BPR160: Insurance, Securitisation, and Loan Transfers

Purpose of document

This document sets out the adjustments that a bank must make to the calculation of its capital ratios to reflect risks arising from its involvement with funds management, securitisation, and affiliated insurance business. It also sets out the conditions under which a bank may exclude from its capital ratio calculations a loan or loan commitment that it has transferred to an unrelated party.

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Banking Prudential Requirements

Document BPR160

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Conditions of registration

The Reserve Bank of New Zealand Act 1989 (the **Act**) permits the Reserve Bank to impose conditions of registration (**conditions**) on registered banks[1].

This document BPR160: Insurance, Securitisation, and Loan Transfers forms part of the requirements for the following conditions:*

- A New Zealand-incorporated registered bank is normally subject to a condition requiring it to maintain capital ratios above specified minimum levels, and also to a condition imposing restrictions on its dividend payments when its prudential capital buffer ratio falls below specified levels.[2] This document sets out adjustments that a bank must make to the calculation of its capital ratios and capital buffer ratio in the circumstances specified in the document. These adjustments are needed to allow the bank to calculate its day-to-day values for the ratios, and hence monitor its compliance with these capital adequacy conditions.

> ** All of the material set out in this document forms part of the requirements of the applicable condition, except material that is expressly identified as guidance by being included in a shaded box like this.*

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[1] The conditions can relate to any of the matters referred to in sections 73 – 73B, 78 and 81. The standard conditions are contained in Appendix 1 of document BS1: Statement of Principles.

[2] These conditions of registration relate to the matter referred to in: section 78(1)(c) (capital in relation to the size and nature of the business).

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Part A: Funds management and securitisation

A1 Introduction

A1.1 Bank involvement in funds management and securitisation

(1) This Part sets out the adjustments that a bank must make to its calculation of capital ratios, to reflect risks arising from its involvement with funds management or securitisation.

> *Guidance: Such adjustments may include deductions from capital (see **BPR110**), and consolidation of special purpose vehicles (**SPVs**) with the banking group for determining the scope of the group capital ratio calculations.*

(2) A bank may be involved in funds management and securitisation through activities such as–

(a) originating or supplying assets to a special purpose vehicle (**SPV**); or

(b) marketing funds management and securitisation products through its branch network; or

(c) acting as a servicing agent; or

(d) acting as a fund manager; or

(e) sponsoring or establishing such arrangements.

(3) A bank may be exposed to risks as a result of its association with funds management and securitisation activities.

(4) For the purposes of this Part, **association** means any relationship other than the provision of normal banking or commercial services on a fully arm's length basis.

Source: BS2A, paras 94 and 95: BS2B, paras 5.0 and 5.1.

A1.2 Risk types

(1) Some of the risks described in section A1.1 arise from implicit, or moral, obligations, rather than formal legal obligations.

> *Guidance: For example, a bank may feel an obligation to provide support to SPVs set up to conduct securitisation or funds management activities, because it considers that its own reputation and/or customer base will suffer if support is not provided. To the extent that a bank creates a degree of separation between itself and its funds management and securitisation activities, these implicit risks can be reduced.*

(2) However, a bank may face more explicit forms of risk where it provides credit enhancements to SPVs.

> *Guidance: Examples of credit enhancements include, but are not limited to, the following:*
> *(a) holding a subordinated class of securities issued by the SPV:*
> *(b) provision of financial services (for example, interest rate swaps) on other than arm's length terms and conditions:*
> *(c) provision of risk insurance:*
> *(d) provision of guarantees:*
> *(e) over-collateralisation:*
> *(f) repurchase or replacement of non-performing loans:*
> *(g) a one-off gift or a long-term loan, maturing after other securities issued by the SPV:*
> *(h) payment of expenses incurred by the fund:*

> *(i) management fee structures that vary with the level of non-performing assets held by a SPV or with the capital value of a managed fund such that there is potential for fees to fall to a level which would be below the level that the bank would expect to receive if fees were set at market levels on arm's length terms and conditions.*

(3) A bank may also face funding risk as a result of its involvement in securitisation schemes.

> *Guidance: This can occur if an associated SPV issues securities with maturities that are shorter than those of the underlying assets. In such cases there is a risk that the bank will be required to fund some, or all, of the underlying assets when the securities mature.*

Source: BS2A, paras 95 to 97: BS2B, paras 5.1 to 5.3.

A2 Requirements on banks

A2.1 Requirement to consolidate SPV with banking group

(1) In determining the banking group for the purpose of calculating group capital ratios, the bank must consolidate a funds management or securitisation SPV if–

(a) the banking group is required under New Zealand GAAP to consolidate the SPV for the purposes of its group financial statements; or

(b) the SPV is a covered bond SPV for a covered bond issued by the bank; or

(c) the bank, or a member of its banking group, has provided credit enhancement to the SPV either–

(i) in the form of a full or partial guarantee; or

(ii) in a form such that the maximum extent of the liability cannot be quantified; or

(d) the **minimum separation requirements** are not met; or

(e) the securities issued by a securitisation SPV have a shorter maturity profile than the assets against which they have been issued, and the bank's role in the securitisation means there is a risk that it will have to fund some of the assets when the securities mature.

(2) In subsection (1), **minimum separation requirements** mean the requirements set out in section A2.2.

Source: BS2A, paras 98, 100(c) to end, 102, and 105: BS2B, paras 5.4, 5.6(c) to end, 5.8, and 5.11.

A2.2 Minimum separation requirements

The minimum separation requirements referred to in section A2.1(2) are as follows:

(a) prospectuses and brochures for funds management and securitisation products must include clear, prominent, disclosures of the following:

(i) that the securities do not represent deposits or other liabilities of the bank; and

(ii) that the securities are subject to investment risk including possible loss of income and principal invested; and

(iii) that the bank does not guarantee (either partially or fully) the capital value or performance of the securities; and

> *Guidance: In relation to these conditions, the bank will need to take account of its legal obligations as an issuer under the Financial Markets Conduct Act 2013 and Financial Markets Conduct Regulations 2014*

(b) when securities are initially issued, investors must be required to sign an explicit acknowledgement that the securities do not constitute bank deposits or liabilities and that the bank does not stand behind the capital value and performance of the securities; and

(c) there must either be–

(i) an independent trustee; or

(ii) clear, prominent, disclosure, in all prospectuses, brochures, and application forms relating to the scheme, of whether or not there is a trustee, and, where applicable, that the trustee is not independent of the bank; and

(d) where the bank or its subsidiaries purchase assets from a SPV, the purchases must take place at fair value and on arm's length terms and conditions; and

(e) where the bank or its subsidiaries provide funding or liquidity support to an associated SPV, or purchase securities issued by an associated SPV, the following conditions must be met:

(i) the transactions involved must take place at fair value and on arm's length terms and conditions; and

(ii) the funding (including funding provided by purchase of securities issued by the SPV) must not exceed 5% of the value of securities issued by the SPV.

> *Guidance: While there is no requirement to hold capital against funds management and securitisation activities where the above minimum separation has been achieved, banks will need to take into account the fact that it is very difficult to totally eliminate implicit credit risk. Thus banks will need to ensure that their capital adequacy policies take account of any residual implicit risk, particularly where funds management and securitisation activities are significant in size relative to the bank's other activities.*

Source: BS2A, para 102: BS2B, para 5.8. Final guidance box is from BS2A, para 104: BS2B, para 5.10.

A2.3 Treatment of credit enhancement where no requirement to consolidate

(1) This section applies to a bank that–

(a) has provided a credit enhancement to a securitisation or funds management SPV; and

(b) is not required to consolidate the SPV under section A2.1.

(2) The bank must treat the credit ~~risk~~ enhancement as a 100% risk-weighted exposure of the bank if–

(a) the bank and parties related to the bank are not associated with the SPV; and

(b) the credit enhancement is provided on arm's length terms and conditions and at market prices.

(3) If either of the conditions in subsection (2) is not met, the bank must apply one of the following options to take account of its provision of the credit enhancement:

(a) it may deduct from CET1 capital the maximum level of its obligation to provide support; or

(b) it may expense the full amount of its obligation at the time its relationship with the SPV commences; or

(c) it may consolidate the assets of the SPV for the purposes of calculating its capital adequacy ratios.

Source: BS2A, paras 100 and 101; BS2B, paras 5.6 and 5.7.

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Part B: Affiliated insurance business

B1 Introduction

B1.1 Overview

This Part sets out the adjustments that a bank must make to its calculation of capital ratios, to reflect risks arising from its involvement with insurance affiliates.

Guidance: Such adjustments may include deductions from capital (as referred to in BPR110).

The role of distributing, or marketing, insurance products underwritten by affiliated insurance entities may involve an exposure to implicit risk, that is, to reputational risks and to moral recourse as a result of a close association with those affiliated entities.

Implicit risk can be reinforced if explicit support is provided to the insurance entity. To the extent that the banking group and any affiliated insurance entities create a degree of separation between each other, these risks can be reduced.

Source: BS2A, para 106: BS2B, para 6.0.

B1.2 Definitions

(1) For the purpose of calculating the bank's capital adequacy ratios, and for disclosure required by Orders in Council made under section 81 of the Act–

affiliated insurance entity means any **insurance entity**–

(a) that is not a member of the banking group; but

(b) that is one of the following:

(i) the ultimate holding company of the banking group; or

(ii) a subsidiary of the ultimate holding company of the banking group; or

(iii) an insurance entity in which the ultimate holding company of the banking group has an interest as an associate, or a direct or indirect interest as a party to a joint venture; and

(c) whose financial products are distributed or marketed by the banking group

affiliated insurance group means any **affiliated insurance entity** and all that entity's subsidiaries

(2) For the purposes of these definitions, **associate** is determined in accordance with GAAP.

Source: BS2A, para 107: BS2B, para 6.1.

B2 Treatment of credit enhancements

B2.1 Requirement to fully expense or deduct

Where the bank or a member of its banking group has provided a credit enhancement to any member of an affiliated insurance group, the bank or group member, as the case may be, must either–

(a) deduct the full amount of all such credit enhancements from CET1 capital; or

(b) expense the full amount of all such credit enhancements.

Guidance: Examples of credit enhancements include, but are not limited to, the following:
(a) holdings of, or investments in, equity instruments or subordinated classes of financial instruments;
(b) provision of currency, interest rate, or other derivatives for hedging purposes on other than arm's length terms and conditions (for this purpose, derivatives that are not traded in an active and liquid market, or whose data inputs are not taken from an active and liquid market, are regarded as credit enhancements);
(c) provision of funding and liquidity support on other than arm's length terms and conditions;
(d) guarantees and other risk assumption techniques which provide support for the asset risks of any member of the insurance group (for example, asset credit risks, equity risks, or property price risks), other than derivatives on arm's length terms and conditions;
(e) asset transfers from the banking group to any member of the affiliated insurance group at less than fair value;
(f) repurchase or replacement of non-performing assets;
(g) payment of expenses or liabilities.

Source: BS2A, para 108: BS2B, para 6.2.

B3 Treatment of funding exposures

B3.1 Requirement to fully deduct funding exposures

The bank must deduct from CET1 capital the whole amount of any funding exposures that the banking group has to an affiliated insurance group, if any of the following minimum requirements are not met:

(a) investment statements, prospectuses, and brochures for insurance products must include clear, prominent, disclosures that the bank and its subsidiaries do not guarantee the affiliated entity which is the issuer of the products, nor any of that entity's subsidiaries, nor any of the products issued by that affiliated insurance group; and

(b) where the insurance products were subject, at the time of issue, to the Financial Markets Conduct Act 2013, product disclosure statements, register entries, and advertisements, must clearly and prominently disclose that–

(i) the policies do not represent deposits or other liabilities of the bank or its subsidiaries; and

(ii) the policies are subject to investment risk, including possible loss of income and principal; and

(iii) the bank and its subsidiaries do not guarantee the capital value or performance of the policies; and

(c) where the insurance products were subject at the time of issue to the Securities Act 1978, the matters listed in paragraph (b)(i) to (iii) must have been clearly and prominently disclosed in the investment statements, prospectuses, and brochures; and

(d) at initial issue to an insurance product purchaser, the purchaser must have been required to sign an explicit acknowledgement that the bank and its subsidiaries do not guarantee–

(i) the affiliated entity which is the issuer of the products; or

(ii) any of that entity's subsidiaries; or

(iii) any of the products issued by that affiliated insurance group; and

(e) where an insurance product was subject at the time of issue to the Financial Markets Conduct Act 2013 or the Securities Act 1978, as the case may be, the investor must also have signed an explicit acknowledgement that–

(i) the policies do not represent deposits or other liabilities of the bank or its subsidiaries; and

(ii) the banking group does not stand behind the capital value or performance of the policies.

(f) asset purchases by the banking group from the affiliated insurance group must take place on arms-length terms and conditions, and at fair value; and

(g) funding and liquidity support provided by the banking group to the affiliated insurance group must not exceed 5% of the total consolidated assets of that insurance group, and must be provided on arm's length terms and conditions, and at fair value.

Guidance: This rule requires the bank to deduct from CET1 capital its total funding exposure to any affiliated insurance group where the above minimum separation requirements are not met. In particular, this applies if the bank's funding of an affiliated insurance group is more than 5% of that insurance group's assets. Part C below requires the bank to deduct from CET1 capital its total funding of all affiliated insurance groups and associated securitisation and funds management vehicles, if that total funding is more than 10% of the banking group's CET1 capital. The funding of an affiliated insurance group is not required to be deducted twice if both conditions are met.

Source: BS2A, para 109: BS2B, para 6.3. The guidance material is from BS2A, para 103: BS2B, paras 5.9 and 6.3.

B3.2 Funding and liquidity support

For the purposes of section B3.1, funding and liquidity support provided by the banking group to any member of the affiliated insurance group comprises the following items:

(a) its share of policyholder liabilities; and

(b) any claims which represent senior credit exposures, other than credit exposures arising from derivatives; and

(c) the undrawn portion of any commitments to provide funding or purchase assets; and

(d) the full amount of direct credit substitutes.

Guidance: This definition of funding includes loans, overdrafts, revolving credit lines, money market placements, investments in senior ranking securities, forward asset purchases, guarantees of borrowings, and similar items. It does not include investments in equity instruments or other classes of subordinated financial instruments, as these are required to be deducted from CET1 capital (see BPR110 and section B2.1). It also does not include credit exposures arising from the provision of derivatives used for hedging price movements, such as interest rate swaps, or currency risk hedging instruments (other than historical rate rollovers, which are effectively a form of lending).

Where there are a number of insurance entities within a group of insurance companies, the definition of affiliated insurance group captures each subgroup owned by one of those affiliated entities. This means that the 5% funding threshold applies to each operating life insurance or general insurance entity (and its subsidiaries) within the group. Therefore, if one operating insurance entity is controlled by another, and the banking group has a marketing role in relation to each of those operating entity's products, the funding requirements apply on a tiered sub-group/group basis. The 5% threshold does not apply to the holding companies or other related parties of these affiliated insurance groups.

*The applicable **connected person** exposure limits specified in the bank's conditions of registration apply to all credit exposures (including funding exposures) to affiliated insurance groups, as well as to any holding companies, parents, or other related parties of those groups. (See Reserve Bank document BS8: Connected Exposures Policy.)*

Even where the above requirements are met, banks will need to take into account the fact that it is very difficult to totally eliminate the implicit risks that might arise from the marketing of an affiliated insurance group's products. Accordingly, banks should ensure that their capital adequacy policies take account of any residual implicit risk, particularly where the volume of insurance products distributed is significant in relation to the banking group's other activities.

Source: BS2A, para 110 to 114: BS2B, para 6.4 to 6.8

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Part C: Treatment of total funding across Parts A and B

C1 Funding of unconsolidated entities

C1.1 Deduction from CET1 capital

(1) This section applies if the aggregate funding provided by the banking group to the following entities exceeds 10% of CET1 capital:

(a) affiliated insurance groups (*see* section B1.2); and

(b) all associated funds management and securitisation vehicles that are not consolidated with the banking group under sections A2.1 or A2.2.

(2) Where the funding exceeds the 10% limit specified in subsection (1), the bank must deduct the full amount of the aggregate funding from CET1 capital.

Source: BS2A, para 103 and 109(g): BS2B, para 5.9 and 6.3(g).

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Part D: Loan transfers

D1 "Clean transfers"

D1.1 Overview

This Part sets out the conditions under which a bank achieves a "clean transfer" of a loan or commitment to lend, which it may then exclude from its capital ratio requirements.

> *Guidance: These conditions are intended to ensure that, as a result of the loan transfer, the bank (or another member of the banking group)–*
> *(a) is under no obligation to repurchase the transferred loan; and*
> *(b) would incur no loss (of interest or principal) in the event of non-performance by the borrower; and*
> *(c) would not feel impelled to support the loan in any circumstances.*

Source: BS2A, para 115(2). No equivalent in BS2B.

D1.2 Exclusion of loans from RWA calculations

The bank may exclude from the calculation of RWAs any loan, or commitment to lend, originated by the bank or another member of the banking group, if–

(a) the loan or loan commitment has been transferred from the originating entity to the bank's ultimate parent bank or to another party that is not a related party; and

(b) the transfer is achieved using one of the methods described in section D1.3; and

(c) the terms of the transfer meet the conditions for a clean transfer, as set out in section D1.4.

Source: BS2A, para 115(1). No equivalent in BS2B.

D1.3 Qualifying transfers

(1) For a loan, the eligible methods of transfer referred to in section D1.2(b) are the following:

(a) transfer through novation; or

(b) transfer by notified assignment; or

(c) transfer through silent assignment; or

(d) loan sub-participation.

(2) For an undrawn commitment to lend, only the following methods of transfer are eligible for a clean transfer:

(a) transfer through novation; or

(b) transfer by assignment, if accompanied by a formal acknowledgement from the borrower.

Source: BS2A, paras 116(1) and 117. No equivalent in BS2B.

D1.4 Conditions applying to qualifying transfers

To achieve a clean transfer, the following requirements must be met:

(a) the transfer must not contravene the terms and conditions of the underlying loan agreement, and all necessary consents have been obtained; and

(b) the seller must have no residual beneficial interest in the principal amount of the loan (or that part which has been transferred) and the buyer must have no formal recourse to the seller for losses; and

(c) the seller must have no obligation to repurchase the loan, or any part of it at any time; and

(d) the seller must have given notice to the buyer that it is under no obligation to repurchase the loan or support any losses suffered by the buyer, and that the buyer has provided written acknowledgement of the absence of obligation on the part of the seller; and

(e) the documented terms of the transfer must be such that if the loan is rescheduled or renegotiated the buyer and not the seller would be subject to the rescheduled or renegotiated terms; and

(f) if payments are routed through the seller, the seller must be under no obligation to remit funds to the buyer unless and until they are received from the borrower; and

(g) if the buyer is subject to a trust arrangement, the trustees of that trust must be independent of the seller, or companies related to the seller, both during and subsequent to the sale negotiations.

Source: BS2A, para 116(2). No equivalent in BS2B.

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