is a fundamental control practice. The conservative stance of the Framework and BS2B reflect this point. Even if there were some advantages in taking a slightly more flexible approach for New Zealand banks, the granting of approvals in exceptional circumstances is not a good fit with the RBNZ supervisory approach.

Summary of response

No change to BS2B.

Funds management and securitisation

The Reserve Bank is not updating the capital adequacy requirements from Basel I to Basel II in the area of funds management and securitisation as part of the current revision of capital adequacy requirements (i.e. Basel I standards are incorporated into Basel II requirements in this area). Some submissions commented on matters relating to funds management and securitisation. The Reserve Bank will take these comments into account in future work.