Reserve Bank of New Zealand new farm lending capital requirements

Feedback statement

Introduction

1. In early April 2011 the Reserve Bank issued a consultation paper proposing changes to the Reserve Bank's Capital Adequacy Framework (Internal Models Based Approach) (BS2B) and proposing a minor consequential change to the Reserve Bank's Connected Exposures Policy (BS8). The changes proposed resulted primarily from the Reserve Bank's review of farm lending capital requirements.

2. The consultation period closed on 29 April 2011, although the Reserve Bank accepted some submissions sent in after that date. In total, the Reserve Bank received four submissions, all from internal models banks. The Reserve Bank also held subsequent discussions with these banks.

3. The Reserve Bank finalised its proposed changes to BS2B to take account of the submissions received and after modifying the proposed changes in response to concerns raised in the submission that the Reserve Bank agreed were valid.

Summary of submissions

4. This section summarises the main issues raised in submissions and the Reserve Bank's response. A further explanation of the Reserve Bank's farm lending capital requirements is provided in the Reserve Bank *Bulletin* (June 2011 edition).

General impact

5. Most banks noted that the cost of the higher capital requirements would be passed onto customers. One bank presented a lengthy submission that argued the impact would make bank funding difficult, tighten credit, hinder the economic recovery, and place farmers under financial stress.

6. In our view the concerns raised in particular by the lengthy submission materially exaggerated the impact of the proposals. Our view is that margins have already been moved to more than compensate for the proposed capital adjustments. Also, the banks' risk weights will remain below the Basel I risk weights that were in effect for nearly two decades until just over 3 years ago, and, following a period of optimistic lending through to 2008, banks have already tightened their lending criteria as they have reverted to more conventional lending standards.

Identification of farm lending exposures

7. All the submissions argued that relying on banks to identify their own farm lending exposures would result in inconsistent application of farm lending capital requirements by the banks, and recommended the use of ANZSIC codes to define farm lending. We agree with this point, and consequently have required adherence to a common definition set out in the capital requirements.

Downturn LGD estimates

8. All banks maintained the proposed LGD estimates were too conservative. The arguments in support of this view included that land prices had stabilised, that there has been a structural shift in

commodity prices and that the estimates do not take account of alternative land use and diversity in the sector. We disagree, moreover the arguments presented did not raise any issues not already taken account of in our earlier analysis of farm price volatility.

Homogeneity in the farming sector

9. Two banks acknowledged correlation among farm lending exposures, while the other two did not agree the industry was homogeneous. Arguments presented against homogeneity included that exposures are diversified regionally (within NZ), across various farm sub-sectors, and that there are limited barriers to change of land use. Consistent with our earlier analysis, we consider the 'diversity factors' identified would have minimal impact on systemic risk.

10. Another argument presented was that small farm exposures are different to large farm exposures as the security of the latter is close to home lending. We note that retail SME lending is not captured by our proposals.

Loan maturity – farm loans

11. Most banks did not agree with the proposal to fix the maturity adjustment, although one bank agreed with the logic with respect to term loans. The arguments against the proposal reflected a view that risk *is* related to contractual maturity. For capital purposes the issue is systemic risk and our analysis has shown the Basel II equation greatly overstates the sensitivity of maturity to systemic risk. In our view, for farm loans in particular, the exposure is equivalent to a term loan, independent of actual contractual maturity. However, we have decided to allow banks to use effective maturities of greater than 2.5 years if they elect to do so and this is consistent with their internal models.

12. While we had expected the removal of the maturity variable would decrease capital requirements for farm loans, according to the submissions we received, the capital of most banks would actually increase. When we investigated this further we found that the maturity variable used by some banks had fallen considerably since accreditation in late 2007. It appears some banks may have reduced contractual maturities to get a capital advantage, notwithstanding our advice to them following accreditation not to do so.

Loan maturity –non- farm loans

13. As with farm loans, there was generally disagreement from banks with our proposal to fix the maturity adjustment for non-farm loans. However, the submissions did not contain any convincing arguments for not calibrating the maturity variable as we had proposed.

14. Prior to consultation we were unsure about the capital impact of this proposal. According to the submissions we received the impact would be to increase capital requirements.

15. Some banks also noted that unlike the farm lending proposals, the proposal on non-farm lending had not been well signalled and that further time should be allowed for consideration. We accept that with more time banks may be able to make a case for using shorter effective maturities in respect of some parts of their portfolios.

16. We have therefore allowed banks more time to make a case that for some particular non-farm corporate exposures the effective maturity variable should not be calibrated as we have proposed.