Banking industry update

June 2018

The Reserve Bank's *Banking Industry Update* is issued periodically to keep banks informed of current and upcoming prudential policy and supervision initiatives and some financial stability issues.

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.

Reprioritisation of Work Programme

This edition of the *Update* incorporates the main messages for banks in the letter that went out to Chairs and CEOs of all banks and insurers early in June. The letter, from Geoff Bascand, Deputy Governor and Head of Financial Stability, set out our decisions on changing the priorities of our work programme across all sectors.

We are committed to playing our part in substantial system-wide initiatives such as Phase 2 of the Review of the Reserve Bank Act and the Conduct and Culture Review, which we are working on with the FMA.

With a number of other significant initiatives under way or on the to-do list, we have just taken a hard look at our work programme and what must be done and what needs to give. We have looked at all our policies under development and all other significant supervisory interactions, across all sectors. We also want to be clear about and commit to timeframes for delivery.

As well as the two initiatives mentioned above, the guiding principles are that we will continue to make progress on policy work that is:

- Of high importance to the regulatory regime, such as the capital review, the Financial Markets Infrastructure (FMI) Bill and implementation of the bank outsourcing policy;

- Well advanced, and where the benefits of completing it are well in excess of the remaining effort. Examples include the banking supervision handbook and the development of new collateral standards for residential mortgage bonds for the RBNZ ("RMOs"); and

- Important to industry. Examples include OTC derivative legislation, and taking account of materiality in reporting or disclosing breaches.

The need to prioritise has meant deferring work on some other initiatives. This includes the review of the bank liquidity policy. We are also deferring new approvals of internal models, pending completion of the capital review, given that it may well lead to changes in the internal models framework (remediation of compliance breaches will be continued). We will not undertake or expand the stress testing work with smaller banks this year. And we are deferring any policy work arising from last year's Attestation Review (e.g. reviewing requirements around directors and senior managers).

Our regular programme of supervisory work will generally continue although we will be somewhat more discriminating with some of the lower level meetings.

Current priorities list

Policy regime work

Activity	Next key milestone(s)
Review of RBNZ Act (including macro-prudential policy review)	See Terms of Reference released on 7 June. Expected to be a two year programme.
Bank Capital review (including benchmarking)	Quantitative Impact Study to be undertaken in Q3. Final consultation paper Q4.
Financial market infrastructure (FMI) Bill	Exposure draft to be published Q3.
Breach reporting, including consideration of materiality	Public consultation in September / October.
Residential Mortgage Obligations (RMOs)	Policy decisions to be made by end-2018.
Over-the-counter (OTC) derivative margins	Legislation to be introduced in 2018 subject to Cabinet approval.

Implementation, Supervision and Thematic work

Activity	Next key milestone(s)
Thematic review: assessment of banking and insurance industry conduct (in collaboration with FMA)	RBNZ and FMA to undertake more detailed work and report by end-October.

Bank outsourcing implementation	We are working with banks on the 5 year path to compliance.
Dashboard implementation	Dashboard went live on 29 May. Some minor enhancements to be explored. Full review after one year of operation.
Banking Supervision Handbook refresh	Send the bank working group exposure drafts of further completed parts in June.
Follow up on selected FSAP issues not covered in Phase 2	Over the next 12 months.

The rest of this Update provides more detail, where available, on the priorities listed in the above Tables.

Policy regime work

Review of the RBNZ Act ('Phase 2'): Last year the new Government announced a two-phased review of the Reserve Bank of New Zealand Act 1989 (the 'Act'). Phase 1 of the review focussed on monetary policy. Following advice provided by an Independent Expert Advisory Panel, the Government announced its decisions on Phase 1 on 26 March.

Phase 2 involves modernising aspects of the Reserve Bank's financial stability framework. This includes the review of macro-prudential policy that was already scheduled for 2018 (the 5 year anniversary of the introduction of the new framework).

The Reserve Bank and the Treasury have worked in consultation with the Independent Expert Advisory Panel to provide advice to the Minister of Finance on the scope for Phase 2. Following consideration by Cabinet, the Government announced a specific terms of reference for phase 2 on 7 June.

Phase 2 will be jointly led by the Reserve Bank and Treasury. The Reserve Bank's involvement in Phase 2 will be a significant impost in terms of resourcing, with a timeframe for completion that is uncertain but will be more than two years. As a consequence, the timing and progress of other on-going (or new) regulatory initiatives are likely to be affected by Phase 2.

Capital Review: In March 2017, the Reserve Bank announced that it was undertaking a review of the capital requirements applying to locally incorporated banks (the 'Capital Review'). The Reserve Bank has released three public consultation papers as part of the Capital Review. These papers addressed the scope of the capital review; what should qualify as regulatory capital (the 'numerator paper'); and the measurement and aggregation of risk (the 'denominator paper'). The Reserve Bank has released the public submissions to these consultations on the Reserve Bank's website.

In December 2017, the Reserve Bank responded to submissions on the numerator paper. The response included four in-principle decisions on what types of capital would be eligible to qualify as regulatory capital under a new regime:

- convertible, contingent debt instruments ('CoCos') will not qualify as regulatory capital;

- perpetual non-redeemable preference shares will be eligible to qualify as Additional Tier 1 (‘AT1’) capital;

- redeemable preference shares and long-term subordinated debt will be eligible to qualify as Tier 2 capital; and

- the Reserve Bank will further consider including an eligible Tier 1 capital instrument that banks structured as mutual societies would be able to issue.

In the denominator paper, the Reserve Bank outlined options to reform the way banks’ risks are measured and aggregated. These took account of recent changes to international standards for capital requirements made by the Basel Committee on Banking Supervision.

The main focus was around the framework for banks that are currently permitted to use their own models to measure risk. The options included:

- removing the option for these banks to use their own models for credit exposures to borrowers with recognised credit ratings, including sovereigns, banks and other entities;

- imposing limits on the risk estimates produced by banks’ internal models for other types of credit exposures;

- requiring risk weighted assets to be calculated and reported on a standardised basis, as well as on an own-model basis; and

- no longer allowing banks to use internal models to measure operational risk.

The Reserve Bank is currently working through the submissions on the denominator paper.

Financial Market Infrastructures Bill: Financial market infrastructures (FMIs) play a key role in the sound and efficient operation of the financial system, through the provision of clearing, settlement, trading and reporting services. However, the operation of FMIs can be subject to market failures such as negative externalities, information asymmetries, and co-ordination difficulties. Many FMIs are also systemically important, in that their disruption or failure could cause significant damage to the financial system (for example, by creating major solvency or liquidity risks for financial market participants). In light of this context, last year the previous Government decided to adopt a new legislative framework for the regulation of FMIs. This new framework arises out of a detailed review that was undertaken by the Reserve Bank during 2013-16 (including three rounds of public consultation).

The first part of the framework is an information-gathering power that applies to all FMIs. This power will support monitoring of the entire sector, and help ensure the prompt identification of systemic risks. The second part of the framework is a set of regulatory powers that will apply to all designated FMIs (i.e. FMIs that are identified as systemically important, or that opt in to designation in order to access the legal protections currently available to designated settlement systems under Part 5C of the Reserve Bank of New Zealand Act 1989). These include the ability to set regulatory standards, powers to oversee their rules, investigative and enforcement powers, and crisis management powers. The focus on designated FMIs is designed to ensure that regulatory interventions under the framework are proportionate to the risks raised by different FMIs, and to minimise compliance costs and barriers to entry for new FMIs. The framework was reviewed during the FSAP review of New Zealand in 2016, and is strongly supported by the IMF.

Legislation establishing the new framework is currently being drafted. Subject to Ministers' approval, we expect that an exposure draft of the legislation will be released for public consultation around the middle of 2018, and a Bill introduced into Parliament in the second half of the year.

Breach reporting, including consideration of materiality: This is a new piece of work that has arisen from the Regulatory Stocktake. Public consultation is expected in September/October.

Eligible mortgage bond collateral: When the Reserve Bank lends to banks and other counterparties it does so against 'eligible collateral'. Mortgage bonds, which combine financial claims from a portfolio of mortgages, are a key form of eligible collateral in many countries.

In November 2017 the Reserve Bank published a consultation paper proposing a new standard for mortgage bonds submitted as collateral. Mortgage bonds that meet the new standard would be known as Residential Mortgage Obligations (RMOs). The proposal's primary aim is to improve the credit quality, liquidity and scalability of mortgage bonds. A secondary objective is to facilitate the marketability of mortgage bonds.

14 submissions were provided to the Reserve Bank in response to the consultation paper.

Responses from potential investors have generally been supportive of the Reserve Bank proposal. Bank responses have been more mixed. While banks, as issuers, accepted in broad terms that current standards need improving, views varied on how best to achieve this. Some submitters suggested the reforms should be based on a more traditional bond structure while others sought an alignment of the current Internal Residential Mortgage Backed Securities framework (IRMBS) with the proposed higher standards, rather than the introduction of a new financial instrument.

The Reserve Bank would like to continue in its efforts to improve the collateral policy regime, operations and infrastructure. This includes some changes from the RMO proposal that was laid out in the November 2017 consultation paper. The Bank plans to meet with the group of stakeholders to discuss the potential changes as well as other operational improvements for eligible mortgage bond collateral.

Over-the-counter derivatives reforms: Reforms are being implemented across the G20 to improve transparency and mitigate risk in over-the-counter derivatives. These reforms require market participants to exchange margin on their bilateral business to protect against current and future counterparty credit exposures. Although the Reserve Bank does not plan to mandate derivatives margining at this stage, large New Zealand entities that trade in international markets must comply with the requirements due to their extra-territorial nature, or the expectations of their foreign counterparties (for whom margin exchange is becoming standard practice).

At present, some technical aspects of New Zealand law prevent New Zealand entities from complying with these requirements. These aspects include:

- moratoria on the enforcement of creditors' claims in statutory management or voluntary administration (which may prevent the non-defaulting counterparty having immediate access to the posted margin); and

- creditor rankings in default or insolvency that mean that another creditor may have a higher ranking claim over the margin (with the result that the full value of the margin may not be available to the non-defaulting counterparty).

The Reserve Bank and Ministry of Business, Innovation and Employment (MBIE) consulted on these issues in the middle of 2017, and Cabinet has recently agreed to a number of legislative changes designed to address these issues.

Implementation, Supervision and Thematic work

Outsourcing: The revised BS11 took effect on 1 October 2017. Large banks have until 1 October 2022 to be fully compliant with the revised BS11. The Reserve Bank has been working closely with large banks both bilaterally and multilaterally on their implementation plans. These implementation plans will set out the existing outsourcing arrangements a bank will need to bring into compliance before the end of the five year period and set out the work the bank will undertake in each of the five years to achieve this. These plans are expected to be iterative in nature and will include external reviews (undertaken annually during the five year transitional path) and will need to provide the Reserve Bank with assurance that banks are making sufficient progress towards compliance.

The Bank Financial Strength Dashboard: The Bank Financial Strength Dashboard ('Dashboard') is an innovative new tool that will put New Zealand in a leadership position globally on prudential disclosures. The Reserve Bank launched the Dashboard on 29 May with data starting from Q1 2018.

The Dashboard is a new online and interactive disclosure tool for prudential and financial information about New Zealand incorporated banks that is updated quarterly. The Dashboard tool utilises cloud-based technology and sits alongside disclosure statements as a source of meaningful information for interested users to better understand and compare a bank's business and its risks. The main point of difference with disclosure statements is that the Dashboard presents information in an easy-to-use and accessible format that will facilitate the comparison of banks, which is a key objective of disclosures.

The Dashboard concept was developed through formal consultation and refined with constructive feedback from industry. The decision to implement the Dashboard was confirmed in September 2017. Since then, two trials were run to ensure that the publication process works well. The Reserve Bank has also done extensive design and development work to deliver its new disclosure tool. The Dashboard showcases data that is drawn from private reporting that banks provide to the Reserve Bank. The reuse of private reporting improves the comparability of prudential disclosures and has the added benefit of minimising any additional compliance costs on banks. An important area of current and future work is promoting the Dashboard and educating users. A public education and awareness campaign is being run to support the Dashboard over the longer term.

Restructuring the *Banking Supervision Handbook*: The Reserve Bank remains committed to the major exercise that is required to restructure the *Handbook*, but progress has been slow until recently because of competing priorities. Considerable work has already gone into the first stage of the exercise, which is to reorganise and clarify the documents making up the capital adequacy framework. Draft documents covering more than half of the framework, along with covering material to explain the changes, have recently been sent to an informal working group of banks for user testing. These documents follow mainly the same approach taken with the first sample document sent out previously (on credit risk mitigation), as that approach was generally well-received. Public consultation will follow later in 2018, once the full draft set of new documents has been tested on the working group.

As noted previously, the Reserve Bank will ensure that the roll-out of the restructured capital documents (which will not change policy in any material way) is co-ordinated with any substantive policy changes arising from the capital review.

The Reserve Bank has also done some work in parallel on the next stage of the *Handbook* review, to break up the document BS1 *Statement of Principles* into shorter, separate documents each serving a clearly defined purpose. Many of the other *Handbook* documents have already been set up in the new clearer layout in draft, and will not need much further work before being rolled out.

Financial Sector Assessment Programme (FSAP): In May 2017 the International Monetary Fund (IMF) released the findings and recommendations from its 2016 review of New Zealand's financial system, known as the Financial Sector Assessment Programme (FSAP). There were over 100 recommendations, most of which had implications for the Reserve Bank given its broad range of financial system responsibilities.

As noted above, the Government announced the terms of reference for the Phase 2 Review on 7 June. Given that these terms of reference entail a broadly-scoped review, it is likely that a number of the IMF's recommendations will fall within the scope of Phase 2.

Other updates

Macroprudential Policy: Loan to Value (LVR) restrictions remain in place, but were eased from 1 January 2018 as announced last year. The review of macroprudential policy (including further consideration of the possible future role of serviceability restrictions) is now expected to be conducted as part of the broader Phase 2 Review of the Act discussed above.

FinTech developments: The Reserve Bank is maintaining a watching brief on FinTech developments. The November 2017 Financial Stability Review included a page summarising the Bank's current thinking on the implications of FinTech for its regulatory responsibilities. Other recent Reserve Bank publications on specific topics in the general area of FinTech include an Analytical Note on crypto-currencies, and a three-part series on central bank digital currency, namely What is digital currency?, Decrypting the role of distributed ledger technology in payments processes, and The pros and cons of issuing a central bank digital currency.

The Reserve Bank will also shortly be publishing a *Bulletin* article that summarises the findings of research carried out last year, and is intended to provide a broad survey of the FinTech landscape. It explains and gives examples of developments in a number of categories of FinTech, and considers their implications for the Reserve Bank's roles as prudential regulator, across banking, insurance and FMIs.

At this stage, the Reserve Bank assesses that recent FinTech developments have had only a limited impact on the financial sector, and new risks that have arisen as a result are minimal and contained. So far, the Reserve Bank's response has been to enhance its monitoring of emerging FinTech developments, and to have more regular discussions on the topic with industry, other relevant parts of Government, and overseas prudential regulators.