

# Changes to the Banking Supervision Handbook

*Commentary on new document BPR001: Glossary*

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## Purpose of the document

1. This document provides explanatory commentary on the proposed new common glossary, 'BPR001: Glossary', a draft of which is being published with this consultation. The Glossary is intended to apply to all of the Reserve Bank's prudential requirements and guidance for registered banks. This document discusses the general approach to creating the Glossary and how it is intended to be used. It gives explanations, where needed, of the choices of definitions for some terms, and also explains why some existing defined terms have been revised.

## General approach and principles

2. The main Consultation Paper 'Changes to the Banking Supervision Handbook: Exposure Draft for Capital Review Changes' summarises the main reasons we have developed the single Glossary, and the problems it is intended to address. The consultation paper also presents options for how defined Glossary terms in the new BPR documents could be marked to show that they are included in the Glossary.
3. The first exposure draft of the Glossary is limited to providing defined terms that will be needed for the first set of the Banking Prudential Requirement (BPR) documents, namely those setting out the capital adequacy framework (BPR100-BPR160). The coverage will be expanded as further BPR documents are issued to replace the current Banking Supervision Handbook. We also welcome any feedback about additional terms in the first set of BPR documents that could usefully be given a Glossary definition.
4. The following three broad classes of defined terms may help to illustrate the choices made in creating the Glossary:
  - The Glossary includes explanations of widely-recognised terms, such as "forward rate agreement", "commodity", or "total return swap". These have been moved to the Glossary rather than only applying only in specific subparts of BS2A and BS2B, so that there is an unambiguous definition that can apply generally.
  - It also includes definitions of terms that can be pinned down by reference to established external definitions such as those in New Zealand legislation, or GAAP (NZ IFRSs). Generally, where there is a choice between primary legislation and NZ IFRSs, we have opted for the definition in primary legislation, to give greater certainty of definition, unless there are overriding reasons to go for the NZ IFRS definition.
  - The Glossary also includes definitions of some "terms of art" that are specific to parts of the capital adequacy framework, such as "income-producing real estate (IPRE)", or "total capital ratio". In some cases these definitions are long and complex, and it is not feasible to give the full definition in the Glossary. With terms like these it seems best to give the detail of the definition in the relevant document (BPR133 and BPR100 in these two cases), and include the term in the Glossary for ease of reference, with a cross-reference to the detailed definition.
5. As with all the other BPR exposure drafts, each defined term in the draft Glossary includes information on the source of the definition, and notes if the wording has been revised compared to the source, or else marks the definition as new text.
6. The Consultation Paper explains the linkage between the Glossary and the terms defined in the interpretation sections of the two disclosure Orders in Council (OiCs). Redlined copies of the OiCs are included as part of this consultation package, and show a few proposed minor changes to the defined terms in each of them, arising out the development of the Glossary.

7. The rest of this document discusses the terms in the Glossary where changes to existing Handbook definitions are proposed, or where explanations are needed of new definitions provided. Groups of related definitions where common issues arise are covered under separate headings, followed by a final section discussing miscellaneous individual definitions.

## Groups of related definitions where common issues arise

### Derivatives

8. The general definitions around derivatives and specific types of derivative have been revised. These are given mainly within the treatment of counterparty credit risk in BS2A (section 55) and BS2B (section 4.83), and are used in that treatment and in several other parts of the capital adequacy framework.
9. For the definition of “derivative” itself, we have opted for the statutory version in the Financial Markets Conduct Act 2013. We have also cut the word “contract” from a lot of the terms, not least because they could potentially refer to contracts other than derivatives: hence “equity contract” has become “equity derivative”, and “derivative contract” has become just “derivative”.
10. We have also replaced “exchange rate contract” with “currency derivative” on the basis that that is more common usage, and this aligns with trying to refer consistently to “currency risk” throughout the framework, rather than the interchangeable uses of “currency risk”, “exchange rate risk” and “foreign exchange risk”. This definition retains the exclusions which are in the source definitions in BS2A and BS2B, as we have not wanted to change those without further consultation.
11. The other aspect of these definitions that has changed is the hierarchy of categories. So rather than defining “precious metal” to exclude gold, the definition now follows normal English language conventions, and instead the separate risk-weighting treatments apply to (1) gold derivatives, (2) precious metal derivatives other than gold derivatives. Similarly, “other commodity contract” is no longer a defined term, but the risk-weighting treatment is divided into (1) precious metal derivatives and (2) commodity derivatives except for precious metal derivatives.

### SFTs and components

12. In line with the tidying up of the various inconsistent references in BS2A and BS2B to repos and reverse repos, stock lending and borrowing transactions, and “repo-style transactions”, we have now defined separately the individual types of transaction that fall within the common treatment. These are defined as “repurchase transaction”, “reverse repurchase transaction”, “securities borrowing transaction” and “securities lending transaction”. The term “repo-style transaction” has been replaced by “securities financing transaction (SFT)”, which is defined clearly to cover all four separate transaction types. This matches the APRA and Basel usage, although the Basel definition also includes margin lending and borrowing, which we have excluded, in line with APRA, as it is a retail form of business and should not therefore fall under the SFT treatments.

### Insurance entity definitions

13. A number of insurance-related terms are used throughout BS2A and BS2B, and also in the disclosure OiCs. These terms relate to two main prudential requirements, namely (1) the capital implications of links to affiliated insurance groups or entities (which is now covered in BPR160), along with the related disclosure; and (2) the standard condition of registration limiting the amount of insurance business carried out within a banking group, which is not part of the capital adequacy regime, but does rely on some terms in common.

14. We have tried to rationalise the current approach by covering all the necessary defined terms in the Glossary. The terms “contract of insurance”, “insurer” and “insurance business” are those from the Insurance (Prudential Supervision) Act 2010, to ensure consistent treatment: these are the definitions currently used in the standard conditions of registration. We propose to delete the definition of “insurance business” from the OiCs, since it simply cross-refers to a bank’s conditions of registration, which the OiCs rely on as a matter of course. We have still kept the separate definition of an “insurance entity”, because it is an entity whose business predominantly consists of insurance business, whereas “insurer” can refer to an entity that writes one contract of insurance. This is needed for the BPR160 treatments.
15. The terms “affiliated insurance entity” and “affiliated insurance group” are used only for the BPR160 capital treatments, and are very specific to that purpose: they include, for instance, that the insurance group’s products are marketed by the banking group. The word “affiliate” is not generally used either in NZ IFRSs or New Zealand legislation, but we have kept it within these definitions as it serves to distinguish this very specific sense. The terms also still need to be defined in the OiCs, since there is required disclosure around a banking group’s affiliated insurance business.

### IRB and related terms

16. For ease of referring to banks that have been accredited to use the internal ratings based (IRB) approach to credit risk, the term “IRB approach” is included in the Glossary, by reference to the existing definition in the local OiC (which needs to be revised to refer to BPR133 rather than BS2B). The term “IRB bank” is then defined by reference to the “IRB approach” (“IRB bank” is currently defined in a similar way in the LVR policy, BS19.) This is based on the assumption that the Advanced Measurement Approach (AMA) to modelling operational risk will not be in place much longer, so that we do not need to distinguish between an “IRB bank”, “modelling bank” and “AMA bank”.
17. The definitions of Exposure At Default (EAD), Loss Given Default (LGD), Probability of Default (PD) and effective maturity (M) have been revised to refer to the specific value of any of those IRB model inputs in relation to a specific credit exposure, rather than to the general concept of EAD, LGD, PD or M: it is the actual estimated values that are relevant for the purpose of disclosure.

### Group definition

18. For the definition of “banking group”, we have kept the current two-stage approach, under which: a bank’s “financial reporting group” is defined by reference back to statutory definitions in the Financial Markets Conduct Act 2013 (FMC Act); and a bank’s “banking group” is the same as its financial reporting group unless the Reserve Bank has given the bank notice that specified entities should be included or excluded.
19. However, a current problem is that for overseas-incorporated banks, the definition of financial reporting group given in their standard conditions of registration is slightly different from that given in the disclosure OiC for branches of overseas banks. We propose to amend the version in the branch OiC to align with that in the standard branch conditions of registration: the latter version seems preferable, as it refers specifically to the concept of New Zealand group financial statements for a branch in section 461B(2) of the FMC Act.

### Various corporate relationship terms

20. The definition of subsidiary given in different parts of BS2A, BS2B and in both OiCs is the version in the FMC Act, which includes the definition in the Companies Act 1993 but is expanded to also include “any entity that is classified as a subsidiary in any applicable financial reporting standard”. We have kept this

same definition in the Glossary, although by reference to the same definition in the Financial Reporting Act 2013, which provides the more fundamental source for the definition.

21. The term “holding company” is not defined in BS2A or BS2B and is hardly used: the term “parent” is used in a few places. “Holding company” is defined in the OiCs by reference to the definition in the Companies Act 1993. That definition is: “a company is another company’s holding company, if, but only if, that other company is its subsidiary”. That creates a problem, because that relies on the Companies Act definition of subsidiary, which we are not using. We have therefore adapted that definition of holding company to refer to the definition of subsidiary that we use. This ensures that the Glossary definitions of subsidiary and holding company are internally consistent. We have generally replaced the uses of “parent” in BS2A and BS2B with “holding company” in the new BPR documents.
22. The concept of “sister company” seems commonly understood, but does not appear to be defined anywhere in New Zealand statute or GAAP: we have therefore drafted a new definition for consultation.
23. The current definition of “ultimate holding company” in both OiCs is not an accurate description of the term, since it excludes a bank. We propose to replace this term in the OiCs with “ultimate non-bank holding company”, defined in the same way, but we have not added this new term to the draft Glossary, as it is only needed for two specific disclosure items which are not in any of the BPR documents. The term “ultimate holding company” is defined in the Glossary using the standard Companies Act definition, but the definition is spelled out, since it depend on the Glossary definitions of holding company and subsidiary, which vary from the Companies Act definition as noted above.
24. We have not included definitions for “parent” or “parent entity” in the Glossary, as we aim to consistently use “holding company” instead, being the usual term in statute as opposed to financial reporting standards.

## Other individual terms where issues arise

25. Under this heading are a number of other proposed Glossary terms giving rise to a range of issues, but without any particular linking theme. They are discussed in alphabetical order.
26. We have included a definition of “control or significant influence” in the Glossary, although it is narrowly qualified narrowly as being “for the purpose of defining eligible capital”. The thresholds for when influence counts as “significant” carry forward those currently in the BS2A and BS2B capital definitions, which align with the intentions of the Basel capital definitions. We see no reason to change those thresholds as part of this restructure. However, we have not attempted to give a separate, more broadly applicable definition of “significant influence” at this point, and we note the definition in the Reserve Bank of New Zealand Act 1989 (the Act) has different thresholds from those in the current combined Glossary definition.
27. In the definition of “direct credit substitute” (from BS2A and BS2B), the list of examples that the definition includes has been turned into guidance, because we do not see it as a comprehensive list.
28. The Glossary includes a definition of equity referring to the definition in the OiCs, but we propose to revise that definition (and hence the Glossary definition) to refer to the new 2018 version of the New Zealand equivalent of the IASB conceptual framework.
29. We have included a general definition of “financial institution” by reliance on the definition in the Act. We note that the definition of financial institution for the purpose of the liquidity policy (BS13) is narrower than the definition in the Act, but we will address that issue as part of the process of converting BS13 into a new BPR-style document.

30. The definition of “forward rate agreement” is currently given in the BS2A and BS2B market risk treatments. We have moved this into the Glossary, as with a number of other contract types. However, the existing definition does not seem to be an accurate description of how such an agreement works, so we have revised it.
31. The definition of operational risk is the same in BS2A and BS2B for the purpose of the operational risk capital treatments. There are also operational risk disclosure requirements in the OiCs (relating to both the regulatory capital requirements and the management of operational risk), although the term is not defined there. For these reasons, we think it is worth making the Glossary the principal source of the definition, which will be applicable for BPR150, BPR151 and the OiCs.
32. The term “other material risks” is currently spelt out as a detailed definition in the standard condition of registration for locally-incorporated banks imposing the guidelines under BS12 (Internal Capital Adequacy Assessment Process – ICAAP). We have rationalised this approach by including the definition within the new Part D of BPR110: the definition can be made much shorter by using the new defined term “total RWA equivalents”, and is also given in the singular, “other material risk”. With this approach, both the Glossary and the standard condition of registration can now define the term by cross-reference to Section D1.1 of BPR100.
33. The proposed Glossary definition of “past due” is taken from the current OiCs, except that the reference to NZ IFRS 7 needs to be corrected to refer to NZ IFRS 9. The definition of “90 day past due asset” in BS2A is broadly in line with the OiC definition of past due, but is worded slightly differently. We have dealt with that inconsistency by removing that definition from BS2A, so that the single OiC definition, relied on by the Glossary, will be the common definition across the capital adequacy framework.
34. “Qualifying interest” has been added as a new defined term (by reference to the definition in the Act), since the definition of “control or significant influence” in BPR110 depends on it.
35. The term “third party” is defined in BS2A and BS2B only for the purpose of defining capital, although it is used elsewhere in those documents. The current BS2A and BS2B definition differs from that given in the Outsourcing Policy (BS11), because the BS11 concept is only in relation to the registered bank itself, whereas for capital purposes, the concept refers to being separate from the bank or any member of its banking group. For this draft of the Glossary, we have kept the BS2A/B definition, and qualified it “for the purpose of calculating a registered bank’s capital ratios”. This widens its applicability from just being for the definition of capital, to the whole of the capital ratio calculations, i.e. documents BPR100 to BPR160. We intend to address the consistency with the BS11 definition when we re-present BS11 as a BPR-style document.