Banking industry update

September 2016

Welcome to the introductory edition of the RBNZ's *Banking Industry Update*. We intend to issue periodic updates to keep the banking industry informed on current and upcoming initiatives related to prudential policy and supervision as well as some financial stability issues.

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: banking.newsletter@rbnz.govt.nz

Ongoing activity

There are a number of consultations that are in various stages of development; our website provides a good source of information on our progress on these initiatives.

Consultations on (1) the outsourcing review for registered banks, (2) dual registration policy for small foreign banks and (3) the publication of submissions have recently closed and we are currently reviewing submissions.

A new consultation on the Dashboard approach for off-quarter disclosure is forthcoming.

Also, you might be interested in a recent speech by Head of Prudential Supervision, Toby Fiennes, about the Reserve Bank's supervisory approach. Other ongoing initiatives are covered in more details below:

- Financial Sector Assessment Program (FSAP) – IMF
- Bank balance sheet redevelopment project
- Macroprudential update
- Banking forum update

Financial Sector Assessment Program (FSAP): The International Monetary Fund (IMF) has commenced a comprehensive review of the New Zealand financial system.[1] This review is under the auspices of the Financial Sector Assessment Program (FSAP). The last New Zealand FSAP was conducted during 2003-04.

1 For a fuller discussion of the 2016 New Zealand FSAP see this *Bulletin* article published in April.

FSAPs cover three general areas: the resilience of the financial system to current risks and vulnerabilities; the quality of regulatory and supervisory frameworks; and the capacity to manage and resolve financial crises. This assessment will take place across two 'missions' in August and November with the findings and recommendations published by the IMF in early 2017.

The banking sector will be a significant focus for the IMF FSAP team, given the predominance of this sector within the New Zealand financial system. The FSAP team will assess New Zealand's regime against the Basel Committee on Banking Supervision's 29 core principles for effective banking supervision.

As part of their work, the FSAP team will review New Zealand's approach to managing and resolving stress across financial institutions and financial market infrastructures (FMIs). This part of the FSAP review will also focus on the banking sector and the Reserve Bank's Open Bank Resolution policy in particular. The FSAP team will examine New Zealand banks' role in the payments and settlement systems and the Reserve Bank's macro-prudential policy framework. The IMF will also undertake a stress-testing exercise directed at the larger banks.

In addition to discussions between New Zealand authorities and the FSAP team, the IMF will be meeting various private sector stakeholders over the course of both the August and November missions. This will include meetings with various New Zealand banks, audit firms and industry bodies.

Balance sheet redevelopment project: This project has been underway since early 2015 and is expected to be completed early in 2017. It involves a complete redevelopment of the monthly bank balance sheet data collection, known as the Standard Statistical Return (SSR). The redevelopment aims to address significant gaps in current statistical and prudential collections as well as establishing agreed clear and consistent definitions. We are currently engaged in a second round of 'trials' for the proposed data templates with feedback from the first trial having been very useful in helping us to refine the draft templates.

Macroprudential update: The Reserve Bank has discussed our concerns with the exposure of the banking industry to residential mortgage lending in the context of rapid increases in house prices across New Zealand. The new LVR policy response is a further tightening of LVR restrictions, which was under consultation during July and early August. The new LVR policy lowers the threshold for investor lending being high LVR to 60%, nationwide (from 80% outside Auckland and 70% within Auckland). We understand that industry have acted promptly to shift lending within the spirit of these restrictions in advance of their formal implementation and welcome this cooperation.

Recent Reserve Bank speeches and the Financial Stability Report have also noted that debt-to-income ratios for some residential mortgages appear to be relatively high based on preliminary data collected from the major banks. We have noted that we are discussing the possibility of adding a debt-to-income restriction to the toolkit for macroprudential policy, which is part of memorandum of understanding (MOU) between the Minister of Finance and the Reserve Bank. As with other macroprudential policies, this would not necessarily mean that the tool would be deployed or specify the exact form that the tool will take. The Reserve Bank is working with banks to formalise a debt to income data collection, which will improve our insights into whether a tool is required and where it would most appropriately be targeted. We will also be forming a working group to discuss the data and design issues around a debt-to-income based measure. As with the other instruments of macro-prudential policy included in the MOU, there would be a further round of formal consultation on the exact definition and scope of the tool if we ever proposed to deploy it.

Banking Forum: The Banking Forum is a sub-committee of the Council of Financial Regulators. Its membership consists of permanent members: the Reserve Bank, the Treasury, the Ministry of Business, Employment and Innovation, and the Financial Markets Authority; and associate members: the Inland Revenue Department, and the Ministry of Justice. The New Zealand Banking Association (NZBA) also regularly attends forum meetings, and their participation is valuable. The Banking Forum's main objectives are to:

- provide an overview of current and upcoming regulatory initiatives of the member agencies affecting registered banks including any new or proposed information gathering or compliance requests;
- identify areas where those regulatory initiatives or responsibilities may overlap and where there is scope for cross-agency cooperation; and
- identify and discuss matters relating to financial intermediation more broadly as they may affect the banking sector.[2]

The Q3 Banking Forum meeting was held on 28 July 2016.

2 A full Terms of Reference for the Banking Forum is available here: http://www.rbnz.govt.nz/-/media/ReserveBank/Files/regulation-and-supervision/banks/relationships/5845550.pdf

What we are planning

Looking ahead, we are planning reviews of capital and liquidity requirements for locally incorporated banks. We also plan to conduct a thematic review on the topic of problem loan identification, forbearance and provisioning practices in the dairy sector. A high level description of these planned reviews is provided below. Further details and timing of these reviews will be communicated when available.

Capital review: The Reserve Bank has initiated a review of the capital requirements applying to locally incorporated banks. In recent years other regulatory authorities have implemented changes to their capital settings, such as introducing buffers for systemically important institutions. The ongoing reforms to the international standards by the Basel Committee on Banking Supervision (BCBS) are reasonably wide-ranging and will be an important input to the Reserve Bank's review of the various components of the capital framework, as will the outcomes of the Financial System Inquiry in Australia. The objective of the review is to ensure that the Reserve Bank's requirements remain appropriate given the current domestic environment and the emerging international regulatory regimes.

While some aspects of the Basel framework are still under consideration by the Basel Committee, the Reserve Bank is taking the opportunity to review how the Basel II and III frameworks have operated over the past decade to inform decisions about whether and how to adopt the new standards. Included in the scope of the review is the extent to which banks should apply internally modelled approaches to credit and operational risks, for example whether modelled approaches should be limited to a narrower range of portfolios. The review will also consider the relationship between modelled and standardised approaches, and whether outputs of modelled approaches should be more closely aligned to standardised outcomes. The Reserve Bank review is in its early stages, and the timing of the significant changes that are expected to be made to the international standards will have a bearing on the progress of the Bank's review. The Reserve Bank will consult on any proposed changes to its framework arising from the capital review in due course.

Liquidity review: The Reserve Bank is initiating a review of its liquidity policy (BS13) that currently applies to all locally incorporated banks. The review follows the finalisation of international standards developed by the Basel Committee on Banking Supervision (BCBS) in the Basel III framework. The Bank was an early adopter of modern prudential liquidity requirements, and its existing framework, introduced in 2010, pre-dates the new international standards. The New Zealand requirements appear to be working well, but in light of international developments it is timely to review the existing policy.

The BS13 framework requires banks to comply with three quantitative metrics: the one-week mismatch ratio, the one-month mismatch ratio and the core funding ratio (CFR). Under the Basel framework, there are two quantitative measures. A Liquidity Coverage Ratio, which is conceptually similar to the one-month mismatch ratio, and a Net Stable Funding Ratio, which is conceptually similar to the CFR. Whilst the objectives and high level frameworks are therefore broadly aligned, there are some important differences in how the measures are calculated, such as the definition of liquid assets. The Bank will be reviewing its policy against the new Basel III requirements to consider whether it would be appropriate for New Zealand to harmonise with some or all of the new international requirements.

As part of the review, the Bank will also consider whether liquidity requirements should apply to banks that operate in New Zealand as branches, and the nature of liquidity disclosure requirements. The Bank will consult on any proposed changes to its framework arising from the review.

Thematic review: Thematic reviews form a significant part of the Reserve Bank's supervisory activity. The reviews assess current or emerging risks within the banking sector, or focus on an area where there has not been regular supervisory activity. The topic for this year's thematic review is: "Problem loan identification, forbearance and provisioning practices in the dairy sector".

Our objective is to better understand how banks are capturing and measuring dairy sector credit risk and how this translates into provisioning and forbearance practices. The review is limited to the industry's five largest dairy lenders and will require the banks to respond to a comprehensive questionnaire and provide supporting data.

For the Australian subsidiary banks, we intend to collaborate with the Australian Prudential Regulatory Authority (APRA) as part of this review and share relevant findings with them.

We hope to finalise the review before Christmas and, as in previous thematic reviews, we will provide specific feedback as appropriate.

We intend to undertake a thematic review of director attestation requirements in 2017.