Banking industry update

April 2017

This is the second edition of the Reserve Bank's *Banking Industry Update*. We intend to issue periodic updates to keep banks informed about current and upcoming initiatives related to prudential policy and supervision, as well as some financial stability issues. The newsletter is organised in two parts. Part I is about ongoing or recently completed initiatives and Part II is about upcoming initiatives.

This edition of the newsletter provides updates on the following initiatives:

- The dashboard
- Financial Sector Assessment Programme (FSAP)
- Restructuring the *Banking Supervision Handbook*
- 2017 Thematic review of the director attestation regime
- Macroprudential update
- Outsourcing policy
- Dual registration policy for small foreign banks
- Statement of policy making approach
- Publication of submissions policy
- Bank balance sheet redevelopment project
- Capital review
- OTC derivatives

Further information on active and completed policy initiatives is available on our website.

If there are topics you would like covered in our updates, or you have a question about any content in this update, please email the team at banking.newsletter@rbnz.govt.nz.

Ongoing or recently completed initiatives

Dashboard approach to quarterly disclosure: In February, the Reserve Bank published a summary of submissions to its consultation from late last year on the 'dashboard' approach to quarterly disclosure for locally incorporated banks.

The dashboard aims to enhance market discipline[1] by publishing key information on locally incorporated banks on the Reserve Bank's website in a standardised and comparable manner. This will support market efficiency as well as financial stability. The dashboard would replace the requirement for these banks to prepare off-quarter disclosure statements.

All submitters on the consultation were supportive of the dashboard's objective to improve the effectiveness of public disclosures by banks, but some submitters raised issues with certain proposed design elements. After a careful review of the consultation feedback, the Reserve Bank considers there should be room to address these concerns, and the dashboard remains the Bank's preferred option to increase the effectiveness of the bank disclosure regime, while minimising any additional compliance costs. The Bank will further engage with stakeholders in the coming months to discuss possible refinements to the dashboard concept and the issues raised during consultation.

1 Market discipline, regulatory discipline and self-discipline are the 'three pillars' that make up the Reserve Bank's approach to banking supervision.

Financial Sector Assessment Programme (FSAP): Early in May, the International Monetary Fund (IMF) will be releasing the findings and recommendations from its 2016 review of New Zealand's financial system – known as the Financial Sector Assessment Programme (FSAP). As noted in the September newsletter, the previous FSAP was conducted over 2003-04.

FSAPs analyse the resilience of the financial sector, the quality of the regulatory and supervisory framework, and the capacity to manage and resolve financial crises. The IMF's assessment covered a number of sectors where the Reserve Bank has regulatory and supervisory responsibilities, including banking, insurance and financial market infrastructures. The health of the banking sector, and the quality of banking sector regulation, was an important focus for the IMF across the two 'missions' that took place in August and November last year. The IMF assessors examined the conjunctural sets of risks and vulnerabilities facing the banking and wider financial system; conducted a series of stress tests of the larger banks to assess their resilience to large, but plausible shocks, and; graded New Zealand against the Basel Committee's 29 core principles for effective banking supervision. New Zealand's macro-prudential policy framework, and the use of loan-to-value (LVR) restrictions, was also assessed, along with the Reserve Bank's approach to crisis management and resolution.

The IMF assessors were very pleased with the cooperation they received from the various regulated entities they met with over the course of the two missions, including their meetings with individual banks. The Reserve Bank appreciates the cooperation industry afforded the IMF assessors.

There are a number of recommendations that relate to the banking sector, and to other areas of Reserve Bank responsibility such as insurance and financial market infrastructures. The Reserve Bank will be considering all the relevant recommendations and the extent to which implementation would support the Reserve Bank's goal of promoting a sound and efficient financial system.

The Reserve Bank will publish a *Bulletin* article following the release of the IMF's main report and supporting material. This will provide further detail on the 2016 FSAP and the key findings and recommendations.

Restructuring the *Banking Supervision Handbook*: The Reserve Bank continues to work on a major exercise to improve the grouping and layout of all of the documents making up the *Banking Supervision Handbook*. The first stage of the work is to reorganise and clarify the documents making up the capital adequacy framework. A working group of banks has been providing informal feedback on specific issues this work has thrown up, and is currently considering an early draft of one of the sample new documents. Further draft documents on capital adequacy will be sent to the group as they are produced, and the plan is to get the full set of proposed new capital adequacy documents out for public consultation later in the year. The Reserve Bank will co-ordinate the staging of this work with that of the capital review. This work on the *Handbook* is not generally intended to make any policy changes, although some minor changes may arise from clarifications. The Reserve Bank is already working in parallel on the later stages of the *Handbook* review, but will not send the revised material out for feedback until the capital adequacy sections have been consulted on.

2017 Thematic review: The Reserve Bank has initiated the thematic review of the bank directors' attestation regime. The review is intended to assess the effectiveness of the New Zealand-incorporated registered banks' arrangements for quarterly disclosure statement attestations, and the processes that bank directors use to fulfil their obligations under sections 81 to 82 of the Reserve Bank of New Zealand Act 1989.

The Reserve Bank has appointed a consulting firm to assist with the review. The review is being conducted in three parts, including: (1) a confidential survey of all directors of New Zealand-incorporated banks, and for selected banks, (2) a desk-based review of attestation process-related information requested by the Reserve Bank and (3) interviews of directors, senior management, and external and internal auditors. The confidential surveys were completed in mid-April and the interviews of directors, senior management, and auditors, will be completed by mid-June.

At the end of the review, the Reserve Bank will provide general feedback to the industry and individualised feedback to the selected banks.

Macroprudential update: The Reserve Bank remains concerned by the elevated levels of New Zealand house prices and the broadening of the Auckland market strength to many other New Zealand regions in the last 12 months. The latest LVR restrictions appear to have helped ease housing market pressure, and will also make the household sector more resilient if there was a sharp decline in house prices.

The previously-signalled consultation paper on the possibility of debt-to-income (DTI) or similar restrictions becoming part of the macroprudential toolkit is expected to be released in the next 6 weeks. There will be a significant consultation period and opportunities for further informal discussion.

Banks have provided data on the debt-to-income (DTI) ratios of new borrowers in a new template presented to banks in industry workshops late last year. Engagement with the industry has provided us with some insight into the reporting capabilities of banks and the comparability of the data. We consider that robust DTI lending data is an important risk indicator and where banks have deficiencies in this area, they should be looking to strengthen their capability to enable more accurate risk measurement and monitoring. We intend to continue to work with banks over the remainder of 2017 to support improved DTI data quality.

Revised outsourcing policy for registered banks: The Reserve Bank concluded an 18 month review of its outsourcing policy for registered banks (BS11) in February. This review arose from a stocktake of how the current policy was being applied by banks and included two rounds of public consultation and numerous engagements with stakeholders. A final policy decisions document, a summary of submissions to the consultations and a regulatory impact statement (RIS) have been published on the Bank's website.

The objective of the outsourcing policy is to ensure that large banks have the legal and practical ability to control and execute outsourced functions. This is to ensure continuity of basic banking services such as liquidity, payment and transaction services, in the event that a service provider fails or becomes dysfunctional, or if a bank, or its overseas parent, fails. This is important to ensure that the impact of the failure of a bank, or a service provider to a bank, on the wider economy is minimised and to preserve options for the resolution of bank failures.

The key requirements of the revised policy are that:

- banks must engage with the Reserve Bank before entering into certain outsourcing arrangements with a related party;
- banks must have robust back-ups for functions outsourced to a related party;
- banks must have specific contractual arrangements included in all outsourcing arrangements;
- banks must maintain compendiums (records) of all outsourcing arrangements; and
- overseas-owned banks must prepare and maintain separation plans.

In March the Reserve Bank released an exposure draft on the revised outsourcing policy. For this consultation the Reserve Bank is seeking submissions on any instances where stakeholders believe the wording of the exposure draft is unclear, could be interpreted in more than one way, or differs in substance to what is set out in the final policy decisions document. The Reserve Bank will consider any concrete drafting suggestions made by submitters that are aimed at clarifying the wording of the policy. However, submitters should keep in mind that the substance of the revised policy has been finalised and that the Reserve Bank is not seeking feedback on the policy decisions that have been made. The consultation closes on 26 May.

Dual registration: In December 2016 the Reserve Bank published a dual registration policy for small (non-systemic) foreign banks, alongside a summary of submissions to an earlier consultation. Our new approach to the registration of small foreign banks relaxes previous policy settings for small, locally incorporated banks. Provided adequate mitigants are in place to limit potential risks to the local financial system, the Reserve Bank may allow a limited-activity branch to operate alongside an existing local subsidiary operation.

The policy provides a standardised assessment framework to support the Bank's decisions on whether to permit a bank's dual-registration, considering:

- the benefits from granting dual registration, for example efficiency gains from enhanced competition and product innovation or funding diversification;
- the risks of dual registration, chiefly stemming from insufficient self, market or regulatory discipline at banks domiciled in 'non-equivalent' jurisdictions;
- whether these risks might be sufficiently mitigated through a range of branch activity restrictions. These include a standard ban on branch retail deposit taking at all banks captured by the policy, plus additional restrictions on the relative size and permitted banking activities of branches from 'non-equivalent' jurisdictions. Where additional restrictions have been imposed on dual registered branches, these must be disclosed.

Assessments will be bank-specific. The dual registration policy augments the local incorporation policy rather than replaces it, and where specific risks cannot be mitigated to the extent necessary to assure us that local branch operations will be run in accordance with promoting a sound and efficient financial sector, the applicant will continue to be restricted to locally incorporated operations only.

Statement of policy-making approach: In April, the Reserve Bank published a statement of its approach to policy-making on its website. Providing such a document is considered best practice for regulators, and is in response to feedback from banks and other stakeholders who, during the 2015 Regulatory Stocktake, indicated they wanted to better understand how the Reserve Bank makes regulatory policy. The statement sets out the key features of the Reserve Bank's approach to regulatory policy-making. This includes conducting stakeholder consultations and applying regulatory impact analysis to all significant policy work. Consultation with stakeholders is an important part of the policy making process and the Reserve Bank aims to provide, where possible, a minimum consultation period of 6-10 weeks. Wider engagement with industry is also important for the Reserve Bank's policy making process as it is one of the ways regulatory policy issues are bought to the Bank's attention.

Publication of summary of submissions: Last year, the Reserve Bank consulted on whether it should publish the individual submissions to its public consultations, alongside its existing practice of publishing anonymised summaries of the submissions feedback with responses from the Bank. After considering submitters' feedback, the Bank decided to publish all individual submissions to public consultations on its website — except in cases where a submitter indicates they would like part or all of their submission withheld.

Submitters who would like part of their submission to remain confidential should provide both a confidential and public version of their submission, which aside from redactions in the public version are otherwise identical. The Reserve Bank believes these changes will support transparency in the policy-making process while still ensuring prudential and other commercially sensitive information is protected.

Bank balance sheet redevelopment project: On 5 April the Reserve Bank began publishing monthly statistics from the new balance sheet data collection for the banking sector. These series will provide greater insight into the structure and activities of the banking sector. The new banking statistics include breakdowns of financial instruments, including loans, securities, deposits and borrowings. They replace the existing statistical framework first introduced in the late 1980s, which was known as the *Standard Statistical Return*.

Users will be able to see aggregate mortgage lending broken down by payment type, such as interest-only, revolving credit and principal and interest. Residential investor mortgage lending will also now be separately identified. Comprehensive sector breakdowns have also been introduced in the collection and aligned with Statistics New Zealand's Statistical Classification for Institutional Sectors (SCIS). We have further expanded the business sector statistics to capture data on agriculture, commercial property and other business lending activity. For the first time, business loans fully secured by residential mortgage have been identified.

The Bank plans to expand the statistical series even further later this year and publish data that provides more detail about bank deposits, as well as lending to the business sector and commercial property sector. Some key statistics such as credit have been backdated to provide comparable historical data. Statistics for most new series are available from the December 2016 month onwards.

What we are planning

Preparatory work continues for the review of capital requirements for locally incorporated banks. The Reserve Bank is also undertaking work to better understand the implications of new reforms to the global Over-the-counter (OTC) derivatives market.

Capital Review: Deputy Governor Grant Spencer gave a speech to the New Zealand Bankers' Association on 7 March, providing more details about the review of capital requirements for New Zealand incorporated banks.

The aim of the review is to ensure that New Zealand has a capital regime that provides a high level of confidence in the solvency of the banking system, while avoiding unnecessary economic inefficiency. In pursuing this objective the review will consider what counts as capital for regulatory purposes, how credit risk and other risks should be measured for regulatory purposes, and the level of minimum capital ratios and buffers.

The review will be underpinned by six principles: capital must readily absorb bank losses before losses are imposed on creditors (including depositors); capital requirements should reflect the riskiness of bank exposures; where there are multiple methods for determining capital requirements, outcomes should not vary unduly between methods; reflecting New Zealand's particular circumstances, capital requirements should be relatively conservative; the capital framework should minimise unnecessary complexity and compliance costs and take into account the role of regulators overseas; and the capital framework should be transparent to promote market discipline.

The Reserve Bank observes that New Zealand banks' capital levels are about average in an international context, but that risks may be higher in New Zealand because: New Zealand is relatively reliant on banks to fund investment; the banking industry and the banks' exposures are relatively concentrated; and New Zealand is relatively exposed to global shocks.

OTC derivatives: New reforms to the global OTC derivatives market require certain participants to exchange margin on their non-centrally cleared derivatives portfolios to protect against current and potential future credit exposures. Although the Reserve Bank does not plan to mandate domestic margin requirements at this stage, the reforms have a wide cross-border reach: Australian-owned New Zealand banks will be directly captured by the Australian regulator's rules, for example, and may also be indirectly captured by the rules that apply to their international counterparts.

Margin requirements are still in the early stages of being introduced across the G20, and are subject to transitional arrangements and staggered phase-in schedules out to 2020 that reflect the size of the margining group. On a conservative estimate, the largest New Zealand banks may be captured by initial margin requirements from September 2017 onwards.

The Reserve Bank is engaging with industry and official stakeholders, both in New Zealand and internationally, to consider the impact of foreign margin reforms on the New Zealand financial sector. This includes a focus on promoting sector efficiency and soundness by ensuring New Zealand banks can continue to comply with the regulatory requirements and market practices of their international counterparts. Indications are that there could be a few limited but specific issues with aspects of New Zealand legislation. The Reserve Bank and Ministry of Business, Innovation and Employment are working with industry on these issues. Any legislative change would involve consultation with affected parties.