RESERVE BANK
OF NEW ZEALAND

Basel II: New Zealand discretions for the internal ratings-based (IRB) approach to credit risk

Reserve Bank of New Zealand Exposure Draft
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The Basel Committee on Banking Supervision has developed a framework for bank capital adequacy called the *International Convergence of Capital Measurement and Capital Standards*, commonly referred to as "Basel II". The Reserve Bank, like many other bank supervisors, has indicated that it plans to incorporate Basel II into its bank capital adequacy requirements, adapted where relevant to take account of the features of the New Zealand financial system.

The Basel II framework explicitly provides national bank supervisors with options on how to apply Basel II in their jurisdiction. These options are often referred to as national discretions. This exposure draft outlines the Reserve Bank's preliminary thinking on how to treat the national discretions available under Basel II's internal ratings-based (IRB) approach to credit risk.

This exposure draft is intended to provide those banks planning to apply for accreditation to use the internal models approaches with an early indication of the Reserve Bank's thinking on the IRB national discretions, which can be incorporated into their application. The exposure draft does not provide finalised Reserve Bank policy positions, nor is it intended as a consultation paper. The national discretions will form part of the Reserve Bank's revised capital adequacy requirements, and will be consulted on when the Reserve Bank releases its proposed requirements later in 2006.

Ref #	Summary of Basel II Framework discretion	Framework paragraph #	Propose exercising the discretion?
Adoption of IRB approaches across asset classes and transition arrangements			
1	Supervisors may allow a phased rollout of the IRB approach across the banking group	257	Yes – case-by-case assessment and may be subject to consideration under pillar 2. Business areas not using the IRB approach will be required to calculate capital requirements for those business areas using the standardised approach.
2	Supervisors may exempt some banks from being required to adopt IRB approaches for non-significant business units/asset classes	259	Yes – case-by-case assessment based on materiality criteria.
3	Supervisors may relax the data requirements for the IRB approaches during the transition period	264-265	No
Foundation IRB approach			
4	Supervisors may choose to employ a wider definition of subordination in determining FIRB LGDs	288	No
5	Supervisors may require banks using FIRB to make an explicit maturity adjustment for corporate exposures to measure effective maturity instead of assuming all exposures have a 2.5 year maturity	318	No
6	Supervisors may recognise the credit mitigating effects of other forms of physical collateral under FIRB	521	No
Corporate, sovereign, and bank exposures			
7	Supervisors may permit banks to base the SME adjustment on the firm's total assets as a failsafe when total sales is not a meaningful indicator of firm size	273-274	Yes – we will provide guidance in the requirements about when the firm's assets can be used.
8	Supervisors may allow banks to assign preferential risk weights for unexpected loss of 50% to 'strong' and 70% to 'good' PF, OF, CF, and IPRE specialised lending exposures under the slotting approach provided that they meet maturity or other requirements	277	No
9	Supervisors may allow banks that meet the requirements for PD estimations for high-value commercial real estate to use an approach that is similar to the corporate approach, though with a higher correlation assumption	250-251	No. We propose not having a HVCRE specialised lending sub-asset class.
10	Supervisors may allow banks to assign preferential risk weights for unexpected loss of 70% to 'strong' and 95% to 'good' HVCRE specialised lending exposures under the slotting approach provided that they meet maturity or other requirements	282	N/A. We propose not having a HVCRE specialised lending sub-asset class.
Retail			
11	Supervisors may wish to establish exposure thresholds to distinguish between retail and corporate exposures	231 first bullet point	No
12	Supervisors may set limits on the maximum number of housing units per residential mortgage exposure	231 second bullet point	No
13	Supervisors may set a minimum number of exposures within a pool to be treated as retail	232	No
14	Supervisors may mandate seasoning adjustments	467	No
Equity			
15	Supervisors will decide which approach(es) (market-based or PD/LGD) will be used for	341-342	Only the market-based approach will be available. We propose having

	equity exposures, and under what circumstances		materiality thresholds for equity holdings in non-financial companies above which the holding must be deducted from capital. We propose setting these thresholds at 15% of total capital for individual exposures and 60% of total capital for all such exposures.
16	Supervisors may allow banks to employ different market-based approaches (the simple or internal-models methods)	343-349	Only the simple market-based approach will be available. Standardised banks will also be required to risk weight their equity holdings in the banking book using the simple market-based approach.
17	Supervisors may exclude equity holdings in entities whose debt qualifies for a zero risk weight under the standardised approach from being treated under the IRB equity method	356	N/A
18	Supervisors may exclude equity holdings made under legislated programmes from being treated under the IRB equity method (subject to limits)	357	N/A
19	Supervisors may exclude equity holdings from being treated under the IRB equity method on the basis of materiality	358	N/A
20	Supervisors may require a bank to employ one of the IRB equity approaches if its exposures are significant (even if it does not employ an IRB approach for other business lines)	260	N/A
21	Supervisors may allow debt obligations that have the economic substance of equity not to be treated as equity where they are hedged by an equity holding such that the net position does not involve material risk.	Footnote 59 to paragraph 237	No
22	Supervisors may re-characterise debt holdings as equities for regulatory purposes and otherwise ensure the proper treatment under pillar 2	238	No. The treatment of debt obligations that have equity characteristics may be considered under pillar 2.
23	Supervisors may exempt particular currently held equity investments from IRB treatment for 10 years	267-269	N/A
Purchased receivables			
24	Supervisors must establish concentration limits for corporate purchased receivables above which the bottom-up approach for calculating default risk must be used.	242 forth bullet point	NZ$100,000 concentration limit
25	Supervisors may allow banks to recognise guarantors with a PD equivalent to less than A- under FIRB when calculating dilution risk capital requirements	Footnote 78 to paragraph 373	No
Maturity adjustment			
26	Supervisors may exempt facilities to smaller domestic corporate borrowers (<€500 million in assets and sales) from having an explicit maturity adjustment made for them	319	No
27	Supervisors need to determine which instruments will be allowed to be part of the carve-out from the one-year maturity floor	321-322	Allow the short-term exposures listed in paragraph 322 of the Framework to be eligible for the carve-out from the one year maturity floor.
Minimum requirements			
28	Supervisors may require banks that lend to a diverse range of borrowers to have a greater number of borrower grades than the minimum (7 non-defaulted, 1 defaulted)	404	No
29	Supervisors may require an external audit of the bank's rating assignment process and loss	443	No. The Reserve Bank's s.95 powers can be used if needed.

	characteristic estimation process		
30	Supervisors may substitute a figure of up to 180 days instead of 90 days as the past-due criterion for default for retail and public-sector entity obligations	Footnote 82 to paragraph 452	No
31	Supervisors may choose to apply more specific re-aging requirements	458	To be determined. Specific re-aging requirements planned by home supervisors of New Zealand banks will be an important consideration.
32	Converting € thresholds in the Basel II framework to NZ$	Various paragraphs	Use a €1:NZ$1 conversion rate